Contractual Rip-off: The Cost of PSAs to Iraq

Greg Muttitt

While the advantages of production sharing agreements (PSAs) for multinational oil companies are clear, there is a severe shortage of independent analysis of whether PSAs are in the short-, medium- and long-term interests of the Iraqi people. Unfortunately, the Iraqi people have not been informed of the pro-PSA oil development plans, let alone their implications, which have transformed so seamlessly from US State Department recommendations into Iraqi government policy.

Our analysis shows that production-sharing agreements have two major disadvantages for the Iraqi people:

1. The loss of hundreds of billions of dollars in potential revenue;
2. The loss of democratic control of Iraq’s oil industry to international companies.

PSAs may also undermine an important opportunity to establish effective public oversight and end the current corruption and financial mismanagement in the Iraqi oil sector.

Once signed, PSAs generally last (with fixed terms) for between 25 and 40 years. The Iraqi people would have to live with the consequences for decades.

Losing revenue: how much would PSAs cost the Iraqi people?
In order to understand why foreign oil companies are so keen to invest in Iraq, one needs to look at the economic results of applying PSA contracts to the Iraqi oil sector.

We have produced economic models of 12 of Iraq’s oilfields that have been listed as priorities for investment under production sharing agreements. We do not know yet what terms Iraqi contracts might contain (that will not be known until they are signed - and possibly not at all, if they are not disclosed to the public). We have therefore taken contractual terms used in other comparable countries, and applied them to the physical characteristics of Iraq’s oilfields (based on data from the Iraqi Oil Ministry, the US government and respected industry analysts such as Deutsche Bank). This process allows us to project the cashflows to the Iraqi state and to foreign oil companies, under a range of assumptions (such as oil price).

Specifically, we look at terms used in Oman and Libya (both having comparable physical conditions to Iraq) and Russia (the only country with any PSAs which has reserves at all comparable in scale to Iraq’s). The terms recently applied in Libya are widely viewed to be among the most stringent in the world. We have then compared the results with expected revenues of a nationalized system, administered by state-owned oil companies.

Using an average oil price of $40 per barrel, our projections reveal that the use of PSAs would cost Iraq between $74 billion and $194 billion in lost revenue, compared to keeping oil development in public hands (see Table 1).

<table>
<thead>
<tr>
<th>Total undiscounted revenue (US$ billion)</th>
<th>State take</th>
<th>Total revenue loss under PSA scenario (US$ billion)</th>
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<tbody>
<tr>
<td>Table 1: Impact of PSAs on Iraqi State Revenues</td>
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This massive loss is the equivalent of $2,800 to $7,400 per Iraqi adult over the thirty-year lifetime of a PSA contract. By way of comparison Iraqi GDP currently stands at only $2,100 per person, despite the very high oil price.

It should be noted that these figures relate to only twelve of Iraq’s more than 60 undeveloped fields. Iraq has identified 23 priority fields on which to potentially sign contracts in 2006. Thus when the other 11 fields are added, along with a further 35 or more later, and especially other fields yet to be discovered (recall that Iraq’s undiscovered reserves may be as large or even double the known reserves), the full cost of the PSA policy could be considerably greater.

Both the corporate lobby group ITIC and the British Foreign Office have argued that foreign investment can free up Iraqi government budgets for other priority areas of spending, to the tune of around $2.5 billion a year. Although technically true, this is deeply misleading - as the investment now would be offset by the loss of revenues later.

Amazingly, in ITIC’s report advocating the use of PSAs, the economic impact is only examined up to 2010 - ignoring the fact that any foreign investment must be repaid. It is as if one took out a bank loan but only considered the economic impact prior to paying it back!

In contrast, in our report, we look at the impact of PSAs over the whole length of the contract. Economists and indeed oil companies compare investments using the process of “discounting,” and the concept of “net present value” (NPV). NPV is a measure of what the later income or expenditure would be worth if they were received or incurred now.

When looked at in these terms, far from “saving” the government $8.5 billion of investment (the whole investment over several years, in 2006 NPV), these contracts will cost Iraq a (2006) NPV of $16 - $43 billion, at a 12% discount rate.

Our assumed oil price for these calculations is $40 per barrel. The oil price is currently fluctuating around $60 per barrel, and there is an argument that structural factors, such as increasing demand in China and India, mean that oil prices are likely to stay at this level - which would make our $40 assumption conservative.

However, the oil price is notoriously difficult to predict. We therefore also look at the models at a higher price of $50 and a lower price of $30 per barrel. Here the models show that Iraq would lose $55 to $143 billion at $30 per barrel, while if the oil price averaged a higher $50 per barrel, Iraq would lose far greater revenues of $94 - $250 billion, compared to the nationalized model. (See Tables 2 and 3.)

<table>
<thead>
<tr>
<th>Nationalized</th>
<th>Russia PSA terms</th>
<th>Oman PSA terms</th>
<th>Libya PSA terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>971</td>
<td>779</td>
<td>777</td>
<td>897</td>
</tr>
<tr>
<td>100%</td>
<td>80%</td>
<td>80%</td>
<td>92%</td>
</tr>
<tr>
<td>-</td>
<td>192</td>
<td>194</td>
<td>74%</td>
</tr>
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Figures in real terms (2006) prices, at constant $40/bbl oil price, for the period 2006 - 20035.

Table 2: Impact of PSAs on Discounted Iraqi State Revenues
### Total undiscounted revenue (US$ billion) | State take | Total revenue loss under PSA scenario (US$ billion)
--- | --- | ---
Nationalized | 183 | 100% | -
Russia PSA terms | 140 | 77% | 43
Oman PSA terms | 147 | 80% | 36
Libya PSA terms | 167 | 91% | 16%


#### Table 3: Impact of Alternative Oil Price Scenarios on Iraqi State Revenues

<table>
<thead>
<tr>
<th>Projected oil company Internal Rate of Return (IRR)</th>
<th>Total undiscounted revenue (US$ billion)</th>
<th>Total NPV revenue at 12% (US$ billion)</th>
<th>Total undiscounted revenue (US$ billion)</th>
<th>Total NPV revenue at 12% (US$ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amara Field (small)</td>
<td>Nasiriya field (medium)</td>
<td>Majnoon field (Large)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nationalized</td>
<td>716</td>
<td>133</td>
<td>1,227 (250)</td>
<td>232</td>
</tr>
<tr>
<td>Russia PSA terms</td>
<td>580 (136)</td>
<td>104 (30)</td>
<td>977 (250)</td>
<td>175 (57)</td>
</tr>
<tr>
<td>Oman PSA terms</td>
<td>573 (143)</td>
<td>107 (26)</td>
<td>982 (245)</td>
<td>186 (46)</td>
</tr>
<tr>
<td>Libya PSA terms</td>
<td>661 (55)</td>
<td>122 (12)</td>
<td>1,113 (94)</td>
<td>212 (20)</td>
</tr>
</tbody>
</table>

### Massive profits: how much do the oil companies stand to gain?

Our economic model has also been used to calculate the key measure of oil project profitability - the Internal Rate of Return (IRR) - that the oil companies are expected to make. This provides another measure of whether PSAs represent a fair deal for Iraq.

Profitability varies according to the size of the oil field, so we have based our projections on three different fields that (in Iraqi terms) are typical small, medium and large oil fields.

#### Table 4: Impact of PSAs on Oil Company Profitability

<table>
<thead>
<tr>
<th>Projected oil company Internal Rate of Return (IRR)</th>
<th>Amara Field (small)</th>
<th>Nasiriya field (medium)</th>
<th>Majnoon field (Large)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russian PSA terms</td>
<td>62</td>
<td>105</td>
<td>162</td>
</tr>
<tr>
<td>Oman PSA terms</td>
<td>51</td>
<td>83</td>
<td>120</td>
</tr>
<tr>
<td>Libya PSA terms</td>
<td>42</td>
<td>67</td>
<td>98</td>
</tr>
</tbody>
</table>


Our figures show that under any of the three sets of PSA terms, oil company profits from investing in Iraq would be quite staggering, with annual rates of return ranging from 42% to 62% for a small field, or 98% to 162% for a large field. This shows that under PSAs, Iraq’s loss in terms of government revenue will be the oil companies’ gain. By way of comparison, oil companies generally consider any project that generates an IRR of more than a 12% to be a profitable venture. For Iraqi oil fields, even under the most stringent PSA terms, it is clear that the oil
companies can expect to achieve stellar returns.

Even at prices of $30 per barrel, profits are excessive on all fields, with any terms, ranging from 33% on a small field with stringent terms to 140% on a large field with lucrative terms. At $50 per barrel, the profits are even greater, ranging from 48% to 178%.

Table 5: Oil Company Profitability at Different Oil Prices

<table>
<thead>
<tr>
<th></th>
<th>US$30/barrel scenario</th>
<th>US$50/barrel scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amara</td>
<td>Nasiriya</td>
</tr>
<tr>
<td>Russia PSA terms</td>
<td>46%</td>
<td>82%</td>
</tr>
<tr>
<td>Oman PSA terms</td>
<td>41%</td>
<td>67%</td>
</tr>
<tr>
<td>Libya PSA terms</td>
<td>33%</td>
<td>53%</td>
</tr>
</tbody>
</table>

**Losing control: the democratic cost of PSAs**

Iraq’s democracy is new and weak. Having suffered decades of oppression by Saddam Hussein, Iraq’s institutions and civil society need time to develop and mature. Many Iraqis may feel, in this situation, that they do not immediately wish to lock their country into any single model of oil development over the long term. Unfortunately, this is exactly what Iraqi politicians, under US and UK pressure, appear to want to do.

In theory, PSAs would allow the Iraqi state to retain ownership and control over their oil resources. However, in practice they will impose severe restrictions on current and future Iraqi governments for the full lifetime of the contract.

PSAs have four key features that will in practice limit and remove democratic control from the Iraqi people:

1) They fix terms for 25 to 40 years, preventing future elected governments from changing the contract. Once a deal is signed, its terms are fixed. The contractual terms for the following decades will be based on the bargaining position and political balance that exists at the time of signing - a time when Iraq is still under military occupation and its governmental institutions are weak. In Iraq’s case, this could mean that arguments about political and security risks in 2006 could land its people with a poor deal that long outlasts those risks and is completely unsuited to a potentially more stable and independent Iraq of the future.

2) They deprive governments of control over the development of their oil industry. PSA contracts generally rule out government influence over oil production rates. As a result, Iraq would not be able to control the depletion rate of its oil resources - as an oil-dependent country, the depletion rate is absolutely key to Iraq’s development strategy, but would be largely out of the government’s control. Unable to hold back foreign companies’ production rates, Iraq would also be likely to have difficulty complying with OPEC quotas which would harm Iraq’s position within OPEC, and potentially the effectiveness of OPEC itself. The only way to avoid either of these two problems would be for Iraq to cut back production on the fields controlled by state-owned oil companies, reducing revenues to the state.

3) They generally override any future legislation that compromises company profitability, effectively limiting the government’s ability to regulate. One of the most worrying aspects of PSAs is that they often contain so-called “stabilization clauses,” which would immunize the 60% to 80%
of the oil sector covered by PSAs from all future laws, regulations and government policies. Put simply, under PSAs future Iraqi governments would be prevented from changing tax rates or introducing stricter laws or regulations relating to labor standards, workplace safety, community relations, environment or other issues. One common way of doing this is for contracts to include clauses that allocate the “risks” for such tax or legislative change to the state. In other words, if the Iraqis decided to change their legislation, they would have to pick up the bill themselves. The foreign oil companies’ profits are effectively guaranteed.

4) PSAs commonly specify that any disputes between the government and foreign companies are resolved not in national courts, but in international arbitration tribunals which will not consider the Iraqi public interest. Within these tribunals, such as those administered by the International Center for Settlement of Investment Disputes in Washington DC, or by the International Chamber of Commerce in Paris, disputes are generally heard by corporate lawyers and trade negotiators who will only consider the narrow commercial issues and who will disregard the wider body of Iraqi law. As the researcher Susan Leubuscher 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.” They may also - especially if connected to bilateral investment treaties - make a foreign company’s home state a party to any dispute, thus enabling that country to weigh in on the company’s behalf.

**Loss of control: the case of Georgia**

This loss of democratic control is illustrated by the case of BP’s Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which is being built from the Caspian Sea to the Mediterranean. This project is governed by a Host Government Agreement, some of whose legal provisions are comparable to those in PSAs.

In November 2002, the Georgian 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. Both BP and the US government put pressure on the Minister, through then President Shevardnadze. 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 and stipulated that the contract had 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.

Shortly after Shevardnadze was overthrown in a “rose revolution” in November 2003, new President Mikhail Sakashvili commented, “We got a horrible contract from BP, horrible” - but he could not change it.

**Multinational companies favor complexity**

Another feature of production sharing agreements is that they are the most contractually complex form of oil contract. PSAs generally consist of several hundred pages of technical legal and financial language (often treated as commercially confidential). It is their complexity, not their simplicity, which is advantageous to oil companies.

The simplest form of oil fiscal system is the royalty (defined as 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. This is used in most concession
agreements, and sometimes in PSAs. In comparison with production sharing formulae, it is very clear what the state should receive from royalties - 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 from the oil companies.

However, oil companies dislike royalties and prefer systems based on an assessment of profits, such as PSAs. The reason is that they want what they call “upside” (i.e., opportunities for greater profits) - ways they can reduce their payments, rather than being subject to a fixed level of payment for oil extracted.

Under profit-based systems, revenue is based on the profit remaining when the oil companies’ production costs have been deducted from the total revenue. As such, they depend on complex rules for which costs can be deducted, how capital costs are to be treated, and so on. The more complicated the system, the more opportunities there are for a company to maximize their share of the revenue by sophisticated use of accountancy techniques. Not only do multinational companies have access to the world’s largest and most experienced accountancy companies, they also know their business in more detail than the state they are working with. Consequently a more complicated system tends to give multinationals the upper hand.

For example, in the Sakhalin II project in Russia, the complex terms of the PSA resulted in all cost over-runs being effectively deducted from state revenue instead of from the Shell-led consortium’s profits. During the planning and early construction of the project, costs 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.

Although three PSAs were signed in the mid 1990s in Russia, they have been the subject of extreme controversy ever since. The changing view of PSAs in Russia in general also illustrates the loss of democratic control inherent in PSAs - if the government or political climate changes, the terms of a PSA cannot change to reflect new priorities. In Russia’s case, the rush to privatize in the early 1990s is now being questioned - but with the PSAs already in force it is impossible to rectify mistakes.

The Sakhalin II PSA is an example of a special type of PSA, which is growing in prominence. In such PSAs, the sharing of “profit oil” is based not on a fixed proportion, but on a sliding scale, based on the foreign company’s profitability. The state receives only a low proportion of profit oil (or in the Sakhalin case, none) until the company has achieved a specified level of profit. Thus, states are deprived of revenue, while corporate profits are guaranteed.

Iraq would fare no better
In theory, Iraq may be able to negotiate PSAs with much more stringent terms than those used elsewhere in the world. As noted above, we do not know what exact terms Iraq might adopt if it uses PSAs. Iraq could also, in theory, avoid some of the more draconian legal clauses outlined above.

However, we have also seen that there are a number of structural features of PSAs that are likely to act against Iraq’s interests, whatever the terms. Helmut Merklein, a former senior official of the US Department of Energy, explains this based on the concept of economic rents - the excess profits of oil production (after deducting production costs and a reasonable return on capital):

For all the sophistication and the bells and whistles these contracts have.... they all have two basic flaws, which make them less than perfect in terms of capturing rent. They are subject to distortions
through petroleum price fluctuations in world markets, and they generally fail to provide the host country with its proper rent if the field turns out to be greater than expected. Various triggers in those agreements reduce the host country’s exposure, but they never really eliminate it.

The generation of rents is a feature of oil production. Because of oil’s sheer value, its extraction generates profits beyond what is normally expected on an investment. These rents should belong to the country that possesses the oil resource. However, Merklein’s point is that PSAs cannot - in unpredictable economic circumstances - deliver the country its fair share of the rents, and inevitably tend to give foreign oil companies excessive profits at the country’s expense.

To the flaws identified by Merklein, we would add the long-term and restrictive nature of PSAs, that their terms are fixed as negotiated in a situation which - one hopes - will not persist in Iraq; and that they also place legal constraints beyond the issue of revenue-sharing, as we have seen.

In some countries, circumstances in the oil sector may favor investment through a mechanism such as PSAs, in spite of these disadvantages - such as where fields are offshore, risk capital for exploration is required, or the country lacks technical competence. In Iraq, however, these conditions do not apply, and given the country’s huge oil wealth, it does not need to accept the negative consequences of PSAs.

On top of these structural flaws in PSAs, there are grounds to doubt whether the specific terms Iraq might achieve would be any better than in other countries, despite Iraq’s enormous oil reserves. The key issue here is bargaining power: the Iraqi state is new and weak, and damaged by the ongoing violence and by corruption, and the country is still under military occupation.

In fact, rather than negotiating a more stringent PSA deal than elsewhere, the oil companies will inevitably wish to focus on the current security situation to push for a deal comparable to - or better than - that in other countries in the world, while downplaying the huge reserves and low production costs which make Iraq an irresistible investment.

Indeed, precisely this point is being pushed by the oil companies and their governments. The corporate lobby group ITIC attempts to invert conventional economic logic, by implying that there is greater competition among oil-producing countries than among private companies:

> Although Iraq’s potential petroleum wealth is enormous, the government still faces competition from other countries offering petroleum rights to investors. ... Investors, too, are competing for access to attractive petroleum deposits but competition among them may be limited if the project in question requires scarce expertise or depth of financial resources.

Thus one of ITIC’s key recommendations is that Iraq “offer to companies profit potential consistent with the risk they bear.”

Their argument that countries, not companies, must compete is especially perverse given the high oil price, and the wide recognition of supply constraint: that there is a shortage of access to reserves, not of access to capital.

Similarly, the US government’s development agency USAID has advised the Iraqi authorities that: Countries with less attractive geology and governance, such as Azerbaijan, have been able to partially overcome their risk profile and attract billions of dollars of investment by offering a contractual balance of commercial...
interests within the risk contract, one that is enforceable under UK and Azeri law with the option of international arbitration.

If Iraq follows that advice, it could not only concede a contractual form which is not in its interests, but specific terms which radically understate the country’s attractiveness to the international oil industry. Along with much of its future income, Iraq could be surrendering its democracy as soon as it achieves it.

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