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Wolfe, George

From: (b)(6)
Sent: Thursday, August 28, 2003 10:13 AM
To: (b)(6)
Subject: FW: DesigningIraq Oil-GasSector.doc

DesigningIraq Oil-GasSector.do...   StatesandNOCs.ppt (43 KB)

Here is some more material on the NPC. I am very excited about this but I thing it is going to take some careful work to get it right, including how it fits into the trust which was presented yesterday to the Governing Council

-----Original Message-----
From: (b)(6)
Sent: Thursday, August 28, 2003 1:59 AM
To: (b)(6)
Subject: FW: DesigningIraq Oil-GasSector.doc

Dear (b)(6)

Robin West asked me write this short memo explaining what we had sent you in the past. It is rather rough around the edges and certainly needs a few edits. But in the name of speed I thought I would send it to you. If you have any questions please feel free to send them to me.

Best regards
(b)(6)
…ef Economist
…C Energy.

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Designing an Oil/Gas Sector and Choosing the Right NOC:
Its all about Priorities of the State

In countries with large oil and gas sectors, the design of the sector determines the type of government the country will have. As a result, the choice of a particular type of NOC[1] is not a politically neutral act.

A rentier state (where the state lives off mineral rents), which is typical of most oil producing countries (eg: Iraq under Saddam, Kuwait, Saudi Arabia, Venezuela, Ecuador, Nigeria, possibly even Russia) usually wants an NOC to possess good operating skills in order to maximize the states' short-term revenue needs. The NOC is not allowed to create its own strategy for long-term development in the way international oil companies (IOCs) do because that would require funds to be diverted for investments and reduce the short-term flows to the state. It would also like the employees of the NOC to be loyal subjects of their political masters.

Rentier states are usually authoritarian (Saudi Arabia and the other Gulf States) or at least ruled by a narrow clique (Venezuela before Chavez or what Russia is becoming). The rulers need the NOC to maximize short-term revenues in order to sustain extensive patronage networks and coercive institutions, which are the means by which they rule. Inevitably, this "short-ism" leads to two major problems over time: first, the under-investment in oil/gas capacity leads to declining production; second, the "Dutch disease" symptoms from excessive government spending precludes the development of a self-sustaining diversified economy. As a result, oil and gas revenues turn out to be insufficient to sustain political loyalty, which leads to political instability. Sometimes the government re-invites foreign companies to help sustain production and revenues in order to bolster the political system but in most cases that never proves sufficient and timely.

The Norwegian model stands in stark contrast to the rentier state system. When vast reserves of oil and gas were discovered, the social democratic (Scandinavian) political system structured the Norwegian oil and gas sector in a very different way then did the Saudis or the Venezuelans. They did this so that:

- The revenues would be fully accounted for,
- There would be maximum distribution without a few individuals intermediating between the collection and distribution,
- The state's earnings would be saved in the general pension fund for the people,
- The NOC (Statoil) would be given sufficient control over the sector to build an indigenous industry, but the government would directly own a sizable portion of reserves,
- A sizable portion of the oil and gas sector would be developed by international oil and gas companies, which would be given competitive terms so that they maintained investments over the long term,
- Contracts with the NOC and the IOCs required the use of local companies and technologies but due respect was given to costs and competitiveness.

[1] See attached Attachment slide 1 for Type of States and Type of NOCs and slide 2 for what different states *want* from different types of NOCs.

The Norwegian model was wildly successful in achieving its objectives. Norway's politics and fiscal accounts were not distorted by the oil/gas sector and its economy did not develop an unhealthy dependency on oil/gas rents. Norway was able to build up a huge pension fund (by 2015 it should have $350 billion for 5 million people). Foreign companies continued to invest in the sector even as the sector matured and under more and more difficult physical conditions. They overcame these difficulties through technological innovation. As a result, Norway at one time in the mid-1990s became the second largest crude oil exporter and an important supplier of gas to Europe. As for its NOC, Statoil was partially privatized and is now embarking on an international strategy to diversify and broaden its portfolio. It is seen as an important vehicle for Norway to export shipping, oil and other technologies.

One important point should be made: Although Norway was a relatively poor European country in the 1960s and 1980s, it had the luxury of having a fairly diversified economy at the time the oil and gas assets were discovered. It did not need those assets to develop its country and could take a longer-term approach to development.

Somewhere in between these two contrasting models lies Malaysia with its NOC, Petronas. In the mid-1980s, Malaysia could be generally characterized as a rentier state living off the rents from rubber, tin, cash crops and oil. The massive investments in education and infrastructure made in the 1970s (as part of the Bumiputra program) and the subsequent inflow of overseas Chinese, Japanese, Taiwanese and Korean investments in the late 1980s (a consequence of new foreign investment legislation, the Louvre currency accords, and the decline in commodity prices) gave the Malaysians an opportunity to diversify their economy. The oil and gas sector had been dominated by Shell and Exxon. Petronas was largely a state bureaucracy at best but it had endeavored to develop some technical prowess.

With the economy being transformed into an industrial economy, Prime Minister Mahatir allowed Petronas to develop a strategy to support this industrialization program and to become more of commercial company in and of its self. Petronas used Mahatir's global political connections to acquire assets overseas but more importantly it embarked on a "perimeter gas strategy" which sought to use Malaysian market power to buy gas from surrounding countries to ensure sufficient and economic supplies at home to support industrialization. As a result, industrialization and increasing non-oil revenues allowed the government to permit Petronas to retain funds for longer-term investments as part of a new development strategy for the company. This in turn allowed Petronas to support indigenous industrial development.

The bottom line: oil and gas sectors under Rentier states are designed to maximize revenues and therefore power for their rulers; industrializing states such as Asian tigers use their sector to support industrialization since economic growth is what sustains their leaders in power (Mahatir's famous quote: "Growth is like a river in flood it masks the rocks below"); and, social democratic states distribute revenues and reduce the negative effects on the productive economy. The latter two systems aim to achieve efficiency while the former strives for revenues.

Lessons for Iraq:

It is unlikely that Saddam Hussein could have financed his repressive system of government, his foreign adventures and his weapons programs without a rentier state system built on the country's vast oil and gas reserves. That allowed him political autonomy at home and huge resources. It is not inconceivable that another dictator or group of individuals will attempt to reassert primacy over the Iraqi oil/gas sector in order to further their political aims.

If the US government wants to avoid this, it behooves policy makers to create an oil and gas sector, which diffuses political power, encourages transparency and accountability of revenues, and incentives for long term investment in the sector. The sector must also not interfere with the longer-term development potential of the greater economy, which is blessed with sufficient water and agricultural resources, human capital and some experience with industrial development, albeit distorted for military ends. But out of necessity and as the only current source of revenues, the sector must be used to "kick-start" the development process.

In order to meet these goals, the national objectives for Iraq should be:

- Maximize revenues in the short-run to support the government's budget needs. This will help reestablish what has become a "failed" state.
- Ensure growth in revenues over the longer term to provide funds for national development. This will overcome the trap faced by rentier states and could form the basis, if the funds are deployed effectively, for the new Iraqi productive economy.
- Enhance sectoral efficiency and best practices. This is another means towards long-term sustainability of the sector, revenues and reduces the chances of environmental problems. This must be achieved through a balance of national talent and foreign investment.
- Exploit national talent and resources fully. Iraq possesses the cadre to re-develop the sector and should be redeployed. Effective use of this cadre will also reduce charges of foreigners stealing the national resources.
- Ensure funds are not squandered or misplaced. The looting of the treasury by local or foreign groups would quickly undermine the effort to resurrect the state.
- Ensure the control of funds and resources do not lead to political monopolies or misused for military reasons. This is essential to avoid a return of the authoritarian rentier state.
- Ensure that revenues go to the national government benefiting all Iraqis equally and ensure regional elites do not "capture" oil revenues to improve their relative power or autonomy. The centrifugal tendencies in Iraq creating conditions for a potential break up of the country are quite strong. If local and particular groups get access to part of the oil/gas resources, the country is guaranteed to fracture.
- Ensure that current power brokers in the Iraqi Governing Council have little say in the design of the oil and gas sector and are not allowed to be agents for foreign or local interests.

The Iraqi oil sector should be designed along the following lines:

An effective government agency should establish Iraq's energy policy, regulatory environment and financial controls.

- A Ministry of Oil and Gas should be established independent of the Iraqi National Oil Company (INOC).
- The Ministry should set a long-term strategy for the oil and gas sector after assessing national resources.
- It should set the annual development plans of INOC.
- It should set the contractual terms and determine the assets that are going to be offered the foreign oil companies.
- It should be manned by local talent with foreign government technical assistance.

The Parliament should have oversight over the Ministry – in the early years the UN and/or World Bank should also be entrusted with oversight and review:

- A parliamentary committee should review the ministry's activities in the areas of finance, resource development, contract awards and best practices.
- Oil revenues accruing directly to the government (see below for those being channeled elsewhere) should be paid into a Ministry of Finance account with oversight from the budget committee in parliament.
- A parliamentary committee should review all awards (service work or future investments and contracts on new oil fields). Severe penalities should meted out to companies and government officials involved in corruption. Companies involved should be banned from

working Iraq for 5 years. Apart from being prosecuted, government officials should be scrutinized for all their awards if found guilty, which would cast a shadow on all contracts and dissuade companies from seeking out corrupt individuals. The World Bank and the UN should be intimately involved in the awards process.

The Iraqi National Oil Company should be revived using existing talent and assets:

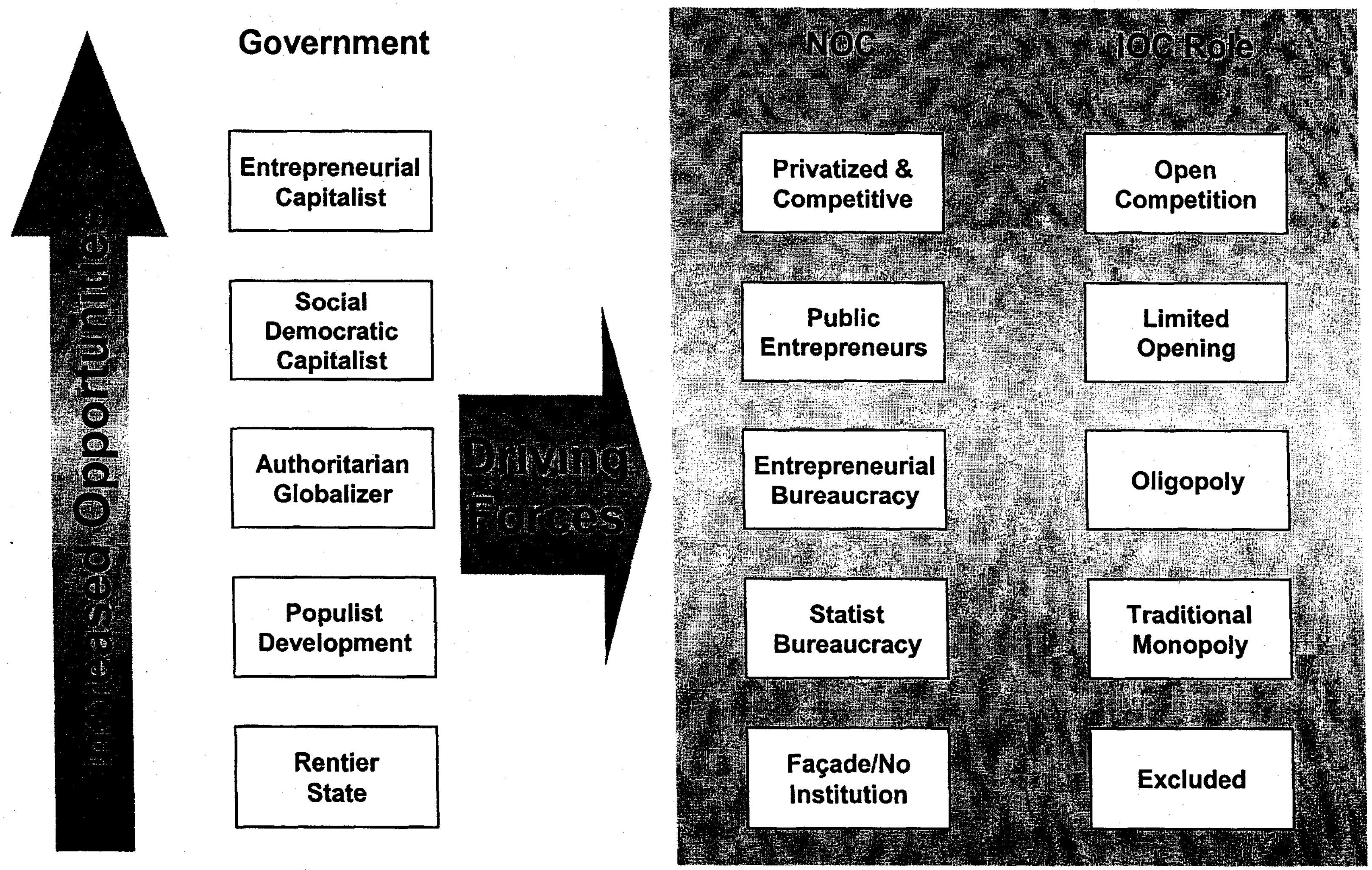
- INOC should be allowed to retain control over current capacity.
- Long-term bilateral and multilateral funds should be provided to it immediately to revive this capacity – avoid expensive and burdensome debt financing in the short run.
- INOC should be a participant in the development of new assets beyond current capacity in joint-ventures or other arrangements with international oil companies.
- After twenty years, INOC should be prepared for partial privatization.

Ensuring long-term growth in the sector and avoiding the short-term trap:

- The Ministry of Oil and Gas should identify assets beyond INOC's current assets that can be developed using foreign company resources and technology.
- Contracts should reflect realistic risk assessment (in other words, this is a very prolific sector so terms can be fairly tough for the foreign oil companies) in order to maximize returns to the government. This will also avoid charges (if terms are made as transparent as possible) of carpet bagging.
- Signature bonuses should go to a national development fund for infrastructure. This is so long-term national development is aided by oil/gas sector development and it will avoid the temptation to put oil revenues in the general government spending, which invariably supports consumption.
- Royalties from new development should be placed in a highly visible fund to enhance health and education with an eye to later building a pension fund. This will directly benefit ordinary Iraqis and help them build a stake in the system.
- Taxes from the new developments should revert to the general government budget.

This three-pronged effort would ensure that corruption and political monopolies do not reappear. It would also ensure that national skills and talent are exploited effectively. And it would make provisions for long-term growth and development.

State Types and Implications For NOCs/IOCs



What STATES Want From NOC & IOC:

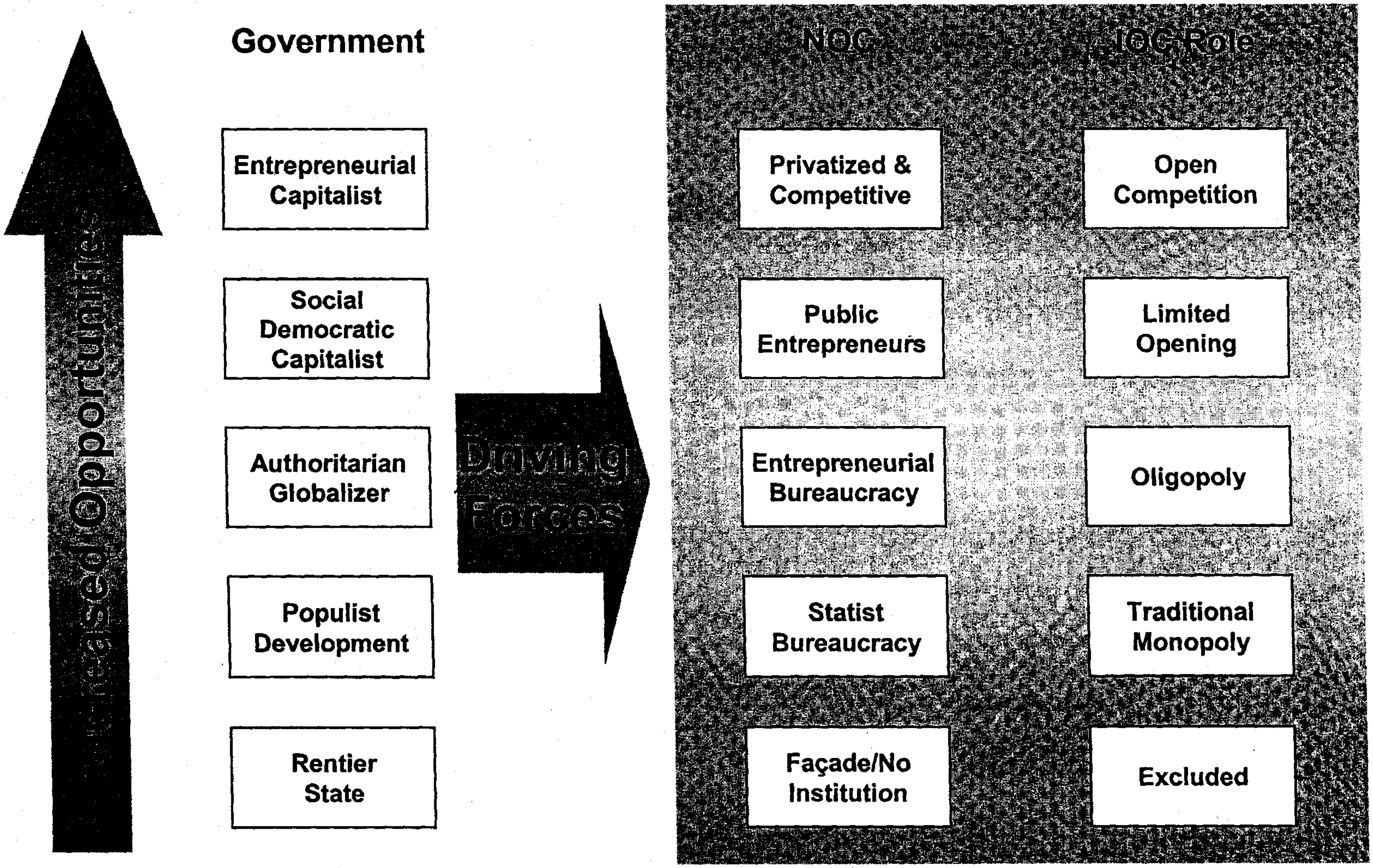
Depends on Own Objectives

Government Type	Economic/Social Objectives	NOC To Provide	IOC Role
Entrepreneurial Capitalist	Efficiency Private Sector Competition	Privatize into One or More If One Exists	Sole Role Competitive
Social Democratic Capitalist	Distribution Private Sector Stability	Fair Priced Resources; Meet Social Concerns	Competition; Capital; Technology
Authoritarian Globalizer	Efficiency Mixed Economy Growth	Support Industrialization and Growth	Capital and Technology
Populist Development	Distribution State Led Growth	Revenue To Government; Meet Social Concerns	What NOC Cannot: Capital; Markets; Tech.
Rentier State	Revenue State Led Stability	Revenue To Government; Meet Social Concerns	What NOC Cannot: Capital; Markets; Tech.

Definition of NOC Types

- FAÇADE: A ‘front’ company; all decisions made by govt.
- STATIST BUREAUCRACY: A functioning company with a set of operational skills, but government sets strategy
- ENTREPRENEURIAL BUREAUCRACY: A company with more independence in finance, planning and implementation
- PUBLIC ENTREPRENEURS: A company that operates like an IOGC but is owned by the State
- PRIVATIZED and COMPETITIVE: A privatized company previously state owned and joins the ranks of the IOCs

State Types and Implications For NOCs/IOCs



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