OIL

July 16, 2003
Amb Bremer's Revisions Included

THE IRAQI HERITAGE TRUST MEMO

To:	L. Paul Bremer
Through:	Peter McPherson
From:	Bill Block
Date:	July 15, 2003
Re:	Iraqi Oil Fund

I. Establishing the Iraqi Heritage Trust

The establishment of an "Iraqi Heritage Trust" should be a high priority. We recommend the structure set forth here. Iraqi foreign oil revenues should be deposited into the Trust, from which funding for the Iraqi budget itself should then be provided.[1]

Oil-dominated economies have generally had problems that seem to come from having too much money, and this is caused many to think carefully about how to avoid such difficulties. To that end, the objectives of the Trust should be: (i) to be fully transparent and held to the highest standards of performance and accountability, (ii) to combine near-term, medium-term, and long-term economic objectives, (iii) to seek to build broad popular and social support among Iraq's population, (iv) to incorporate international best practices and draw upon "lessons learned" from oil funds that other countries have previously established.

Even if the amount of money allocated for the Trust during the next fiscal year is very small, ensuring that the Trust receives some amount of "seed money" will help to create its institutional structure. The Trust should in due course be legally established in the Iraqi Constitution, with the operational workings of the Trust then codified by statute.

II. Types of Funds

The Trust should be comprised of three distinct funds: An Alaskan-style "Dividend Fund," a macroeconomic "Stabilization Fund," and a long-term "Savings Fund." Although each fund will fall beneath the umbrella of the Trust, the funds will be operationally separate in order to maximize transparency, accountability, and incentives for good long-term performance.

Near-term "Dividend Fund": One goal of the Trust should be to provide "oil dividends" that are paid directly to the Iraqi people. These payments will ensure that at least some portion of oil revenues flow directly to the Iraqi people.

[1] Domestic sales proceeds could also be placed in the Trust. Those proceeds are currently kept by the Ministry of Oil for operations. At a minimum, the sales on proceeds should be reported to the Trust for public disclosure.

Dividend payments could be linked in part to decreases in petroleum subsidies – i.e., increasing petroleum prices. Because price increases could be politically volatile, they may prove more acceptable if some or all of the net revenues received from these increases were "passed through" as oil dividend. Historically, countries have decreased taxes as they decrease subsidies so as to create money in the hands of the purchaser. Because Iraq does not have much of a tax structure, oil dividends may be a substitute. Dividend payments could also be linked directly to the Oil-for-Food program. As food subsidies are removed, oil dividend payments could compensate for higher food costs.

The Dividend Fund can (i) provide direct financial benefits to the population, (ii) limit the room for potential mismanagement of oil revenues by the public sector (in U.S. terms, it is the equivalent of a tax cut), and (iii) build hope and support for democratic institutions, but it may also, (iv) skew the use of oil revenues toward immediate consumption rather than long-term capital investment, (v) stoke nationalistic sentiment over Iraq's oil resources.

Medium-term "Stabilization Fund": Another goal of the Trust should be to create a "Stabilization Fund" that will allow the Iraqi government to implement countercyclical fiscal policies when oil prices fluctuate widely (i.e., spending more when growth slows, spending less when inflation rises). A Stabilization Fund will help to "smooth" public sector expenditures, countering the tendency toward "stop-go," pro-cyclical fiscal policies that characterize many oil-dependent economies.

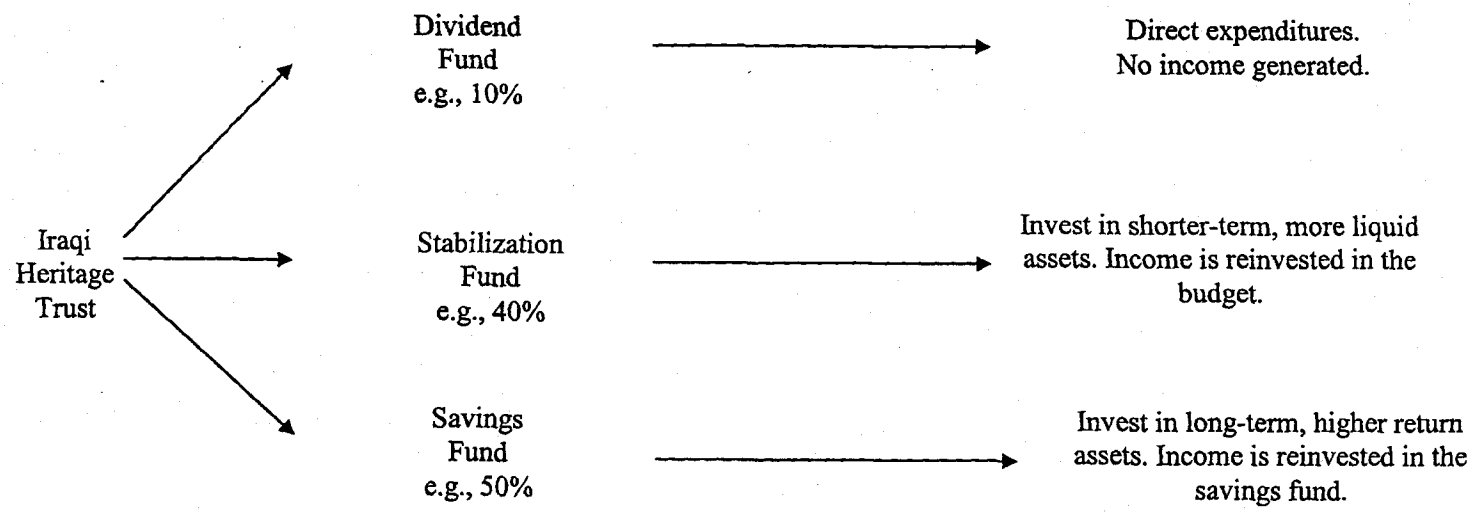
The Stabilization Fund may: (i) smooth business cycle fluctuations by providing room for countercyclical fiscal policy, but can (ii) create new and long-term spending pressures – in other words, once you start spending you cannot stop.

Long-term "Savings Fund": A final goal of the Trust should be to establish a Savings Fund that will be available to meet future liabilities of the Iraqi government – pension payments, for instance, or long-term educational needs. The Savings Fund would be "inter-generational" in that it would force current Iraqi leaders to set aside at least some portion of current oil revenues for the benefit of later generations.

A particular proposal favored both by Fed Chairman Greenspan and Treasury Secretary Snow is for the Savings Fund at some point to support one or more mutual funds that will in turn invest part of its assets in the Iraqi stock market, thereby encouraging private business development in Iraq.

The Savings Fund may: (i) help to ensure that some portion of oil revenues are saved for future investment and expenditure needs of the country, but can be (ii) politically unpopular because it effectively reduced current consumption levels.

Iraqi Oil Fund Overview



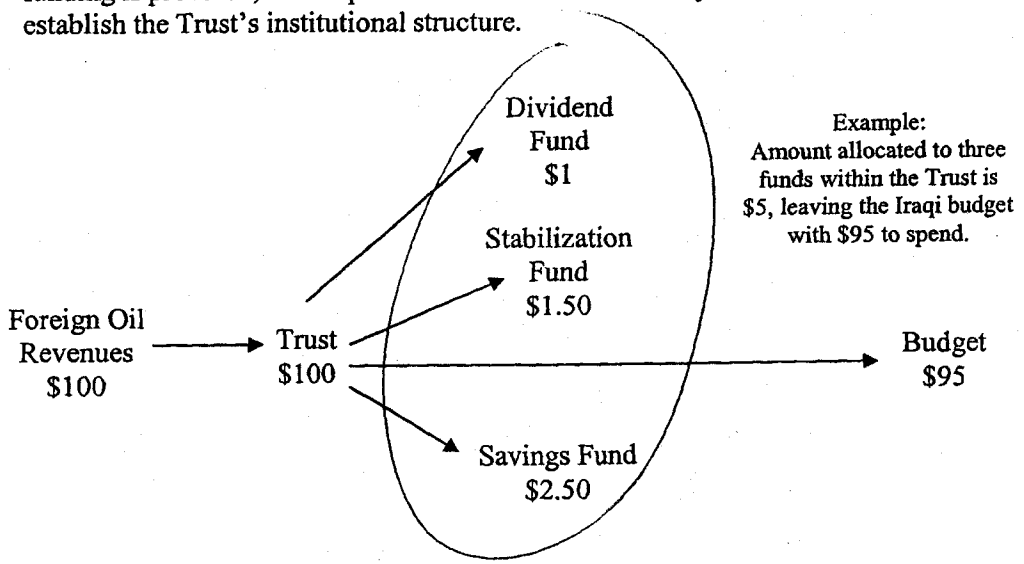
III. Operational Decisions and Steps

#1: Establish an "Iraqi Heritage Trust"

The legal basis for the Trust should be written directly into the Iraqi constitution. Foreign oil revenues will be deposited into the Trust, which will in turn finance the Iraqi budget, Domestic oil sales would be retained by the Oil Ministry but reported to the Trust. The Trust will serve a purpose similar to that of the DFI once an Iraqi government is established and the DFI is dismantled – helping to ensure that oil revenues are well-managed and to maintain mechanisms that ensure accountability, governability, and performance over Iraq's oil resources. A web site for the Trust should be established. There should also be quarterly reporting of financial statements, including oil revenues for the quarter. A distinguished international advisory board should be appointed.

#2: Establish an initial level of capitalization

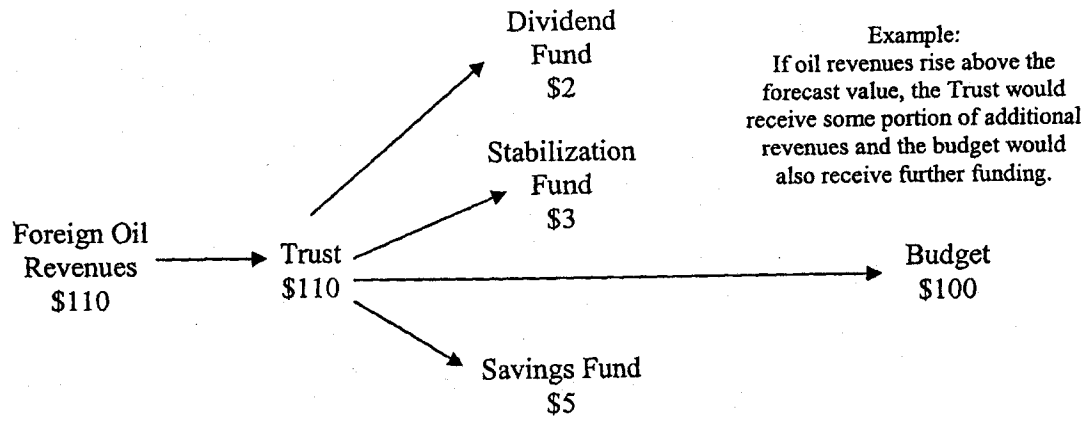
The level of funding to be "set aside" for the Fund at the outset (i.e., for fiscal year 2004) should be determined by an exact dollar value - $50-$100 million may be suitable for this purpose. Pension payments should be paid immediately from the Savings Fund. A decision will be needed by Ambassador Bremer, in consultation with the Governing Council, about the desired amount of funding. Even if only a small amount of initial funding is provided, it is important that some "seed money" be available in order to establish the Trust's institutional structure.



#3: Establish a formula for defining subsequent levels of financing

After the first fiscal year has passed, financing for the Trust can be adjusted by a formula that varies according to changes in foreign sales revenue – higher revenues would provide more funding for the Trust. A sliding scale of revenues to Trust contributions and

other factors will need to be agreed upon. Using the example above, additional money might be allocated toward the Trust if actual oil revenues were $110 rather than $100 - $5 of the additional revenues would be allocated to the Trust, and $5 to the budget.



#4: Establish a long-term allocation scheme among the funds

A wide range of funding allocations among the various funds is possible. One such scheme would be as follows:

- 1.0% of all foreign oil revenues would be paid into the Dividend Fund
- 1.5% of all foreign oil revenues would be paid into the Stabilization Fund
- 2.5% of oil all foreign revenues would be paid into the Savings Fund

#5: Establish clearly defined rules for altering fund allocations

Changes in the allocation among funds should be permitted but should require a broad consensus – for instance, a three-fourths supermajority among the Congress along with presidential concurrence – in order to ensure transparency and limit the possibility of sudden or arbitrary changes meant for short-term political purposes.

#6: Define asset management guidelines for each of the funds

- Assets of the Dividend Fund" should be held in highly liquid assets at all times – deposits and short-term debt instruments.
- Assets of the Stabilization Fund should be held in liquid, international assets that are weighted toward fixed income instruments (of various maturities) but may also include other asset categories.
- Assets of the Savings Fund should be held in a diversified portfolio – bonds, stocks, and other assets that offer higher returns over a longer time period.

Each of the funds should be managed professionally (and internationally), though in consultation with Iraqi government officials. International management is advisable to maximize long-term financial performance of the various funds and to hinder the Iraqi government from using the funds as "captive source" of government financing. Fund management should be assigned on the basis of a competitive selection process. Each of the funds must be subject to regular and frequent external audits.

#7: Establish clear expenditure guidelines

✓ There must be clear guidelines that define permissible spending. Expenditures from the Stabilization Fund, for instance, should be spent only on items that can be quickly discontinued, will not create long-term spending obligations, and will provide the maximum amount of near-term economic stimulus. Funds maintained within the Stabilization Fund should also be capped.

IV. Conclusion

Given Iraq's extraordinary dependence on oil, careful management of its future oil revenues is critically important to build broad popular support, prevent erratic "stop-go" macroeconomic policies that characterize many oil-dependent economies, maximize financial returns, and strike a balance between Iraq's near-term, medium-term, and longer-term economic priorities. The above structure is recommended.

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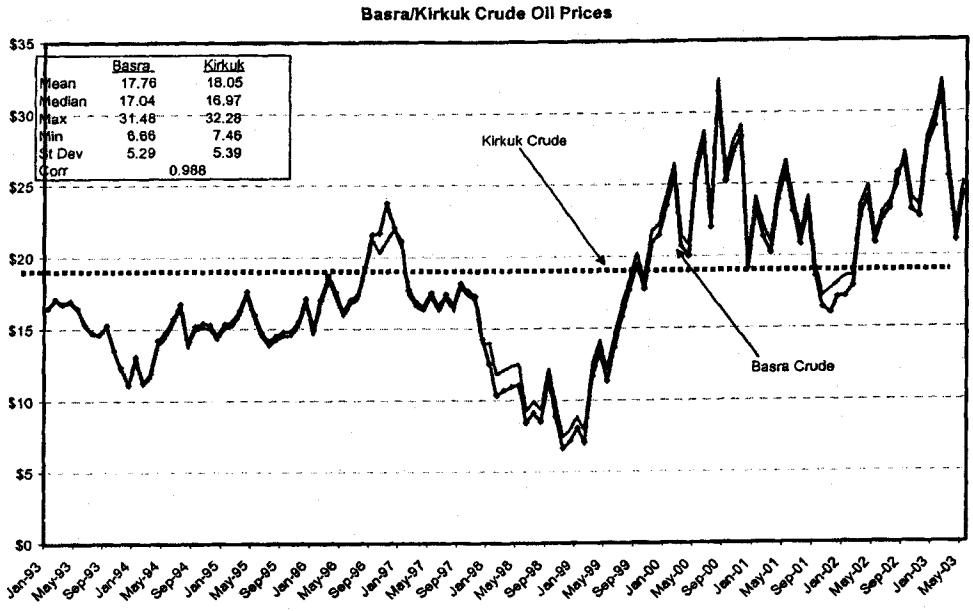
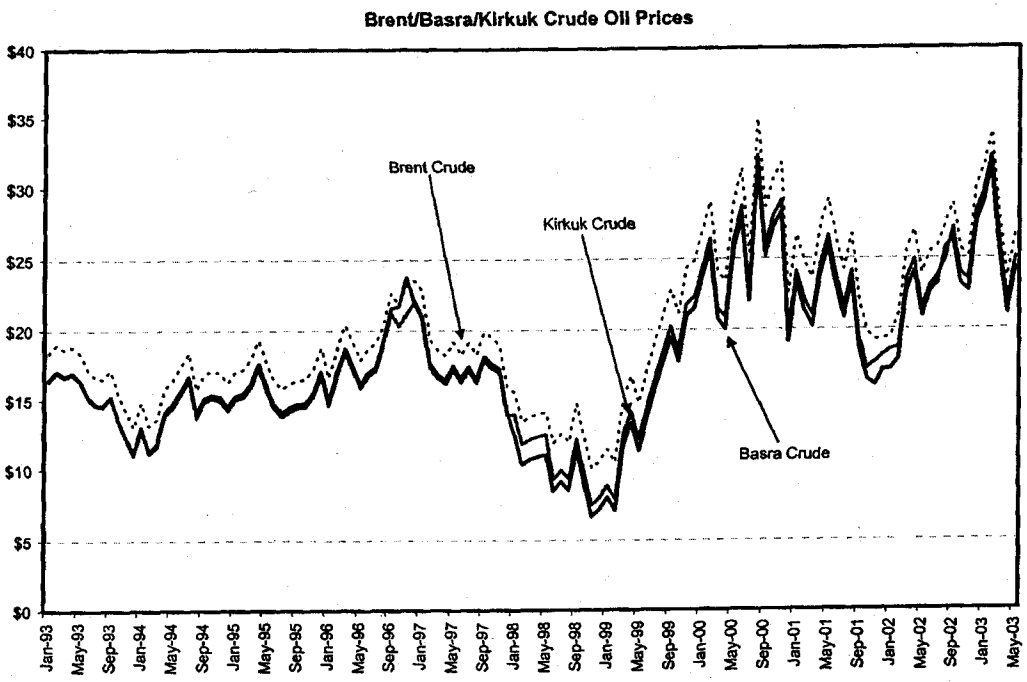
Appendix 1: Oil Price Simulations

The table below sets forth five different oil fund scenarios. The projections are highly preliminary and subject to *significant* change following further analysis, but do provide some basic sense of the range of payments that might be made depending on the priority assigned to this type of payment.

Simulations		Crude Oil Price	Annual Dividend Payment
Scenario #1		$15	$0
		$20	$0
Dividend Fund	10%	$25	$48
Stabilization Fund	40%	$30	$64
Savings Fund	50%	$35	$80
	100%	$40	$96
Scenario #2		$15	$0
		$20	$0
Dividend Fund	15%	$25	$72
Stabilization Fund	35%	$30	$96
Savings Fund	50%	$35	$120
	100%	$40	$144
Scenario #3		$15	$0
		$20	$0
Dividend Fund	20%	$25	$96
Stabilization Fund	30%	$30	$128
Savings Fund	50%	$35	$160
	100%	$40	$192
Scenario #4		$15	$0
		$20	$0
Dividend Fund	30%	$25	$144
Stabilization Fund	20%	$30	$192
Savings Fund	50%	$35	$240
	100%	$40	$288
Scenario #5		$15	$0
		$20	$0
Dividend Fund	40%	$25	$192
Stabilization Fund	30%	$30	$256
Savings Fund	30%	$35	$320
	100%	$40	$384


Basra/Kirkuk Crude Oil Prices
Basra Kirkuk
Mean 17.76 18.05
Median 17.04 16.97
Max 31.48 32.28
Min 6.66 7.46
St Dev 5.29 5.39
Corr 0.988
Kirkuk Crude
Basra Crude
$35
$30
$25
$20
$15
$10
$5
$0
Jan-93 May-93 Sep-93 Jan-94 May-94 Sep-94 Jan-95 May-95 Sep-95 Jan-96 May-96 Sep-96 Jan-97 May-97 Sep-97 Jan-98 May-98 Sep-98 Jan-99 May-99 Sep-99 Jan-00 May-00 Sep-00 Jan-01 May-01 Sep-01 Jan-02 May-02 Sep-02 Jan-03 May-03


Brent/Basra/Kirkuk Crude Oil Prices
Brent Crude
Kirkuk Crude
Basra Crude
$40
$35
$30
$25
$20
$15
$10
$5
$0
Jan-93 May-93 Sep-93 Jan-94 May-94 Sep-94 Jan-95 May-95 Sep-95 Jan-96 May-96 Sep-96 Jan-97 May-97 Sep-97 Jan-98 May-98 Sep-98 Jan-99 May-99 Sep-99 Jan-00 May-00 Sep-00 Jan-01 May-01 Sep-01 Jan-02 May-02 Sep-02 Jan-03 May-03