In payment drought, oil companies pare KRG investment

Exports through the KRG's politically troubled pipeline have not yielded regular payments, so producers are pinning revenue hopes on the crowded local market.

TheTaq Taq-Khurmala Oil Pipeline. (KAMARAN NAJM/Metrography/Iraq Oil Report)

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ERBIL - Iraq's autonomous Kurdistan Regional Government (KRG) has not paid its oil contractors since November, highlighting political and financial problems that could hamper plans to increase production and exports.

“We’re not going to be in a position to invest until we are able to receive more in payments,” said Bijan Mossavar Rahmani, the Executive Chairman of Norway's DNO, in a Feb. 5 presentation to investors. “Companies expect and were promised payment. And without payment they’re not in a position to continue spending.”

All of the KRG's most prolific international oil company (IOC) partners – DNO, as well as Anglo-Turkish Genel Energy and Bermuda-registered Gulf Keystone Petroleum – are pinning their short-term financial hopes on the local market rather than export sales. They are owed a total of about $750 million, according to Iraq Oil Report estimates based on corporate disclosures and interviews with company officials.

“Selling locally is a good mechanism to help tide us over," said an official from Anglo-Turkish Genel Energy, one of the KRG's biggest producers. "It’s a good revenue source for coming weeks or months while the export position clarifies.”

As oil producers reduce spending and shift output toward the local market, the flows through the KRG's export pipeline to Turkey are likely to decrease, at least temporarily. If so, the reduced export volumes would hurt KRG's ability to pay off massive debts quickly, and would also put additional strain on a cooperative oil and revenue-sharing agreement between Erbil and Baghdad.

The KRG is in the throes of a financial crisis compounded by the threat posed by the so-called Islamic State (IS) militant group. The KRG has been so strapped for cash that it has been forced to delay salary disbursements to public employees and even soldiers on the front lines.

The financial problems also pre-date the current political and security crises. The KRG, like all of Iraq, has a bloated public payroll, and its budgets contain huge subsidies of agricultural production, electricity and fuel supply. So far there have only been slight indications that the region's ministries are cutting enough to alleviate fiscal strain in the year ahead.

In this atmosphere, payments to oil companies have fallen lower on the agenda – at a time when company balance sheets are already strained by the low price of oil.

DNO, which in its fourth quarter 2014 results took a $297 million hit on its asset valuations as a result of falling oil prices, is ramping up production at Tawke to around 200,000 bpd in the next few weeks. But without ongoing investment, Rahmani warned, "these levels will go down as fields go into natural decline."

For several years, KRG Minister of Natural Resources Ashti Hawrami has ambitiously projected that Kurdistan's total production capacity will rise to 1 million bpd by the end of 2015. Production capacity stands at about 722,000 bpd now, including fields the KRG appropriated from the federal North Oil Company (NOC) in June 2014. Hitting 1 million bpd could happen because of upgrades already in the works at Taq Taq, Tawke and smaller fields, which are due to come online.

After that, the sector's future is uncertain. While IOCs have made formal commitments to field work under plans with Hawrami's ministry, they may be unwilling or unable to follow through if they don't get paid and can't attract financing.

Financial woes with political roots

Kurdistan's financial problems first came to a head in January 2014, when Baghdad stopped making regular budget transfers that supported almost all of the KRG's spending. The cutoff stemmed from political disputes surrounding the KRG's autonomous exports through its independent pipeline to Turkey, and from Baghdad's own shortage of cash.

Although the pipeline provided oil companies an independent export route – and some hope that they would finally start getting regular payments – the Baghdad budget cutoff forced KRG leaders to seek out billions of dollars in advance payments for oil shipments and loans from creditors at home and abroad. Those bills have come due and appear to be taking priority over debts to oil contractors, as does the government payroll, which is two months overdue.

A political rapprochement with Baghdad seemed to provide some relief. In November and December 2014, Baghdad and KRG leaders negotiated a series of agreements under which the KRG agreed to contribute some of its production to federal oil sales in exchange for monthly payments of $500 million, which were made in November and December.

Kurdistan's oil contractors received their last payments in November. The Taq Taq and Tawke consortia, consisting of Genel and DNO, both received $30 million, and the Shaikan consortium, led by Gulf Keystone, received $15 million, according to statements from the companies.

At the time, the MNR released a statement that promised “further payments to follow on a regular basis... With further production increases, producers will receive their full contractual entitlements.”

No further payments have been made, however, and oil company executives canvassed by Iraq Oil Report said they still had no clarity when they might be paid, or what a stable oil payments mechanism might look like.

Some of the uncertainty is tied to the political tension between Erbil and Baghdad. In January, KRG contributions to federal exports dropped sharply, raising suspicions in Baghdad; the federal government also did not make an expected budget payment due on Jan. 12, reinforcing fears in Erbil about surrendering any significant control over oil sales, especially while other debts were outstanding.

The Jan. 29 passage of the 2015 federal budget could help break the logjam by removing some ambiguity over each side's obligations. The law requires the KRG to contribute 250,000 barrels per day (bpd) of its own production to federal oil sales and facilitate another 300,000 bpd of exports from Kirkuk, in exchange for a 17 percent share of the money that is distributed to the regions and provinces.

Yet there is still ample room for conflicting interpretations and political friction. The two governments disagree about who should control oil resources along the KRG's southern border, and whether the KRG's ongoing independent export sales should be set off against its federal budget dues.

Local sales to the rescue?

With further payments from Baghdad in political limbo, producing companies in the KRG are looking for revenue through domestic sales.

In a Feb. 6 statement to investors, Gulf Keystone said it would redirect its entire 40,000 bpd of production from the Shaikan field to local buyers. “This is expected to be a short-term measure until a regular payment cycle can be established for sales via the export route,” the company said.

Executives from Genel, a partner in the company that operates the Taq Taq field, spoke with KRG Natural Resources Minister in early February about payments and redirecting crude production to the local market, according to a Genel official.

The Genel official declined to specify the volumes to be redirected, but said “it is a not insignificant amount of production that will go locally.”

The Kurdistan region’s local market consists of several local oil traders, with the market dominated by Iraq Oil and Qaiwan Group. These traders purchase crude for either refining in the region’s 80 or so small "topping plant" units dotted across the countryside, or for export by truck, mainly via Iran.

Although companies selling to these traders have to accept a discounted price, they also face little payment uncertainty. Local traders typically pay for cargoes a month in advance, and sometimes longer on term contracts with the IOCs.

Although the local market might offer IOCs a financial respite, it is also in flux.

Oil producers are worried that the MNR is making adjustments to regulated sale prices in a way that could discourage traders. If their discount is not big enough, traders will have little incentive to export oil by truck, which would put a cap on demand.

Oil executives and a KRG official said those changes are not yet finalized.

In an apparent nod to the financial squeeze of the IOCs, the MNR is also increasing the companies' take from local sales. Traditionally, the KRG has kept 70 percent, but now it will split revenues 50-50 with the companies, according to Rahmani and another oil executive in Erbil.

Companies feel the squeeze

IOCs are also facing financial pressures that local sales alone are unlikely to solve.

Largely because of low and irregular payments from the KRG to date, companies have their own borrowings to pay back: Gulf Keystone owes $575 million with interest on bonds that mature in 2017. Last year, Genel borrowed $500 million in medium-term bonds.

DNO’s cash has dwindled to $114 million and the company is “looking to match our spending with our earning,” Rahmani said.

The local market could also get even more crowded, as imminent field expansions at Taq Taq and Tawke in the next few weeks will bring a further 120,000 bpd of production capacity online. This domestic over-supply is likely to discourage other companies from bringing new production online.

Some crude varieties generally fare better than others in local sales for local use and for trucked exports, and oil producers are selling into a buyer’s market.

With an API gravity of 48 degrees and low impurities, Taq Taq crude is valued more highly for the greater diesel quantity it yields in topping plants and its wide marketability abroad.

At 18 degrees API, Shaikan crude is both heavy and sour, making it likely to fetch lower prices than oil from other fields in the region. Tawke’s oil has an API of 27.

“We remain confident that a stable payment cycle will be established in the near term,” said John Gerstenlauer, Gulf Keystone’s chief executive.

For Gulf Keystone, one mitigating factor is the potential for reduced transport costs. Rather than send its crude to the Turkish coast by truck - at a cost of at least $21 per barrel, company executives have said - buyers will collect oil from the Shaikan field itself. That reduction in costs could substantially make up for the discount between international and local prices.

Others are less optimistic, and can’t see how they can provide further investment in the region if IOCs are not paid in full.

“They’re using oil companies as a credit card," said an oil company executive in Erbil, "and we’re fed up with it.”

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