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From Glass Box To Smoke-Filled Room: How Rumaila Contract Was Renegotiated

By Greg Muttitt

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For watchers of Iraqi oil the events that followed the first oil field auction on 30 June 2009 have been a mystery. The story of what really happened goes to the heart of the Iraqi oil industry, and will shape Iraq's relations with OPEC as well as the depletion rates of its fields. And it reveals why the Ministry of Oil has so far proved unable to renegotiate the ambitious production targets set out in the contracts, despite announcing earlier this year that it wished to.

A Series Of Unfortunate Events

To recap, after companies placed their bids in the al-Rasheed hotel in June 2009, the Ministry of Oil sprung a surprise by announcing the maximum remuneration fee it was prepared to pay. Only one bidder accepted: BP and its partner CNPC decided to take the offer on the Rumaila field, slashing their bid from $3.99/B to $2/B. So far, so unusual. But it was what happened next that raised the biggest questions.

BP/CNPC had been expected to sign fairly quickly: after all, the model contract was written and all they had to do was insert the two figures they bid – their production target and per-barrel remuneration fee. But discussions between the companies and the oil ministry dragged on through the summer, and the deal was not signed until November. What were they doing all that time?

Meanwhile in October, consortia led by ExxonMobil and Eni announced that they would accept the ministry's maximum price on the West Qurna-1 and Zubair fields. They had walked away in June when the ministry offered $1.90/B and $2/B respectively, compared to their bids of $4/B and $4.80/B. What changed the companies' minds?

A Clarification Or An Obfuscation?

The Ministry of Oil insisted the terms of the contracts were unchanged – the discussions with BP and the change of heart by Eni and ExxonMobil were down to some "clarifications", primarily that income tax would not be charged on cost recovery, only on remuneration. This seemed to make little sense: no-one would expect the reimbursement of costs would be taxed, as that would completely distort the projects' economics. And in any case if it were just clarifications that were required, surely the companies would have taken the deal at auction and negotiated the precise legal wording of the offending article afterwards.

Furthermore, the companies gave quite a different account, which did not fit the "clarification" narrative. For example, the chief financial officer of Eni told financial analysts that, "we accepted $2/B because, basically, the fiscal terms are different now." [2] He added that the new terms with a remuneration fee of $2/B were equivalent to the pre-bid terms at a fee of $4.50/B. How the terms changed was not explained.

Now these questions can at last be answered. I have obtained a version of the Rumaila contract dated 8 October 2009 – the day the contract was agreed and initially signed before being submitted to the Cabinet for approval. Close comparison of this version with the original model contract,[3] on which companies bid in the June auction, reveals small technical changes of wording which nonetheless have profound implications.

It seems reasonable to assume that these changes were also made on the West Qurna-1 and Zubair contracts, and were what persuaded ExxonMobil and Eni to accept the lower remuneration fees. Let us have a look at these changes.

Iraq And OPEC

Perhaps the most important change is in Article 12.5, which determines what happens in the event of government-imposed curtailment of production. This might occur to comply with a future OPEC quota, or to otherwise manage the Iraqi economy and natural resources. The issue is especially pertinent, as the total Iraqi production according to the contracts awarded in the two auctions of 2009 is projected to be over 12mn b/d by 2017, up from around 2.5mn b/d today. If this were achieved, it would crash the oil price, and Iraqis would get less income, for more depletion of their natural resources, than at lower levels of production.

In the original model contract, the cost of such curtailments was shared between both sides, by delaying revenues for them both. Companies would be compensated by producing the curtailed amount of oil later on. [4]

In the renegotiated contract another option is added: payment of lost revenues. In this approach, which is considerably more attractive to the companies, BP/CNPC would be paid whether or not they produced oil. If the government required lower rates of production, perhaps to meet an OPEC quota, it would have to pay BP/CNPC for the oil they did not produce, as well as the oil they did.

By definition, this payment could not come out of oil revenues – instead it would come out of other budgets. And this fact would create a strong incentive for the government not to impose any restrictions, for fear that it could not afford the compensation. The result could be overproduction, a dramatic weakening of OPEC and a return to a period of sustained low price. It could become companies like BP, rather than the government, that determined rates of production and depletion. So the addition to the contract of those four words "payment of lost revenues" could have an enormous impact on the future Iraqi economy.

It will be recalled that back in 2002-03, certain neoconservatives fantasized about pulling Iraq out of OPEC. Soon after the invasion it became clear that the neocons had over-reached and that such ideas had little mileage. Even the more pragmatic policy of the British government – that "it would be preferable that Iraq remained within OPEC, but that its future production levels are such that they put pressure on OPEC in terms of the price levels it is able to target" [5] (as revealed in my book) looked ambitious. But now perhaps some of those ideas seem less far-fetched.

A Very British Coup

Four other small technical changes to the contract wording also radically shift the balance of power, and of economic benefits and costs, between BP/CNPC and the Iraqi side.

Also in Article 12.5, an extra item was added to the list of circumstances in which the companies would be compensated: failure of transporter to receive produced oil or associated gas. It refers to the major risk that Iraqi pipeline and export infrastructure would not be expanded sufficiently to cope with the increased production. The original model contract provided a mechanism for the companies to help expand the infrastructure themselves, charging their expenditures as 'supplementary costs'. But following BP/CNPC's renegotiation this risk was shifted entirely to the Iraqi side, with the companies now entitled to be paid any revenues lost as a result of infrastructure bottlenecks. Just as with OPEC quotas, the companies would be paid whether or not they produced oil.

Next, in Article 9.20, Iraqi powers of oversight were weakened. As is normal in oil projects around the world, the contracts required Iraqi approval of major project expenditures. This is important to combat corruption, to prevent cost inflation depriving the government of revenues and to ensure development occurs in a way that meets the national interest. Whereas the model contract had required regional oil company approval of any expenditures above $50mn, the renegotiation upped this threshold to $100mn and set a time limit of 45 days for the Iraqi company (in the Rumaila case, South Oil Company) to make any formal objection – if it did not, its approval would automatically be assumed. Given the devastating loss of Iraqi human resources since 2003, there was a significant chance commissioning expert advice could take time – raising the danger that expenditures could pass through not properly examined.

Article 31.4 determines the *force majeure* provisions: what happens if an unforeseen event such as natural disaster or war affects production. The model contract had these risks shared by the two sides in the form of delayed revenues – not unreasonably, since such events could be seen as neither's fault. If *force majeure* stopped production, the contract would be extended accordingly. The renegotiated contract shifted these risks entirely onto the Iraqi side: so BP/CNPC would be fully compensated from Iraqi public budgets for any loss.

Finally, Article 22.4 was changed so as to specifically immunize BP/CNPC from any liability for reservoir damage caused by non-optimal production practices. This was significant because the companies were incentivized to maximize production only over the 20-year lifetime of the contract – it was only the Iraqis that would be concerned about geological damage constraining production after the fields reverted to public ownership.

Fixing The Problems?

Whatever their view of the bid rounds, Iraqi oil experts were almost unanimous in criticizing the production levels the contracts set – both for their impact on the oil price and for being unrealistic given the state of Iraqi infrastructure. During the course of 2011, the Ministry of Oil finally seemed to accept this view.

The minister thus announced in early May that he intended to renegotiate the contracts so as to lower the production targets to more feasible levels. But the companies commented that they would expect to be compensated for any change, and shortly afterwards the ministry stepped back from the proposal. This sequence of events may have looked odd at first – as it would appear to be in both sides' interest to contract an achievable level of production. The contract changes revealed here perhaps explain the deadlock.

As a result of BP/CNPC's renegotiations in 2009, the Iraqi government is obliged to pay the companies at the rate they bid, even if OPEC/oil market considerations or infrastructure constraints prevent them actually delivering those levels of production. So from the companies' perspective it does not matter whether their target rates are achievable or not – they get paid anyway. Hence they would be unlikely to accept being paid according to a lower target rate. In other words, while the oil ministry erred in accepting such high production targets, the contract renegotiation prevents the ministry from correcting its error.

There is a way out of this conundrum however, as the government does have one card up its sleeve in relation to the companies – the issue of legality of the contracts. As has been pointed out by many observers, Iraqi law still in force (in particular Laws 97 and 123 of 1967) requires an act of parliament to specifically ratify any contract in order to make it valid. [6] This has not happened in relation to any of the contracts awarded in the first three bid rounds. So while the companies might point to their contracts and argue the government has no right to change the production targets without compensation, the government could point to the law and argue the contracts do not give the companies any rights at all until ratified by parliament.

Clearly it would be politically uncomfortable for the government to follow this course, given that it has consistently argued that parliamentary ratification of contracts is not required. But Iraqis might ask whether it is reasonable to sacrifice future control of the country's natural resources for such political considerations.

Some Lessons

With renewed talk of an oil law, these revelations highlight the importance of not simply retrospectively legalizing the existing contracts in their current form. Analysts have estimated rates of return of over 20% on the largest fields. Given that the renegotiations removed the largest inherent risks in the projects, that return begins to look unacceptably high. If the final risk – the non-legality of the contracts – were to be removed by a retrospective oil law, there is a strong argument for parliament to use its power to review and amend those contracts.

More fundamentally, the story demonstrates the crucial importance of transparency. The bid rounds started out well, with a clear and transparent process, where bids were posted into a glass box in front of the TV cameras. But the fact that the deals were changed after being awarded fatally undermines that transparency: if the changes had been included in the model contract, companies might have made very different bids.

Former Minister of Oil Husain al-Shahristani promised that contracts would be made available to anyone who asked for them. [7] While a generalized version was posted on the ministry's website in 2010, the actual contracts – in their final form as signed – have never been released. There is now an urgent need to publish them. Iraqis, after all, have a right to know.

Notes

1. G Muttitt, '*Fuel on the Fire – Oil and Politics in Occupied Iraq*', Random House, April 2011 (for further details e-mail author at info@fuelonthefire.com). The original documents, including the leaked Rumaila contract and an explanatory briefing published by Platform, are available at www.fuelonthefire.com
2. Eni SpA, 3Q09 earnings conference call, 29 October 2009.
3. Released with the Final Tender Protocol on 23 April 2009.
4. This could be either by extending the term of the contract or by increasing the production profile at some later date from that specified in the development plan. Either way, over the full life of their contract they would produce the same aggregate amount, but it would be worth less due to the time value of money.
5. UK Foreign and Commonwealth Office, Iraq Policy Unit, 'UK Energy Strategy for Iraq', 6 September 2004. (See 'Fuel on the Fire', p.52).
6. Eg Nori Jafar et al, 'Legal Opinion Presented to Iraqi Parliament', 4 June 2009 (http://www.iraqenergy.org/news/downloader. php?dfile=Legal%20Opinion%20on.pdf).
7. Jasim Azzawi interview with Husain al-Shahristani, *al-Jazeera English*, 'Inside Iraq', 18 December 2009 (http://www.youtube.com/watch?v=u5NyqhNgYDE).