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Research Memorandum

U.S. DEPARTMENT OF STATE
DIRECTOR OF INTELLIGENCE AND RESEARCH

RNA-10, February 27, 1969

To : The Acting Secretary
Through: S/S
From : INR - George C. Denney, Jr. *h.c.d.l.*

Subject: Iraq: The National Oil Company Takes Action to Develop the Disputed North Rumaila Oilfield

The Iraq National Oil Company (INOC), an Iraqi governmental agency, reportedly has sent formal invitations to thirteen (unspecified) companies to submit tenders for preparing (on a turnkey basis) the North Rumaila oilfield for production. Such an action by INOC would end speculation on the nature of the oil policy of the Baathist regime in Iraq. It would appear to be identical with that of the previous 'Arif government. This paper examines the new action and its implications.

ABSTRACT

The overthrow of the Iraqi government headed by 'Abd al-Rahman 'Arif raised some hope in Western circles that Iraq's long-standing disputes with the Western-owned Iraq Petroleum Company (IPC) might be amicably settled. However, the new regime of Ahmad Hasan Bakr has now reportedly taken steps which indicate that its oil policy will be essentially the same as that of its predecessor. This would mean that, whatever else might happen, IPC will not get back the concession areas that the Iraqi Government unilaterally took from it in 1961, the most important of which was the known oilfield called North Rumaila.

The Bakr government has stated that it will honor the commitments of the previous regime to the French government-owned oil company ERAP, which had entered into a contract with INOC, the Iraq National Oil Company, to explore for and produce oil in certain areas still claimed by IPC. The new government's

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call for bids for the preparation of North Rumaila for production indicates that, like the previous government, it has decided to have INOC handle the development of that field itself--by hiring whatever skills it may need, rather than by turning over the field in toto, either under a managerial contract or by concession, to a foreign oil company.

Before the change of government (and of INOC's management), INOC had held discussions with several companies on just such an in-toto contract but was dissatisfied with the net return it was offered by the companies. Whether its own method of development of the field will yield as much as it might have received from a foreign oil company is highly questionable. Moreover, it will now have no built-in sales agreement for the oil, a usual feature of in-toto contracts, and IPC has indicated that it will use whatever means are available to block any sales attempted by INOC.

It remains to be seen what IPC actually can or will do in this respect. An attempt, particularly a successful attempt, to block Iraqi exports of "IPC's" oil could mean that in spite of the resultant probable loss to Iraq, the government would nationalize IPC's remaining holdings--its producing fields. On the other hand, the major shareholders of IPC (British Petroleum, Shell, Esso, Mobil, and the Compagnie Française des Pétroles) have important oil concessions in other countries that might be endangered if IPC does nothing about Iraqi exports of oil from expropriated concession areas. The governments of these other countries might decide that if Iraq could expropriate and not be penalized, they could do the same. IPC hopes that Iraq can be persuaded to pay some compensation for North Rumaila (and the other areas as well), which would more or less legitimize the takeover. Otherwise, the company's alternatives are not very attractive.

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The Background in Brief

The Iraq Petroleum Company (IPC) and its affiliates, the Basrah Petroleum Company (BPC) and the Mosul Petroleum Company (MPC)* formerly held (and in their own view still hold) oil concession rights over most of Iraq. In 1961 the Iraqi Government unilaterally rescinded these rights except in the limited areas where the companies were already producing oil. The choicest of the areas taken from the companies was one known as North Rumaila, where an oil-field, which is an extension of the South Rumaila field already under production by BPC, had been located and on which work had begun, including the drilling of productive wells. The field had not, however, been developed to the point of tying the wells in with BPC's existing collection system or of constructing a new system. For many years after 1961, succeeding Iraqi governmental regimes had been unable to come to any final decision on what to do with the concession areas taken back from IPC and its affiliates.

The Oil Policy and Actions of the 'Arif Regime

Finally in 1967, under the 'Arif regime, the preempted areas were definitively assigned to the governmental oil company INOC, which was empowered to develop them itself or in conjunction with others but not under a concession type of agreement. INOC entered into a contract agreement with the French governmental company ERAP (Entreprise de Recherches et d'Activités Pétrolières), under which ERAP would explore for and produce oil in certain limited areas in southern Iraq for INOC's account and would be permitted to purchase at an attractive price a portion of the oil it might produce. The North Rumaila field was not included in this agreement. Negotiations were also undertaken with a Yugoslav company leading reportedly toward an ERAP-type contract for another small area in southern Iraq (not North Rumaila), but no agreement had been signed by the time the regime was ousted. On North Rumaila itself, there were negotiations with several foreign companies, but INOC finally announced that the offers made by these companies were not sufficiently attractive and INOC would develop the field itself.

INOC Plans for North Rumaila

The general outline of INOC's plans called for a first phase of development which would take about two years and cost six million Iraqi dinars (\$16.8 million). This stage would result in an annual production of five million

* These three companies have the same shareholders in the same percentages (British Petroleum, 23.75%; Royal Dutch/Shell, 23.75%; Compagnie Française des Pétroles, 23.75%; Near East Development Cooperation, i.e., Standard of New Jersey and Mobil in equal shares, 23.75%; and Participations and Explorations Corporation, belonging to the Gulbenkian estate, 5%). The three companies (IPC, MPC, BPC) are usually referred to collectively as IPC.

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tons of oil. The profits from oil sales would be utilized to expand production in the second phase to eighteen million tons a year. The oil would be marketed through long-term contracts with independent refiners, and INOC claimed to have a number of contract offers. Since neither INOC nor any other Iraqi company or organization was capable of handling the development of a new oil-field, there was speculation that it might be done with the aid of Soviet or Eastern European technicians and equipment or by hiring various specialist companies to undertake different parts of the job. In fact, some well-drilling companies operating in the Persian Gulf area were approached but turned down the opportunity because they were reluctant to get on the wrong side of the powerful shareholders of IPC. Discussions were also held with an Italian consulting engineering firm (Techint) and with the National Iranian Oil Company (NIOC) over the possibility of their providing assistance in developing the field. Finally, the commercial attachés of various foreign embassies in Baghdad in late April 1968 received a letter from the then Chairman of INOC announcing that INOC would soon be inviting suppliers and contractors to tender, on a turnkey basis, for projects involved in the development of North Rumaila. The attachés were informed that if any companies or organizations of their countries should be interested in tendering, INOC would be pleased to discuss the subject with them.

The letter also outlined the work to be done. The first phase--to develop an export capacity of five million tons of oil a year--was to consist of work-over and completion of five wells, installation of the necessary production and field facilities, construction of 130 kilometers of 16-inch pipeline, and improvement of terminal and leading facilities. The "five wells" are presumably those already in existence--drilled by BPC before the Iraqi Government excluded the company from the North Rumaila area. The terminal and leading facilities are also in existence, although they may need some reworking and updating. In order to avoid another confrontation and some sticky questions of valuation, BPC has offered to turn over to INOC its old terminal facilities at the port of Al Faw (Fao) near the mouth of the Shatt al-Arab, now unused except in emergencies, since BPC has a newer deep-water terminal offshore at Khor al-Amaya. The second phase--to raise export capacity to eighteen million tons a year--was to consist of the drilling and equipping of twenty wells, installation of the required production and field facilities, 150 kilometers of 32-inch pipeline, and an offshore loading terminal with submerged pipelines. It was intended that all contracts be awarded on a turnkey basis; however, "other suitable alternatives [would] also be considered." Presumably, a company with the necessary qualifications could bid on more than one, perhaps all, of the stages of each phase.

The Oil Policy of the New Regime

After the change of regimes in Iraq in July 1968, the new (Bakr) government announced that it would honor the ERAP contract, which had been under heavy fire from Iraqis and other observers who considered it too favorable to ERAP. As for North Rumaila, the first indication of the new government's approach was a tentative inquiry as to whether BPC would undertake a contract to produce and deliver certain quantities of North Rumaila oil through its own facilities

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to Al Faw for INOC's account. The Government did not follow up this idea, and it would now appear that the new regime has adopted more or less in toto the plans of the old regime. The thirteen companies to which invitations to bid have reportedly been sent are probably those which indicated their interest in response to the letter or letters sent out by the former regime. They are believed to include firms (or state agencies) in Eastern Europe, in some Western European countries, and in Japan, but not in the US or Britain. No new disclosures have yet been made to indicate what arrangements the new regime contemplates for financing the development of North Rumaila and for marketing the oil but presumably they too are more or less the same as those the old regime had in mind. The cost of the first phase of development, although it may turn out to be substantially greater than the original estimate of about \$17 million, should not be beyond the resources of the Iraqi Government, particularly since the successful contractor will probably have to provide, or assist in finding, at least partial medium- or long-term financing for the project. Some contracting companies or organizations might well be willing to take payment in oil, when it is available. Even if first-phase development costs should run as high as \$25 million, this amount would represent little more than half a year's output of oil at the five-million-ton rate.

The Profitability of North Rumaila Under INOC Management

Reportedly, when the development of North Rumaila under an ERAP-type contract was being negotiated by the previous government, the highest offer made by any interested company would have netted INOC \$1.12 per barrel of oil. Although INOC did not publicly reveal the offers that were received, it did announce that they were not good enough and gave an estimate of what it could expect to realize by going ahead on its own. Net return was estimated at \$1.20 a barrel, assuming a posted price of \$1.76 a barrel, a discount of 40 cents (since posted prices now bear little relation to realized prices), and production costs of 16 cents a barrel. INOC may yet be sorry the \$1.12 offer was not accepted. In the first place, the posted price at the crude oil terminal of Khor al-Amaya for crude with an API gravity of 34.0-34.9 degrees is \$1.70, not \$1.76. Oil from the main pay zone of the North Rumaila field is reportedly of 34.5° API gravity and from the other two known lesser pay zones is 33° and 27° API. If INOC chooses to shut off the subsidiary pay zones and draw only from the main zone, the posted price would still be only \$1.70. With a discount of 40 cents a barrel and production costs of 16 cents, the net profit would be reduced to \$1.14 a barrel. INOC could, of course, reduce its discount to something less than 40 cents. With Persian Gulf realized prices continuing to slide downhill, and considering the risks a purchaser would run in contracting with the less-than-reliable Iraqis while incurring the displeasure of not only IPC's shareholders but probably many other oil producers as well, INOC could well find itself compelled to offer more than a 40-cent discount. Moreover, the 16-cent production cost assumed by INOC is presumably based on BPC's costs for the South Rumaila and Zubair fields. It will be somewhat surprising if inexperienced and inefficient INOC, even with outside technical assistance, can keep

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its unit costs on a relatively small volume of production down to the level attained by the experienced BPC on a considerably larger volume.

It is true that INOC's initial capital costs will be low--with no exploration necessary, with the initial wells already drilled, and with the terminal facilities already in place--but presumably the second phase of development, involving full capital costs, will begin as soon as the first phase is completed. Even when the second phase is completed, the expected production of 18 million tons a year will approximately equal BPC's 1964 output, in which year BPC's costs were over 19 cents a barrel (not including payments to the government). With a 40-cent discount and costs of 19 cents a barrel, INOC's net return even on its second-phase production would be one cent less than the highest offer by an outside company, and there is reason to believe that INOC will be extremely fortunate to do that well. However, whether or not INOC makes the profit it hopes to make, it will undoubtedly make a profit, provided it can sell the oil. Inefficient as it may be, its production costs can hardly be expected to rise to the point of eliminating all profit, even if it finds that it must offer a more substantial price discount on its sales than it had expected to give.

Can INOC Sell Its Oil?

It is probable that INOC could dispose somewhere of at least the first-phase production of five million tons a year from North Rumaila. One fairly large refinery could take it all, although a refinery with a capacity of five million tons might be reluctant to tie itself to a long-term contract with one possibly erratic supplier and would probably need more than one grade of crude. How much success IPC or its shareholders would have in any attempts to prevent consummation of sales through legal actions or commercial pressures is questionable. It is unlikely that they could close all doors, even in free-world countries, let alone in Eastern Europe. The French Government, for instance, has obviously chosen to ignore IPC's claims to its former concession areas in Iraq, since ERAP has entered into an oil production contract with INOC for certain ex-IPC territories. In fact, ERAP may be one of the thirteen companies INOC has invited to bid on the development of North Rumaila. The French Government is aware that its regulatory powers give it a life-and-death hold over the very substantial refining and marketing interests of the IPC shareholders in France. Any attempt to prevent ERAP from lifting the oil it may find in Iraq or, for that matter, from developing North Rumaila and buying the oil from INOC, would almost certainly provoke French Government retaliation.

What Will IPC Be Able To Do?

It remains to be seen what IPC can or will do when INOC or its contractors begin to export oil from Iraq. When the Anglo-Iranian Oil Company's Iranian holdings were nationalized in 1951, the company, assisted by the other major oil producers (and by Iranian ineptitude as well) was able to prevent more than

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token sales by Iran, most of which were subsequently immobilized by litigation. However, the major oil companies at that time controlled ninety percent or more of the available market and controlled or were able to influence most of the available tanker transport. This is no longer true to the same extent, especially now that Eastern European countries are looking for crude from other than Soviet sources. There would seem to be relatively little IPC could do either by legal action or commercial pressure against the Eastern European countries or in fact against a number of the less-developed countries in the free world, unless for instance, the tankers carrying the "misappropriated" oil were to put in at a port where it would be possible to take legal action to attach their cargoes. Pressure brought to bear upon tanker owners to refuse to charter to INOC or its oil purchasers would presumably have no effect upon Communist country tankers, and some free-world owners willing to take a risk could probably be found, especially as within a couple of years the tanker market is likely to be glutted again. Moreover, Anglo-Iranian was free to go all out against Iran since it had nothing left to lose there. IPC has a good deal more to lose in Iraq, and while the Iraqis would themselves undoubtedly take a heavy loss by nationalizing IPC's present producing fields, their emotional response to "imperialist pressures" might well persuade them to do it at whatever cost.

The Other Side of the Coin

On the other hand, if IPC does nothing to prevent the lifting of "its" oil by INOC, ERAP, or other oil purchasers, or if it makes the attempt and is notably unsuccessful, other producing countries in which IPC's shareholders have important interests might consider that the door was open for them to do what Iraq has done. The Iranian Government, for instance, has already threatened to take over a producing field from the Iranian Oil Consortium. The Iranians appear to be taking considerable interest in the outcome of Iraq's venture into the partial unilateral abrogation of its concession agreements.

When Does the Crunch Come?

The question of preventing Iraqi sales of oil will probably not arise in the immediate future. INOC, or at least its previous management, had estimated the time required for the first-stage development of North Rumaila at about two years, to which must be added the time it will take to come to agreement with a company (or state agency) over the details and the price of the job. At present, the Iraqi Government seems incapable of making final decisions on anything, let alone a sensitive and complex subject like oil development. ERAP, which has drilled one dry hole in Iraq, might take somewhat less time than INOC to begin exporting if it finds oil but probably not much less than two years. It may be noted that IPC has taken no legal action to prevent ERAP from exploring and drilling for oil in areas still claimed by IPC. Legal action in Iraq would presumably have been useless, but it might have been possible for IPC or some of its shareholders to proceed against ERAP in France. However, any such move, certainly if it were successful, would have invited retaliation by the French Government. Whether IPC can take legal action against companies

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that might undertake the development of North Rumaila for INOC would depend upon their country of origin. If the "company" were an Eastern European state agency, it seems improbable that anything could be done, and if it were French, it might be impolitic to do anything.

If there then appears to be no prior action that is useful or desirable, IPC has two or three years before it must finally decide whether or not to go all out to block, or attempt to block, Iraqi exports of oil. Presumably, IPC is devoutly hoping that something will happen in the meantime to obviate the decision--e.g., a settlement of some sort that will at least partially compensate IPC for its loss of concessionary rights and make it appear that Iraq did not get off scot-free with its unilateral abrogation of those rights. In fact, Iraq will not have got off scot-free even if it is able to sell oil with no difficulty. It has sacrificed hundreds of millions of dollars in potential revenue from the increased production that might have been expected during the seven years or so that have already passed since IPC was precluded from further exploration and the development of new fields. However, this thought might have little effect upon governmental officials of other producing countries, who might believe that they would not be afflicted by the same indecision as the Iraqis and could immediately increase their country's total production by a similar abrogation of existing concession rights.

Conclusion

IPC's choices in this matter, assuming no settlement with the Iraqi Government, are not attractive. If the company (or its shareholders) succeeds in blocking INOC's sales, IPC may lose its remaining highly valuable properties in Iraq. If the company does nothing or, even worse, if it tries to block the sales and does not succeed, its shareholders' properties in other countries may be endangered. It will seem, at least to the less discerning, that abrogation of concessions incurs no penalty. Although IPC is not renowned for flexibility and appears at present to be determined to take action if there is no settlement of its dispute with the Iraqi Government, it remains to be seen what it will and can do when the time for action arrives.

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