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You may be interested.

PIRINC has prepared the enclosed report, *Iraqi Oil: A Love-Hate Relationship*. The report reviews the complex, even contradictory, concerns associated with Iraqi oil.

Iraq is one of the three countries, along with Iran and North Korea, named by President Bush as members of the "axis of evil." Yet the US is a sizeable market for Iraqi oil. The growth in imports from Iraq has generated opposition in Congress, most recently expressed in a Senate bill to prohibit them. Companies importing Iraqi oil in support from and conformity within US and UN sanctions regulations, find themselves under public scrutiny, and occasional outright criticism for doing so.

The US has a strong interest in maximizing legal exports from Iraq. At the same time, the US wants to close off illegal revenue sources that support the Iraqi regime. Recently, the UN pricing regime was modified to reduce the scope for illegal surcharges but an unintended result has been a significant fall-off in legal exports and funds for humanitarian imports. The loss could push up oil prices, given OPEC's likely decision to maintain production levels. It is not clear that overall illegal revenues have fallen. Illegal revenues from smuggled oil are far larger and only modest oil price increases, supported by a tighter world market, would offset any losses in surcharges.

It is proving extremely difficult for the US to achieve all its objectives. The US has succeeded in overseeing the return of an important source of supply to the world oil market while insuring that most of proceeds go for approved purposes. Any slippage, however, is a cause for concern, given the nature of the Iraqi regime.

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June 2002

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Iraqi Oil: A Love-Hate Relationship

Since the 1990 invasion of Kuwait, the U.S. has viewed the Iraqi regime as hostile. Iraq is one of the three countries, along with Iran and North Korea, named by President Bush as members of the "axis of evil." On August 2, 1990, former President Bush issued an executive order declaring a national emergency and by executive order imposed a complete trade embargo and blockage of government financial assets on Iraq. Within a few days, the UN Security Council imposed similar comprehensive sanctions. The original executive order has been renewed over the years, most recently on July 31, 2001 by the current President Bush.

In 1995, in response to growing humanitarian concerns for the Iraqi population, the UN sanctions regime was modified to carve out an exception to the total embargo, oil. UN Security Council Resolution 986 allowed the Iraqi government to sell a limited amount of oil for a limited period, with proceeds to be deposited in a specified bank account and to be used for specific purposes, primarily humanitarian supplies and compensation to war victims.[1] Sanctions are still in effect although with significant changes, in particular the removal of limits on oil sales and most recently, a streamlining of the review process regarding purchases of imports. US sanctions regulations have incorporated the changes made over the years by the UN Security Council.

Although US-Iraq relations are no less hostile than they were in the aftermath of the Gulf War, the US has become a sizeable market for Iraqi oil. In the first three months of this year, US imports of crude oil from Iraq amounted to nearly 50% of UN monitored Iraqi oil exports and about 10% of total US crude oil imports. Despite this substantial commercial relationship, companies importing Iraqi oil in support from and conformity within US and UN sanctions regulations, find themselves under public scrutiny, and occasional outright criticism for doing so. Part of the problem lies in the manner of just how the oil is acquired. Iraq refuses to sell oil directly to US companies. From those who do buy the authorized oil at approved prices, Iraq is accused of collecting illegal surcharges above and beyond authorized prices, which in turn are presumably "incorporated" in prices charged to third parties. Thus, US companies are accused of indirectly lending financial support to the Iraqi regime even though they have no incentive whatsoever to pay anything more than competitive market value for the oil---indeed, perhaps a bit less given the supply risks associated with this source. For any sustained surcharges to be possible, there has to be some gap between approved prices and market value, an issue that the UN has been attempting to address. Iraq is also accused of collecting revenue through illegal commissions on import contracts, and most important, through oil smuggling.

This report reviews the complex, even contradictory, concerns associated with Iraqi oil. The return of Iraqi oil to the international market has played an important moderating role on world oil prices.[2] The US has an interest in supporting high levels of legal, controlled exports both as an ongoing force for price moderation and as a means of funding approved humanitarian imports. At the same time, the US wants to close off illegal revenue sources. An official pricing

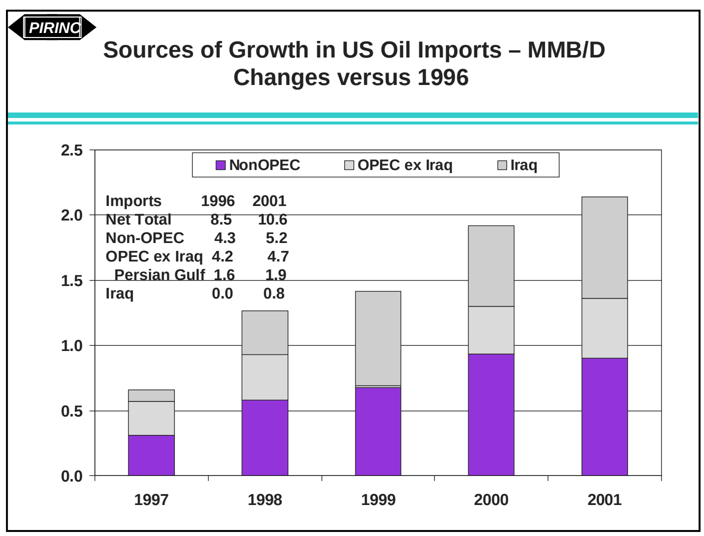
[1] Of the total proceeds, 72% were to finance humanitarian imports--split between the Iraqi government controlled areas (59%) and the Northern Governates or areas controlled by the Kurds (13%)---and 25% for compensation of victims. The balance funds the UN administration costs, and monitoring and inspection programs.
[2] Just as its periodic loss has undoubtedly raised world oil prices.

system that leaves no money on the table for surcharges would in principle meet both objectives although such a system in practice has been difficult to devise. Until late last year, the UN had been pricing Iraqi oil preferentially to and not competitive with other comparable crudes in a broadly successful effort to encourage legal export volumes and raise revenues for humanitarian imports. However, recent attempts to price closer to market, in particular through a shift to retroactive pricing, is having the undesirable effects of cutting monitored export volumes and revenues available to finance humanitarian imports.[3]

The illegal revenues from surcharges are estimated to be a very small fraction, about 2-3% of total legal revenues. They are also modest relative to the 10 times larger revenues from smuggling. On the surface, it's therefore puzzling, why we haven't focused efforts on eliminating the smuggling. The illegal sales through the Syrian pipeline by itself nets Saddam 5 times the illegal revenues from surcharges, where he gets dollars per barrel not dimes. Reducing smuggling, however, involves gaining the cooperation of countries receiving the oil, which so far has not been successful.

Iraq's Role in Oil Markets

Toward the end of 1996, Iraq accepted the UN conditions for oil sales laid out in the August 1995 UN Security Council Resolution 986 and Iraqi oil began its reentry into world markets. Production levels rose from about 580 MB/D in 1996 to 2.5 MMB/D in 1999, a level that has more or less been sustained through 2001. In 2001, OPEC's production was up by about 1.8 MMB/D versus 1996, with the entire net difference accounted for by Iraq. In effect, Iraq, which currently is not subject to any OPEC production limits, has pre-empted market gains for the rest of OPEC, putting pressure on that organization's cohesion and ability to influence prices.



Sources of Growth in US Oil Imports – MMB/D
Changes versus 1996

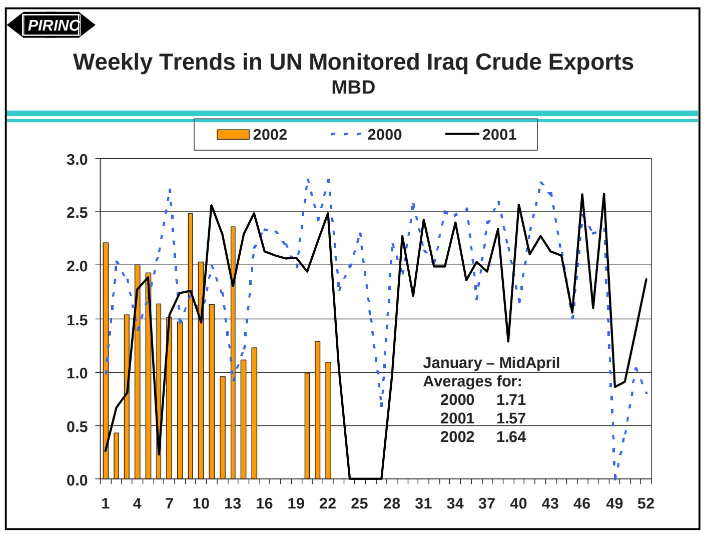
The impact of Iraq's return to market is illustrated by the changes in recent years in US sources of supply of imports. The chart on the right shows the broad sources of growth in US net oil imports since 1996.

From 1996 through 2001, US net imports grew by 2.1 MMB/D or from 8.5 to 10.6 MMB/D. All non-OPEC sources supplied 0.9 MMB/D of the growth followed closely by Iraq, which supplied nearly 0.8 MMB/D. The other OPEC

[3] This could result in an annualized loss of $3 billion to the escrow account without necessarily cutting into the net illegal flow of funds to Saddam. It takes only modest increases in the much larger flow of illegal revenues from smuggled oil to offset the reduced revenues from surcharges, a process facilitated by a tighter world market. With refinery margins weak and other crudes readily available, the new level of uncertainty created by retroactive pricing has moved Iraqi oil from the top toward the bottom of a refiners preference list.

countries collectively supplied less than 0.5 MMB/D. The share of total 1996-2001 growth accounted for by the other OPEC group amounted to about 20% of the 2.1 MMB/D total, well below the group's 50% share of total US net imports in 1996. The growth in imports from Iraq has generated opposition in Congress, most recently expressed in a Senate bill to prohibit them. The bill is opposed by the Administration and is highly unlikely to become law. Nonetheless it reflects the uncomfortable balance in perceptions between the advantages to the US of having a new source of supply come to market and the desire not give any support to a hostile regime, even if in fact the lion's share of Iraq's oil revenues go for humanitarian purposes.

While annual figures give some perspective on the impact of Iraq's return to the world oil market, they miss another aspect of Iraqi exports, at least those monitored by the UN, namely their short-term volatility. Sharp swings in a country's export volumes can result from sudden changes in market conditions, physical production and logistics problems and, especially in the case of Iraq, political decisions to curtail exports. The chart below illustrates the weekly trends in UN-monitored crude exports since the beginning of 2000.



Over the period shown, monitored exports have varied from weekly highs exceeding 2.5 MMB/D to weekly lows of zero. The zero export periods all have political roots. The 2000 and 2001 zero export intervals occurred when a six-month sanctions phase had come to an end and Iraq was refusing to accept the terms of the next six-month phase as set by the UN Security Council. Exports rebounded once Iraq finally agreed to the terms. The latest, mid-April to mid-May curtailment was stated to be in support of the Palestinians during the recent intensification of the Israel-Palestinian conflict. The Iraqi government called on the other Arab exporters to follow suit. When it was clear that no other country would join in cutting oil supplies, Iraqi (monitored) exports resumed. However, the bounce back does not appear to be as vigorous as has been the case after earlier curtailments. This year through mid-April, monitored exports have averaged 1.6 MMB/D, about 0.5 MMB/D below its 2-2.2 MMB/D export capacity. Setting aside the curtailment period, monitored exports since early March have averaged about 0.7 MMB/D below year-earlier volumes.

The significantly lower volumes are generally considered to be the result of changes in UN pricing formulas designed to reduce the scope for illegal surcharges.[4] Pricing issues are

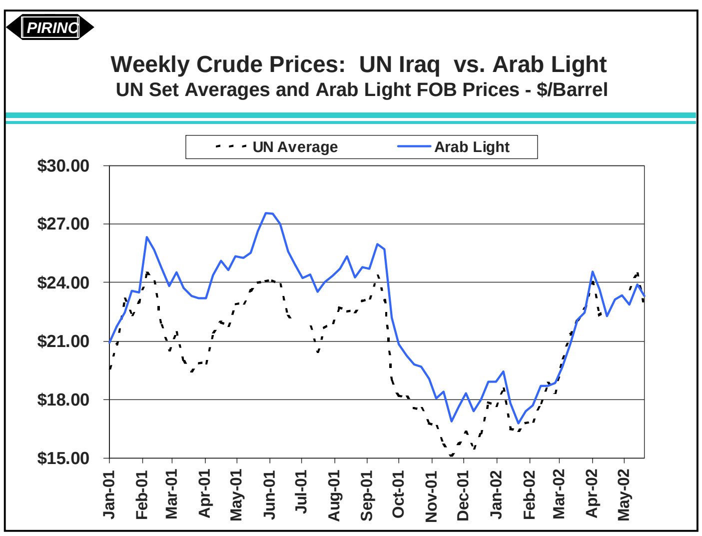
[4] Earlier, concerns over Iraqi production capability led to a broadening of permitted imports to include oil-related equipment. As of mid-May of this year, about 8% of the value of import contracts approved for the Iraqi government controlled areas were for oil-related equipment.

discussed in more detail in the next section of the report but before turning to them, it should be kept in mind that whether or not Iraqi exports recover toward earlier high levels is an important near-term issue for world oil markets. OPEC has already indicated that it will not raise official production quotas when it meets later this month. Recent forecasts, including those issued by the US Department of Energy and the International Energy Agency project higher world oil demand in the third quarter (due mainly to seasonal factors). The third quarter is typically a stock-build quarter as well. With non-OPEC production expected to rise only modestly, the world will be looking to OPEC for more oil. While the OPEC members apart from Iraq are already producing beyond their quotas, and the gap could rise still further, there is little doubt that an early return by Iraq to at least its prior high levels of exports would go far towards alleviating risks of a significant tightening of world oil markets over the summer.

Pricing Iraqi Oil

Under the current UN sanctions regime, a special committee sets the prices under which Iraqi oil is legally exported. The prices are meant to be in line with market values of the oil although precision is impossible to assure. The demonstrated political supply risks associated with Iraqi oil mean that ultimate buyers view this source differently from other more stable sources and allow for this difference in what they are willing to pay. A further complication comes from at least the early need to raise revenues to finance humanitarian imports, and therefore the priority given to insuring that the world oil market would take large volumes of oil on offer.

Iraq refuses to sell oil directly to US buyers, so US companies purchasing Iraqi oil must do so through resellers. It is the initial, direct buyers who would be paying the illegal surcharges to the Iraqi government. In late 2000, as the sanctions regime was coming up for renewal, the Iraqi government announced that anyone buying oil from the national oil company would have to pay an explicit 50 cent/barrel surcharge to a bank account controlled by Iraq. The UN Security Council rejected the demand. There was a brief stoppage of exports before Iraq agreed to the six-month renewal of the program but the matter of illegal surcharges remains.



In principle, the closer the UN price is to market value, the less room there would be for surcharges and there are indications that the recent changes in pricing practices, especially the shift early this year from forward to retroactive pricing, has cut into the potential for surcharges.

The chart on the right shows the weekly average crude prices set by the UN for Iraqi exports and for comparison purposes, the FOB Arab Light prices. Prices are shown from the beginning of 2001 through the end of May 2002.

Through early 2002, the average UN set prices tended to be significantly below the Arab Light prices. But with the change in UN pricing practice that was introduced early in the year, the gap has virtually disappeared. At that time, the shift was made from forward to retroactive pricing. Differences between the two crude streams limit the value of exact price comparisons between them but the data strongly indicate a substantial narrowing of any gap between UN prices and market values. The narrowing suggests that the move to retroactive pricing was accompanied by other changes as well that effectively narrowed the gap.[5] But caution is needed before concluding any per barrel surcharge has been similarly reduced.

The substantially lower UN-monitored Iraqi export volumes since early March, setting aside the Iraqi political curtailment discussed earlier, suggests that effective prices relative to values seen by final consumers have moved up with the new pricing. Such a development encourages the more marginal buyers to look elsewhere for supplies.

The Iraqi government has placed a high priority on revenue fully under its own control — through surcharges, smuggling, and illegal commissions. It has also shown willingness suspend temporarily all legal exports and forgo the associated UN-controlled revenues and the far smaller revenues from illegal surcharges. The Iraqi government may prefer, at least for the time being, to accept substantially lower UN-controlled volumes and money into the escrow account since there doesn't seem to be any reduced flow of illegal payments to the government.

The Iraqi government's own revenue losses would be reduced to the extent reduced legal oil exports tighten the market and raise revenues received on smuggled oil. As published by the GAO, smuggled oil amounts to between 325 to 480 MB/D. [6] The losses of illegal surcharges on authorized oil could be offset if markets tightened sufficiently to raise prices received on smuggled oil by between 50 cents and 75 cents/barrel.[7] It should be noted that the estimated range for smuggled oil as published by the GAO includes 100 MB/D of exports to Jordan. Although technically in violation of the UN sanctions, the exports to Jordan are tacitly accepted by the UN, and the US government.

[5] Retroactive pricing per se need not necessarily impact the margin between the official price and the prices in turn set by the middlemen to their customers. While it does offer UN officials more information about market conditions before setting approved prices, the more discretion the pricing officials exercise, the less certainty buyers have about their ultimate costs, adding to their market risks.

[6] See, US General Accounting Office, Weapons of Mass Destruction: UN Confronts Significant Challenges in Implementing Sanctions Against Iraq, May 2002.

[7] A sustained loss of 0.5 MMB/D from global oil markets would easily raise world market prices by that level.

The Oil Companies

The US regulations for companies buying oil from the Iraqi government or its state oil company are clear. To receive a specific license to import the oil, any purchase contract must accord with "normal arms-length commercial practice" and the applicant must certify that it understands that:

> "---issuance of a license does not authorize a licensee to provide goods, services or compensation of any kind to the Government of Iraq other than that specifically provided in contracts entered into by the applicant and the Government of Iraq and submitted to and approved by the UN 661 Committee or its designee."[8]

US companies are thus prohibited from paying surcharges on purchases of oil directly from Iraq. However, as noted earlier, Iraq refuses to deal directly with US companies. As has been widely reported, last year the US State Department wrote to the US companies buying Iraqi oil on the world oil market warning them to be sure their purchases are not tainted by payment of a surcharge that Iraq has reportedly demanded. US companies in any case have no incentive to pay anything above their judgments of competitive market value for Iraqi oil, including any allowance for supply risk. By importing competitively priced Iraqi oil, they are in effect holding down the cost of imported oil to US consumers. This is particularly the case when as part of their effort to prop up oil prices; OPEC has been holding back supplies of comparable crudes available to the market.

The companies importing Iraqi oil into the US are thus not the appropriate targets of any effort to cut the illegal flow of revenues to the Iraqi government. The appropriate targets have proven more difficult, the direct buyers paying the reported surcharges, and the countries such as Russia who could exercise greater oversight over their national's behavior, as well as those entities and countries receiving the smuggled oil. The problem is further complicated by the apparent willingness of the government of Iraq to sacrifice substantial legal revenues in order to maintain the far smaller flow of direct illegal revenues to itself. As with much else concerning Iraq, imperfect results seem to be the most that can be achieved. In his May appearance on Meet the Press, Secretary Powell summed up the current imperfect situation as follows:

But he is able — through smuggling activities and other states that are neighbors of his, and this kind of duplicitous action in arranging surcharges — he is able to generate an additional $2-$3 billion a year that he can use for whatever purpose he chooses. I wish that were not the case. I wish we could shut it down entirely, but we haven't been able to. But we have been able to keep the Oil-for-Food program in place, and that controls about 80 percent of the funds available for the regime.[9]

In sum, it is proving extremely difficult for the US to achieve all its objectives when it comes to Iraqi oil. Nonetheless, the US has succeeded in overseeing the return of an important source of

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[8]Quotations taken from, U.S. Department of the Treasury, Office of Foreign Assets Control, An Overview of the Iraqi Sanctions Regulations---Title 31 Part 575 of the U.S. Code of Federal Regulations.
[9] Meet the Press interview, May 5, 2002.

supply to the world oil market while insuring that most of proceeds go for approved purposes. Any slippage, however, is a cause for concern, given the nature of the Iraqi regime. A narrow focused forward pricing formula would appear to be more consistent with US interests than the retroactive pricing method currently in place.