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SUBJECT: BASRA: LOCAL DISSATISFACTION GROWS IN FINAL RUN-UP TO FIRST OIL BID ROUND

¶1. (C) Summary. In the run-up to the long-awaited and possibly historic late June-early July first round oil auctions, a growing opposition to the plan has emerged in Basra Province, where three giant oil fields are included in the first round, and state-owned South Oil Company (SOC) holds sway. If the first round goes as planned, a significant influx of international oil companies (IOCs) could soon ramp up production in the region. But with this increase in activity, the prospect of greater Baghdad control of revenues and operations, a less independent SOC, and greater transparency has raised resistance in some circles. And while the prospect SOC and worker resistance, and some observers' fear of sabotage might be overstated, overall resistance to any wholesale changes is evident. While SOC officials, its workforce, and some local politicians have called for a scrapping of the first round, other leaders are more sanguine, and ascribe this resistance to politics and an attempt to maneuver for position under new operating rules. In any event, if the first round goes forward, it could mark the beginning of the most significant event in Iraq's oil industry in decades. End summary.

Countdown to first round oil/gas licensing round

¶2. (U) In what industry analysts are calling a watershed event in Iraq's hydrocarbon sector, the GOI appears set to go forward on its late June-early July first licensing round. Thirty-two firms are expected to bid for the right to revive production at six developed oil fields and two undeveloped gas fields that

have suffered from years of war, sanctions and neglect, and could pump in an estimated \$50 billion in investments in the next five years (refs A, C). The Government of Iraq (GOI) hopes this first round will increase national production to six million barrels per day (bbl/d) by 2014, up from the current 2.4 million bbl/d, and raise badly-needed revenues. Contracts run for 20 years, with a possible five-year extension. Within Basra Province, the giant Zubayr, Rumaila, and West Qurna fields are up for bid. A second round auction is planned for late 2009, which could increase production by another 2.5 million bbl/d over five years. Although Iraq sits on the world's fourth largest proven oil reserves (115 billion barrels, after Saudi Arabia, Iran and Canada), security, bureaucratic, and infrastructure problems have left them largely untapped. There are about 80 oil and gas fields in Iraq, but only 15 of them are producing.

¶3. (U) Production will be run via technical service contracts, unlike more common production-sharing schemes found elsewhere, in a joint venture between the IOC and SOC, in the case of the three Basra fields. SOC will continue as sole owner and operator of the fields, with IOCs providing investment and expertise. Assuming production increases in line with targets, IOCs will recover costs and receive a fee in dollars or oil. The fields will be jointly operated Field Operating Divisions (FOD), controlled by the GOI and IOC.

New joint venture rules might affect South Oil and Basrawis

¶4. (C) Under these joint ventures, operations are expected to be more transparent than is now the case with SOC, where industry analysts have long alleged that theft, lack of metering, and under-reporting of revenue can occur. However, for many Basrawis, the new rules will unfairly tilt control and revenues too much in the favor of the GOI and the Ministry of Oil (MOO). Basrawis widely contend that, given that SOC produces and

exports roughly 70%-80% of Iraq's total crude, they deserve higher revenues and a greater say in operations, and fear new rules that might leave them begging to for GOI revenues. Some PRT Basra contacts also contend that at least some of SOC's largesse is also spread to rehabilitate the city and province's public infrastructure -- schools, parks, roads and hospitals -- which has contributed to a palpably more spruced up city in recent years.

And could open up a hornet's nest

¶5. (C) Some PRT contacts have alleged that some SOC funds also must pay "protection" money, an allegation which the PRT cannot independently verify. Norway-based Petronor oil company representative Hans Hoisker, who has done business in the Basra for 19 years, claims that some SOC money "ensures that operations and transportation run smoothly, with no delays," and are spent on "certain tribes and trucking companies why do you think there has not been any sabotage in recent months?" Hoisker in fact credits the last two SOC Directors General (DG), Jabbar Al-Laebi (now a senior MOO advisor) and Kifah Numan for "doing a good job spreading the wealth, allowing a bit of pilfering, and keeping SOC and Basra together," for which "Basra and Iraq owes a lot to SOC." For Hoisker and other local analysts, this system, as flawed and unpalatable it may be, has worked, and radically different new rules could threaten these arrangements, even if they're expected by IOCs. Hoisker stated flatly: "it is impossible for oil [in Basra] to flow if anyone along this 'supply chain' is unhappy."

¶6. (C) Hoisker also expresses some concern that SOC's 12,000-strong security force, tasked to protect pipelines and installations, could also become "restless" if not satisfied if enough money is not spread their way. While the force is said to have been recently and formally transferred from SOC to the Ministry of Interior, Hoisker said "I'm not sure if they really

have full control." While under SOC, and during the previous, Fadhilah-controlled government (also widely accused of pilfering), some contacts said it acted at times like a virtual Fadhilah militia.

SOC DG opposes first round

¶7. (SBU) Meanwhile, the rivalry between SOC and MOO continues. Newly installed SOC DG Fayad al-Nema upset the Iraqi oil establishment and IOCs on June 14 when he urged that the first round be scrapped. SOC engineers also mounted a petition drive against the plan. On June 26, the prime minister of the Kurdistan region also announced his opposition to the auction. MOO Sharistani himself was grilled in Parliament last week, accused of "giving away" Iraq's resources.

¶8. (C) Sharistani was said to have felt betrayed by Fayad, having handpicked him for the job just last month, with the backing of Prime Minister Maliki; Fayad is also a Da'wa/State of Law political ally of them both (ref E). According to media reports, Fayad's comments were not well received by IOCs, either, given that billions in investments are on the line, and millions have already been spent preparing bids. The IOCs could now face the prospect of uncooperative and unwilling local partner. Fayad has already established a reputation in Basra for opposition to IOCs: Basra representatives of U.K.-based oil services company Mott McDonald, a subcontractor for Shell's gas project (refs B, F), said that Fayad is "openly hostile" to IOCs, and regularly obstructs access to oil fields that Shell needs to visit in order to prepare for its gas project.

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Oil workers entity opposes deal, issues warning
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¶9. (C) In a June 23 meeting with PRT EconOff, Iraqi Petroleum Workers Union head Muhammed Ali Hassan said that his union also

opposes the first round, and "Iraqi workers alone are capable of increasing production, we don't need foreign companies, and we don't need outside help." He said that if this first round goes forward, IOCs should "stay out of Iraq, because we cannot guarantee their safety."

¶10. (SBU) Note: It is hard to gauge the legitimacy of Ali Hassan's "union" (or his threat), which claims to represent 36,000 Iraqi hydrocarbon industry workers outside of the Kurdistan region. Iraq has never legally established the right of oil and gas workers to organize; under the Saddam era, such unions were banned. This "union" was established in 2003, has no legal basis, and relies on voluntary member contributions. In 2008, the group claimed responsibility for a small act of sabotage against a Basra Shell facility, and passed out anti-Shell pamphlets. At the same time, Ali Hassan said that his union is not against private sector participation in principle, as long as it is "within the law, and does not infringe on Iraqi sovereignty." End note.

"The GOI should have auctioned second round oil fields first"

¶11. (SBU) Some GOI officials and private sector reps contend that the GOI should have first opened up the eleven largely undeveloped fields identified in the second round, and only later offered up the more developed fields of the first round. Politically, second round fields are popular, as they infringe on few if any vested interests, and prospects for production and jobs can only improve. For these advocates, the GOI wasted two years promoting the first round. (Note: Some petroleum analysts opine that IOCs might experience legal uncertainties operating in these less developed fields. End note.)

Political football

¶12. (C) Some observers predict that a successful first licensing round can and will be used by the opposition Fadhillah party in the run-up to the January 2010 national elections, in hopes of regaining political strength in the province. A local electorate could be open to conspiracy theories pitched by the Fadillah party. Already, the Da'wa-dominated Basra Provincial Council (BPC) (and GOI) face charges of "neocolonialism" and "selling out" SOC to the west (even though the PC plays no role in this first round). However, according to Ihsan Abdul-Jabar, senior SOC engineer and member of the Basra Investment Commission, despite these objections, the "first round will go forward, it has the strong support of Maliki and Sharistani," and "they have the power to make the deal work." On SOC DG Fayad, he said "they will likely replace him soon anyway."

Crunch time

¶13. (SBU) One factor that could favor the first round is the provincial council's perilous finances, severely impacted by declining oil revenues (ref D). Some analysts predict that provincial salaries will need to be renegotiated, even if crude prices remain at their relatively higher level. According to local United Nations and Mott McDonald reps, some sub districts could start to run out of money as early as July, and already many planned capital projects are on hold. The prospect of IOCs creating new jobs will be most welcome. And while world crude prices have increased from around \$50/barrel in April to around \$70 today, Basra crude is discounted by around \$15-\$20 due to its poor quality and transportation costs. In addition, according to industry reports, SOC suffered a 100,000 bbl/d decline in 2008, and faces further declines ahead. SOC has papered over this decline by maintaining its export levels, and sending less crude to local refineries, all while facing pressure to comply with the MOO's "crash" production program.

Comment

¶14. (SBU) It is hard to sort out just how strong local resistance really is to a first round contract award, and how much of it might be due to politics. Some of this opposition is also likely attributable to interested parties jockeying for position under new rules to come, and staking out bargaining positions for still-to-be-negotiated final contract details and subcontract tendering after awards are made. Some local observers are still hopeful that there still exists room enough for all sides to come to an agreement. However, one thing is certain: if all goes more or less according to plans, and despite the opaque nature of Iraqi business and politics, this first round oil licensing round could indeed be the beginning of the most significant development in the Iraqi oil sector in the last four decades.