

## Iraq's 4th oil and gas licensing round

### Introduction

Since 2008, Iraq has been conducting a series of high profile oil and gas licensing rounds with the Iraqi Government's strategy being to increase its energy reserves and raise oil production from current levels of 2.5 million barrels per day ("BPD") to 6.5 million BPD by 2014.

With the country having amongst the highest oil and gas deposits in the world (with proven reserves of 143.1 billion barrels of oil and 111.9 trillion cubic feet of gas), the previous three licensing rounds have been hugely popular, with the major international oil companies ("IOCs"), including BP, Shell, Total and Eni, competing hard and, in the process, accepting tough contract terms to secure a foothold in the region.

The 4<sup>th</sup> licensing round involved the auction of seven gas and five oil sites, with the focus for the first time being on the gas sites.

The results were announced on 30 May 2012 and, for the reasons considered below, display a far more muted response from the IOCs, with successful bids being received for just one of the gas exploration sites and two of the oil exploration sites.

### Lack of proven reserves

Each of the previous three licensing rounds offered rights to immediately commence or raise output at large and medium sized sites with proven reserves. The 4<sup>th</sup> licensing round on the other hand only involved areas with undetermined levels of hydrocarbons on offer.

There was therefore little or no guaranteed return for the bidding IOCs and Abdual Al-Ameedi, the director general of Iraq's Ministry of Oil (the government body responsible for the licensing rounds) (the "Ministry"), admitted as much in an interview leading up to the 4<sup>th</sup> round when he said that *"there is a higher risk [in the*

*4<sup>th</sup> licensing round sites] since the contractor could spend millions of dollars and find dry holes and lose everything he spent"*.

### Use of service contracts

The Iraqi Government's belief is that a production sharing model, used in Kurdistan and the most commonly used model for exploration work of this type, which typically gives foreign companies the right to a portion of oil produced or profit made from sales, would be in contravention of Iraq's constitution (which states that the oil and gas in Iraq is the property of the Iraqi people and therefore should not be shared).

The Ministry however, as with the previous rounds, insisted on using a "service contract". Under the service contract model IOCs are paid a fixed fee per barrel of oil or gas equivalent, subject to a tax at 35%. Furthermore, this fee is only payable once prescribed production targets have been reached.

While service contract terms have been acceptable to the IOCs in the previous licensing rounds, these have all concerned already producing or production ready fields where the spoils on offer have been greater and more certain. It is highly unusual and almost unseen in the industry to ask companies to accept service contract terms for oil and gas exploration work. In particular, agreeing a fee per barrel, that may be redundant or inappropriate when it comes to the point of production, carries with it considerable risks.

### Tougher contract terms

Throughout the licensing rounds, one of the few redeeming features of the service contracts from the perspective of IOCs has been the fact that a service contract model does not impose a ceiling on costs and, under the terms of the contracts already signed, all costs are entirely repaid by the Ministry.

This benefit however has been countered in the revised service contract for the 4<sup>th</sup> licensing round which introduced a new formula for the calculation of the fee per barrel, meaning that the IOC will only be paid the FPB on the remaining production after deduction of costs. This is aimed at increasing the cost-efficiencies of the IOCs with the cost of the sub-contractors being deducted from the total production (on which the contractors fee is determined). The worked example provided by the Ministry is that if total production is 1 million barrels and the contractor has spent the value of 300,000 barrels on a subcontractor, the contractor will receive payment only for the remaining production, or 700,000 barrels.

While one can see the reasoning behind this amendment from the point of the Ministry, it has seemingly done little to incentivise the IOCs who were already being asked to stretch themselves into accepting service contracts terms for exploration licences, into bidding again, particularly as the terms of the services contracts were otherwise broadly the same as for the previous licensing rounds involving production sites.

## Restraints on exploration and production

The winners of the gas contracts on offer in the 4<sup>th</sup> licensing round are entitled to proceed to production immediately on discovery as the Ministry believes that gas is currently in short supply. Conversely, a clause has been inserted into the services contracts for oil sites such that the Ministry has the right to impose a potential seven year holding period on oil field discoveries, the purpose being to avoid the market being over-supplied and overwhelming Iraq's underdeveloped infrastructure.

The impending effect of OPEC quotas (which the Iraqi Government has indicated they could sign up to as early as 2014) would have played heavily on the minds of bidding IOCs. The quota figure that Iraq would be subject to is yet to be determined, however it is thought likely to be around the 4.5 million BPD mark, which would make the Ministry's plans to be producing 6.5 million BPD by 2014 redundant.

Given that the oil fields on offer are only exploration fields at this point, combined with the fact that the contracts did not cater in anyway for the effects of OPEC quotas, it is easy to understand why the majority of the 48 IOCs that qualified for the 4<sup>th</sup> licensing round were put off by the prospect of investing in the exploration of oil fields. The possibility that any resulting production (and their potential for return given that rewards are linked solely to the FPB) may be curtailed by the need to constrict Iraqi oil production to within the confines of the OPEC quotas and underdeveloped infrastructure would have clearly influenced their decision.

## Infrastructure concerns

It is widely acknowledged, and has been a concern of IOC's throughout the licensing rounds, that in order to handle the planned increases in oil and gas production, much of the existing infrastructure for both oil and gas production will have to be upgraded and a considerable number of new structures will have to be built both inside and outside Iraq.

Of particular relevance to the 4<sup>th</sup> licensing round, when for the first time the focus has been on gas, is the view strongly held by IOC's (and shared in Iraq) that, in the long term, a more extensive gas infrastructure will be required to enable the country to access the gas pipeline routes in Turkey that supply the European markets.

## Kurdistan

It is also worthy of note that the Kurdish Regional Government has signed 48 production sharing contracts with numerous IOCs, all of which the Iraqi Government views as illegal. These agreements are far more lucrative for IOCs than the service contracts offered by Iraq because companies receive a share of the oil produced.

Controversially, several companies who are party to those agreements have been excluded from the licensing rounds in Iraq; Sinopec was excluded from the 2<sup>nd</sup> licensing round, and US oil firms Exxon Mobil (which has signed 6 Kurdish production sharing contracts) and Hess were excluded from the 4<sup>th</sup> licensing round, as a result of their dealings with Kurdistan.

The Iraqi Government have formalised and strengthened their position in this respect by inserting a provision into the service contract on offer in the 4th licensing round which gives the them an automatic right of termination should a contractor subsequently engage in agreements with Kurdistan (or any other regional government).

## Conclusion

It seems that the 4<sup>th</sup> licensing round saw the Ministry, buoyed by the successes of the previous rounds, asking IOCs to take a leap of faith too far. No attempt was made to address the foreseeable concerns of the IOCs in the service contract structure for exploration work and indeed, if anything, the terms of the contract were made even harder to swallow.

The possible impact of OPEC quotas tied with the inclusion of a provision in the service contracts granting the Ministry complete autonomy over when to produce from an oil field in which reserves are discovered makes it easy to see why the majority of the pre-qualified IOCs chose not to participate in the bidding process. The reality is that the gamble the Ministry took, by asking IOCs to bid a fixed fee (albeit slightly higher than the fees that have been on offer in the previous licensing rounds) on unknown reserves and production, proved unsuccessful.

Nevertheless, the 4<sup>th</sup> licensing round was not all bad news; Block 9 near Basra, with its potential as an extension to the already producing Azadegan field on the Iranian side of the border (thus making it unlikely to be subject to a holding period once reserves are confirmed) may prove to be a greatly profitable for the successful bidder, Kuwait Energy.

In the immediate aftermath of the 4<sup>th</sup> licensing round results, the Ministry announced firstly that the state owned Oil Exploration Company will search for oil and gas in the nine exploration blocks that were not awarded to IOCs and is planning a \$160 million expansion to more than double seismic crews and equipment and secondly that a 5<sup>th</sup> licensing round of 60 new sites would take place in the near future (with no date confirmed as yet).

It is hoped that the Ministry will have learned lessons from the results of the 4<sup>th</sup> licensing round and will look to revise its contract terms to make them more suitable to exploration areas and work.

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