The Kashagan stitch-up

Update to the *Hellfire Economics* briefing paper[a]

By Greg Muttitt of PLATFORM
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Late on Sunday 13 January, the Kazakhstan government reached agreement with international oil companies on revised terms for extraction of the Kashagan oilfield, apparently bringing six months of dispute to an end.

Kashagan, in the shallow waters of the north Caspian Sea, is the world's largest untapped oilfield, and is being developed by a consortium of European, American and Japanese oil companies, led by the Italian Eni.

Our December 2007 briefing paper, *Hellfire Economics*, showed how the contract for developing the field, signed in 1997, was heavily weighted in favour of the oil companies. It argued that they took advantage of Kazakhstan's weakness in the immediate post-Soviet period to lock the country into unfair terms for 40 years.

The revised terms are intended to reduce that imbalance, by allowing state-owned KazMunaiGaz' to purchase an increased share in the project, and a series of extra bonus payments from the consortium to the government.

This update briefing applies our economic model[1], used in *Hellfire Economics*, to examine those terms.

Our key finding is a surprising one: that Kazakhstan is actually worse off since the changes announced on 13 January!

This result is due to the fact that there were actually three announcements made simultaneously that day:

- the change in economic terms,
- a planned change in the oil company operating the project,[c] and
- a further delay to start of oil production, from 2010 to 2011.

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[a] Available at http://www.carbonweb.org/documents/hellfire_economics.pdf

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[c] It was also announced that Eni, ExxonMobil, Shell and Total are to become joint operators after production starts in 2011 (with Eni to continue as operator in the mean time for the rest of the development phase)

Whilst media reports focussed on the first two, our economic model shows that the third is the most significant. It seems that the companies may have used the media interest in the other announcements to sneak in the news of the delay – what public relations specialists refer to as “burying bad news”.

This further delay will have a greater impact on Kazakhstan’s revenues than the improved terms. The result is that, even with the improved terms, Kazakhstan is *worse off* than it would have been with the 2010 startup and the original economic terms.

Whilst both sides are obviously claiming success in the negotiations, in order to save face, it is clearly the oil companies who are the winners in the dispute.

Background to the dispute

The dispute began in 2007 when Eni, the Italian company leading the international consortium developing the field, announced that project costs would double, whilst oil production would be delayed by two years to 2010.

Although the cost increase and delay were largely because of mistakes made by Eni,[d] it is not the oil companies who will pay for them. The contract for the field allocated economic risks in such a way that it was Kazakhstan, rather than the foreign investors, that would effectively pay most of any increased costs. On this basis, it was unsurprising that the government sought either compensation or amendments to the terms of the contract.

Our *Hellfire Economics* briefing found that the primary compensation measures that had been proposed would have only a very marginal impact on the balance of benefits from the project: in all scenarios, the majority of Kazakhstan’s loss from the cost increase and delay would not be recouped, whilst the project would remain highly profitable for the foreign oil companies.

This same conclusion applies to the agreement that was finally reached on 13 January. However, because of the structure of the contract, the further delay to 2011 affects Kazakhstan revenues more than it affects the foreign companies. The net result is that Kazakhstan is worse off than projected prior to the combined announcements (of delay and changed terms).

The economic impact of the deal

Whilst full details of the agreement have not been released, we understand from press reports that the outline of the deal is as follows:

- State-owned KazMunaiGaz to purchase an increased share in the consortium (from 8.33% to 16.81%), for $1.78 billion, payable in three tranches after start of production;
- Consortium to pay $300 million extra bonus immediately, followed by further bonus after start of production, ranging from $2.5 billion if the oil price is $55 per barrel, to $4.5 billion at $85.

However, the newly announced delay to the start of oil production from third quarter of 2010 to end of 2011 more than cancels out the benefits Kazakhstan derives from these new terms.

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[d] and also partly because of economic factors that would normally be the responsibility of the investor

The graph below shows net cashflows (income minus expenditure) to Kazakhstan over the life of the project, under four scenarios, each assuming an oil price as predicted by the US government's Energy Information Administration[2]:

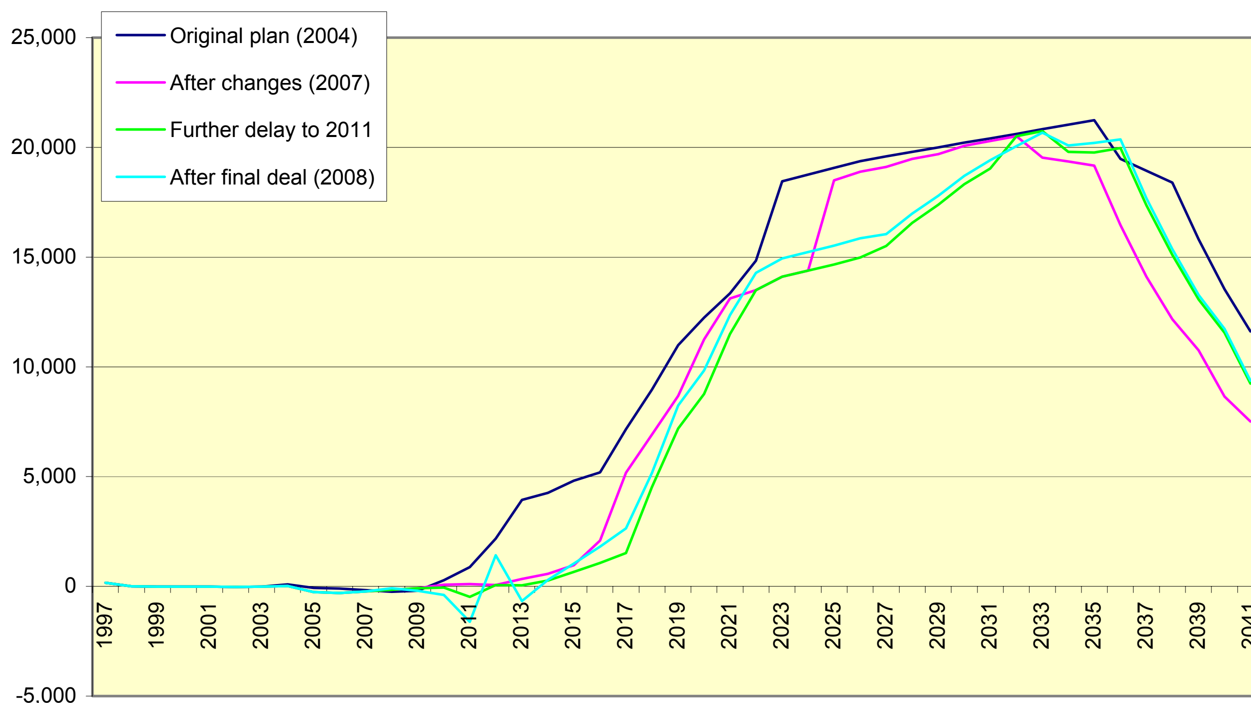
1) The field is developed according to the original development plan, which was submitted in 2004: this entailed first oil production in 2008, and peak production of 1.2 million barrels per day (bpd) in 2016;
2) Following announcements in early 2007, delaying first production to 2010, peak production of 1.5m bpd in 2019, and with dramatically increased costs;
3) Containing the 2007 revisions, but with startup of production delayed further to the end of 2011;
4) With both delays, but with the revised economic terms announced in January 2008 (the current projected scenario).

We see clearly that until the year 2033, Kazakhstan is now worse off in almost every year than we projected prior to the combined announcements of January 2008. Throughout the entire project, it is *considerably* worse off than anticipated in the original 2004 development plan, before the delays and cost increases announced in 2007.

The reason for these surprising results is that, because of the sheer volume and value of oil extracted, any delay is by far the most significant factor. When production peaks at 1.5 million barrels per day, conservatively assuming an oil price of $52 per barrel[e], the field will generate total revenues of $25 billion per year. Clearly, this figure well exceeds the extra bonuses and compensation payments.

In short, Kazakhstan is still paying for Eni's mistakes.

Graph: Projected cashflows to the Kazakhstan state



[e] This is the price prediction of the US government's Energy Information Administration, one of the most respected energy forecasters. Of course, the price could be much higher than this – it is currently around $100 per barrel – in which case the impact of delay would be all the greater.

Economists use the concept of net present value (NPV) to examine long-term investment projects. This is a measure of net profits, adjusted according to the time at which money is spent or received.

We find that whereas the NPV received by Kazakhstan improves by $3.5 billion as a result of the changed terms, it is worsened by $8.7 billion because of the delay. This is shown in the table below. Thus Kazakhstan is more than $5 billion worse off, from the combination of delay and revised terms.

Meanwhile, the project remains highly profitable for the foreign oil companies, generating an internal rate of return (IRR) of 12.8% - comfortably above their average target of 12%.

Table: Economic impact of successive changes to the project

	Original plan (2004)	After 2007 delay (to 2010) + cost increase	Further delay to 2011	After final deal (2008)
International oil cos (IOC) IRR	20.6%	14.5%	13.1%	12.8%
IOC NPV[f]	$29.6 bn	$30.5 bn	$27.2 bn	$23.6 bn
State NPV	$95.4 bn	$75.0 bn	$66.4 bn	$69.9 bn

Whose fault is the delay?

If challenged with the results of this economic analysis, the oil companies are likely to argue that the cause of the delay is Kazakhstan's suspension of the project, and that it is therefore right that Kazakhstan should pay. The government announced a suspension in August 2007, for breaches of environmental regulations – although some linked it to the contract dispute.

However, this argument is difficult to sustain.

Firstly, the environmental concerns are indeed real, as has been well documented. Any delay to the project due to regulation of environmental violations should rightly be paid for by those responsible for the violations (the companies), not by the state.

Secondly, in September 2007, more than one month after the Kazakhstan government supposedly suspended work on the project, Eni chief executive Paolo Scaroni announced that work was continuing despite the formal suspension, and that it would not affect the completion date of 2010.[3]

Meanwhile, there were persistent rumours that even while continuing work, Eni was falling behind schedule again.[4]

Finally, even if the suspension had been in effect, Eni would only have lost three months' work. (The construction season, when the sea is ice-free, is from April to November). This could have pushed back startup to late 2010, or *at worst* May/June 2011. Yet the delay announced in January 2008 was from third quarter 2010 to end of 2011 – between 15 and 18 months.

[f] 2007 net present value, at discount rate of 8%.

We infer that at least the large part of the delay (and possibly all of it) is primarily due to further failures of project management and planning, rather than the environmental and contract disputes. Yet once again, it is Kazakhstan that is to pay for Eni's mistakes.

A win for corporate negotiators

We conclude from these results that:

- The changes to the economic terms of the field development are extremely mild; they ensure that the project remains highly profitable for foreign oil companies, while doing little to improve Kazakhstan's position;
- Kazakhstan, rather than the companies, is continuing to pay the price of the investors' mistakes, and carrying the economic risks that should normally be carried by investors;
- The delays, announced quietly alongside the headline revisions to contract terms and future change of project operator, are far more economically significant than the revisions;
- Combining the revisions and the delays, Kazakhstan is still worse off than after the original delays announced in 2007.

When the dispute first started in summer 2007, Kazakhstan asked for compensation of $40 billion. This was quickly dropped to $10 billion in summer 2007. By the end of 2007, the demand had fallen to $7 billion. The final settlement was at a level between $2.8 billion and $4.8 billion. This rapid reduction in government demands illustrates the course of the negotiations, and who had the real power within them.

Indeed, that the companies came out well is illustrated by the fact that many financial analysts recommended buying Eni shares after the announcement of the deal, and predicted that its share price would rise.[5] Even ExxonMobil, the most intransigent member of the consortium, declared itself "satisfied" with the outcome.[6]

How did this outcome arise?

Most likely, the Kazakhstan government's negotiators realised that they had very little leverage. As we explained in Chapter 5 of *Hellfire Economics*, the legal terms of the 1997 Kashagan contract strongly defended investor interests, and fixed the economic terms of the project.

In particular, they give the consortium the right to go to international investment courts to enforce the contract, or obtain compensation for any changes. Such enforcement of investor interests has been used many times before, notably in Total's over-riding of the Russian government's attempts to regulate budgets on its Kharyaga field in Siberia.

Thus, both sides will have known that the legal options for renegotiation were limited, and could not be insisted upon. Therefore, the settlement that companies were prepared to pay was not guided by any principle of fairness or reasonable rates of profit. Instead, they paid only to the extent that the compensation cost them less than the inconvenience of going to court, and the difficulties of being in dispute with the government.

Recommendations

Our 14 recommendations in the *Hellfire Economics* briefing are needed more than ever. That a six-month, high-profile dispute has generated so little change to project economics only illustrates further that the problems reside in the original contract itself – in particular the fixedness of its economic terms, and the allocation of risk to the state party.

In particular, given that as a result of the delay Kazakhstan is worse off – whilst most Kazakhstanis believe the opposite – this further reinforces the urgent need to publish the contract, so that academics, oil experts and civil society groups can closely examine its contents and implications.

In the long-term, the announced resolution is likely to be in the interests neither of Kazakhstan nor even of the oil companies. History tells us that grossly unfair investment contracts generally lead to political and economic instability. In the Kashagan contract, the government's priority objective is a fair level of revenues for depletion of the country's natural resources. For the companies, the priority is a stable and predictable investment framework. Publication of the contract and of key economic data would greatly help towards both objectives.

References

[1] The analysis is based on a discounted cashflow model. Full details of the methodology, and economic results under a range of scenarios, are given in the *Hellfire Economics* briefing, available at http://www.carbonweb.org/documents/hellfire_economics.pdf
[2] Energy Information Administration, *International Energy Outlook,* May 2007, http://www.eia.doe.gov/oiaf/ieo/graphic_data_liquidfuels.html
[3] Dow Jones Newswires, 'Eni CEO Sticks With '10 Kashagan Output Start; Work Continues', 27 September 2007
[4] Barry McCarthy and David Cline, *Eni – Counting the Costs,* ABN Amro, 17 October 2007
[5] Dow Jones Newswires, 'Kashagan Deal May Boost Eni Shares – Analysts', 14 January 2008
[6] Isabel Ordonez, 'ExxonMobil 'Satisfied' With Agreement On Kashagan Project', Dow Jones Newswires, 15 January 2008