1) Introduction

During its informal consultations on the 22 February 2002, the Security Council Committee established by resolution 661 (1990) concerning the situation between Iraq and Kuwait requested the United Nations oil overseers to compile a discussion paper on ideas/proposals to reduce excessive premia and maximize exports/revenues under the Programme.

2) Current System

Since December 2000, contract-holders of Iraqi crude oil have insisted on premia at a level that is considerably higher than the normal commercial practice. These premia have been achieved without any risks taken by the contract-holders. Nevertheless, it has become evident that at times, when the contract-holders had to choose between accepting lower premia and not lifting the oil, they chose the latter option. This has become particularly clear during the recent introduction of retroactive pricing: rather than being satisfied with a level of premia corresponding to normal oil industry standards, the contract-holders preferred not to lift the oil. This has meant that in order to maintain the premia at a level of say 30 - 45 cents a barrel, the contract-holders brought about a substantial reduction in exports, thereby causing losses to the United Nations-Iraq account, averaging approximately $20 per barrel for each and every barrel not exported. The contract-holders' discretion to lift or not to lift, in the event of not being able to receive excessive premia, is not provided for under the United Nations approved Crude Oil Sales Contract and is, therefore, apparently based on a direct arrangement between the Iraq's State Oil Marketing Organization (SOMO) and the contract-holders.

Before, going into further detail, the following observation should be taken into account.

> *In the current situation under which the contract-holders choose whether to lift or not to lift, depending on the level of premia to be obtained, any measures taken by the Committee to reduce these premia can only result in a reduction of export levels. In the absence of cooperation by SOMO and the contract-holders, any attempt to reduce excessive premia can only lead to lower crude exports and, therefore, less income to the United Nations-Iraq account. The more effective the measures taken by the Committee are, the more export levels will then be reduced and, vice versa, the less effective the measures, the higher the export levels will be. Until the contract-holders reduce their demands for high premia, any decision taken by the Committee for the implementation of new proposals should, therefore, be considered essentially a choice between the level of crude oil exports from Iraq and the revenue level under the Programme.*

3) Options

The options that the Committee may wish to consider fall into two broad categories:

3.1 Measures to set the price of Iraqi oil close to the "fair market value", making it difficult for the traders/refiners buying the oil from the contract-holders to pay excessive premia to the contract-holders. Such measures would not only be restricted to setting of the price of Iraqi oil, but would also include measures related to other general terms and conditions under which Iraqi oil can he lifted. (For example, the enforcement of contractual lifting obligations.)

3.2 A more stringent selection of contract-holders (who's current integrity status can sometimes be questioned) could reduce the likelihood of arrangements being made between them and SOMO which are outside the terms of the United Nations approved contract. This would then reduce the chances of exports being reduced for the purpose of maintaining excessive premia.

Applying measures proposed in paragraph 3.1 above may also automatically lead to improvements in the integrity status mentioned in paragraph 3.2., i.e. where there are no longer any risk-free trading profits, only refiners and/or legitimate crude oil traders would be interested in buying the oil. It is assumed that well-established refining and trading companies are less likely to become involved in extra-contractual arrangements due to strict auditing procedures and the economic consequences of a loss in reputation.

The above-mentioned options are discussed in more detail below.

Option 3.1: Measures to set the price of Iraqi oil close to "fair market value"

Measures under this category are the following:

A) Frequency of price setting.

The more frequent setting of price for Iraqi oil facilitates it being closer to fair market value. The frequency can vary from a cargo-by-cargo price setting at one end of the spectrum, to proactive price setting for a full month at the other end of the spectrum. Retroactive price setting is effectively a daily price setting, since the retroactive price is calculated as the average of all prices of all trading days for the period. Price setting for 10 or 15 days lies somewhere between retroactive price setting and full month proactive price setting. With reference to remarks in section 2 above, the frequency of price setting will impact on the export levels, unless the contract-holders will be satisfied with more reasonable profit levels. For illustrative purposes please see the table below, showing pricing methods of decreasing accuracy and resulting expected export levels if the current attitude of the contract-holders remains unchanged.

Pricing Method	**Expected Export Level***
Cargo by Cargo	1.0 million b/d
Retroactive (and period)	1.5 million b/d
10 day proactive	1.6 million b/d
15 day proactive	1.7 million b/d
One month proactive (without interim price revisions)	1.8 million b/d
One month proactive (with the possibility of interim price revisions)	2.1 million b/d

* This assumes the contract-holders will continue to insist on excessive premia, The expected export levels are notional and for illustrative purposes only. The exact figures would depend, amongst others, on prevailing market conditions and could be higher or lower.

B) Lifting Obligations

Over time, excessive premia will be reduced if the contract-holders are forced to comply with their lifting obligations irrespective of subsequent market movements after the price has been set. One possible method of enforcing lifting obligations is illustrated in the following example:

At the beginning of March, the official selling price (OSP) for April liftings is proposed by SOMO and approved by the Committee. The lifters then have 3 - 5 working days to commit to how much oil they will wish to lift during April at the approved OSP. This OSP will not be changed irrespective of market conditions. The lifters must honour their lifting commitments both in terms of volume and timing. Performance would need to be guaranteed by a clause in the letter of credit which provides for a penalty payment in case of non-performance.

The system described in the above example would be close to normal commercial practice. Under such a system, the contract-holders are unlikely to be able to receive excessive premia for the full export volume on a continuous basis. Again, as has been said before, export levels under this system would fall if the contract-holders were to insist on excessive premia.

<u>Option 3.2: Measures to select customers on an integrity basis</u>

This section describes the different categories of contract-holders and some details of the revised criteria that could be considered for their involvement in the oil-for-food programme.

> *It should be emphasised that if the Committee were to apply revised criteria restricting the con tract-holders' eligibility for holding a contract and SOMO refused to accept this, it could load to a reduction or stoppage of exports.*

Potential contract-holders fall into three categories.

<u>Refiners</u>

Refiners buy Iraqi crude oil with the intention of processing it in their own refineries. They would normally like to buy directly from SOMO, without the involvement of intermediaries. They are well-established companies and would generally be reluctant to get involved in anything which is not allowed under the relevant regulations as set forth by the Security Council and its Committee. **The Iraqi oil sales revenues would be maximized with the substantial involvement of these types of companies in the Programme.** It would be relatively easy for the oil overseers to advise the Committee whether a particular company falls into this category.

The substantial involvement of refining companies would also lead to a better compliance with the terms of the United Nations approved oil sales contract which states:

"It is expressly understood that BUYER will process crude oil sold under this contract in its own processing-facilities or under processing arrangements with other refiners for BUYER's own account for which SELLER's prior approval must be obtained. BUYER also undertakes that under no circumstances shall BUYER resell or exchange the said crude oil in its original form or blend it with any other crude oil or crude oil derivatives for purpose of resale or exchange." (State Oil Marketing Organisation Crude Oil Sales Contract, Section 2, Article 10.)

It should be noted, however, that the trading of Iraqi crude oil (buying the oil with the intention of re-selling it rather than processing it directly in a refinery) has been an established practice since the beginning of the Programme.

<u>Established crude oil traders</u>

Established crude oil traders are companies that are involved in the purchase and re-sale of crude oil but do not generally process the, oil in their own refineries. They often charter ships and expedite the logistics of getting oil to a refinery. Although under the United Nations approved oil purchase contract Iraqi oil should not be traded, under some circumstances **the involvement of traders can assist to maximize revenue for the oil-for-food programme.**

The oil overseers could advise the Committee whether a particular company is likely to add value to the Programme and the conditions attached to this. Such conditions might include providing transparent information with respect to their Iraqi crude oil transactions.

Middlemen

Most contract-holders currently fall under this category. They don't seem to add any value to the Programme and are just there to earn a risk-free commission at the expense of the United Nations-Iraq account. **It is very difficult to find a justification for their participation in the Programme.**

4) Summary

- The options available to the Committee in its efforts to reduce premia may fall into two categories - those aimed at setting a price closer to fair market value and; those aimed at changing SOMO's customer portfolio in order to reduce the demand for excessive premia.
- As long as SOMO's contract-holders refuse to compromise over excessive premia, any measures to reduce premia will only lead to a reduction in exports and hence revenue. The more effective the method, the greater the drop in exports and revenue.
- Suggestions have been made as to how to deal with the different categories of contract-holders and their degree of involvement in the Programme.
- Should SOMO not cooperate with the buyers eligible under a revised selection criteria employed by the Committee, exports would again be reduced as would revenue.

Glossary of terms

SOMO	State Oil Marketing Organisation (of Iraq).
Contract-holder	A company which has a direct contract with SOMO to purchase Iraqi crude oil.
OSP	Official Selling Price for Iraqi oil. This is the pricing formula at which SOMO's contract-holders acquire the oil. It is submitted by SOMO, analyzed and recommended or otherwise by the Oil Overseers, and subject to the 661 Committee's approval under the no objection procedure. This formula is fixed for a certain period of time but SOMO con initiate a change at any time it deems appropriate.
Fair market value	This is the price level (OSP) of Iraqi oil at which the profits on this oil are in line with the profits of alternative oils (taking all circumstances into account).
Market price	This is the price at which the oil industry purchases Iraqi oil from SOMO's contract-holders. Market prices are in the context of Iraqi oil generally expressed as OSP + Premia.
Premia	Premia: Market Price = OSP + Premia This is the amount which the oil industry can afford to pay to the contract holders over and above the OSP. The level of the premia can be considered as a measure of how close the OSP has been set to fair market value.
Retroactive pricing	The system under which the formula for OSP's are set AFTER the oil has been lifted.
Proactive pricing	The system under which the formula for OSP's are set BEFORE the oil has been lifted.
Trading	Buying the oil with the intention of re-selling it rather than processing it directly in a refinery.