Kuwait Petroleum Corporation: Searching for Strategy in a Fragmented Oil Sector

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Working Paper #78

July 2008

PROGRAM ON ENERGY AND SUSTAINABLE DEVELOPMENT

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About the National Oil Company Study

While the role of the state is declining in nearly every sector of world economic activity, in hydrocarbons the pattern is quite different. State-controlled oil companies—so-called national oil companies (NOCs)— remain firmly in control over the vast majority of the world's hydrocarbon resources. Some NOCs are singular in their control over their home market; others engage in various joint ventures or are exposed to competition. PESD's study on National Oil Companies focuses on fifteen NOCs: Saudi Aramco, NIOC (National Iranian Oil Co), KPC (Kuwait Petroleum Co), PDVSA (Petróleos de Venezuela) , ADNOC (Abu Dhabi National Oil Company), NNPC (Nigerian National Petroleum Co), PEMEX, Gazprom , Sonatrach, CNPC, Petrobras, Petronas, ONGC, Sonangol, and Statoil.

These enterprises differ markedly in the ways they are governed and the tightness of their relationship with government. NOCs also vary in their geological gifts, as some are endowed with prodigious quantities of "easy" oil while others must work harder and apply highly advanced technologies; some have sought gas, which requires different skills and market orientation than oil, while others stay focused on liquids. These case studies explore whether and how these and other factors actually explain the wide variation in the performance of NOCs.

About the Author

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1. INTRODUCTION[1]

a. OVERVIEW

History of KPC

The history of oil in Kuwait has been crucial in determining the context for KPC operations. That history is riven with disputes and political interference. It has left abiding legacies of distrust towards international oil companies (IOCs) and the national oil sector itself. This has coloured the political environment and attitudes to KPC. Since its creation in 1980, KPC has struggled to absorb the elements of the oil value chain represented by its subsidiaries both at home and abroad who had different former owners, histories and corporate cultures. Operations have suffered from excessive bureaucracy (as a state owned enterprise) and excessive political interference. Attempts at reform faced serious political constraints and policy paralysis. Strategy and the resulting decisions go through a tortuous process of negotiation and approval. The result has been the lack of coherent strategy since 1991. In particular, the fact that since 2000 there have been 5 oil ministers appointed was a major problem, since the minister as Chair of KPC plays a

[1] A major problem in the writing of this study relates to referencing material and citations of sources. Much of the information contained in this report comes from conversations with many involved in the Kuwaiti oil sector over a number of years. For the most part they were very open in their discussions and were willing to have their remarks on the record. However, on some occasions, anonymity was requested. Therefore, while those contributing to my knowledge on my recent field trip to Kuwait in February/March 2007 are listed in PESD Interviews 2007 specific remarks are not attributed. Where the source is publicly available I have cited this in the conventional manner. A major source of information has been the excellent Middle East Economic Survey. Where this has been specifically referenced it appears as (MEES Vol: Number Year)

pivotal role. The structure of the oil sector is such that the Supreme Petroleum Council (SPC)[2], which is part of the government administration, has a majority of private sector appointees who are not part of government, acts as KPC's shareholder and often exerts strong oversight. But KPC is also accountable to the National Assembly (Kuwait's parliament). And the government and the National Assembly are not accountable to each other since the former derives its authority from the Emir and the latter from popular election. The situation has been confused because KPC is subject to its founding law (Law 6 1980) while its subsidiaries are subject to Kuwaiti commercial law. Necessary reforms of KPC have been thwarted because a change in the founding law would be required, which is unlikely since the National Assembly fears changes that could undermine the benefits they channel to their constituencies, and high oil prices in recent years have masked the urgent need for reform.

KPC Performance and Strategy

Unlike many NOCs, KPC and its affiliates produce annual reports with audited accounts; thus, in theory, it is possible to assess the company's financial performance. In practice, however, the efficiency of the operations is difficult to assess. Upstream operational costs appear low but this is normal in the Middle East reflecting very favourable geology. In general the performance of the sector is suspect. This is reflected in a succession of missed targets and a recent series of serious accidents.

In the 1980's Kuwait developed a strategy of moving downstream and operating outside of Kuwait as the result of a system of governance that encourages the company to earn profits (which it can keep) from downstream operations even as it is largely indifferent to the actual performance of its upstream operations (from which nearly all profits are repatriated to the government, where they account for 94% of the budget). Since 1991, this strategy has come under scrutiny on a number of occasions. In particular, as will be developed below, there is concern that such overseas operations allow KPC to disguise its operations from scrutiny within Kuwait. Thus the policy of overseas activities remains

[2] See below for further details

controversial. While there is a strategy document – "Vision 2020" – it is constantly revisited and frequently revised.

Government goals, capabilities and the relationship between the state and the oil sector

There is little alignment between KPC's strategy and more general plans of the Kuwaiti government for the economy. In particular, the prioritization of targets is ad hoc and whimsical, which has notably hobbled the government's periodic plan to privatize elements of the oil sector. A central plank of the strategy –Project Kuwait – has a long and controversial history. It has been bogged down in Kuwaiti politics for a number of years. There is considerable suspicion within the government, the National Assembly and its own shareholder (the SPC) that KPC indulges in classic rent seeking behaviour. The sector is financially vertically integrated and also uses operational vertical integration rather than markets to govern interactions between affiliates. This reinforces suspicions of inefficiency and high cost. There is complete disagreement between KPC and the oil ministry over regulatory issues which has been rumbling on for more than three decades (since 1976) and shows no signs of resolution. The bureaucracy involved in KPC's operations in relation to procurement, project evaluation and agreement on budgets is awesome in its magnitude and a major explanation for KPC's inability to meet targets. As in the case study on Mexico, lack of trust by the host state has led to debilitating oversight of the procurement process—in effect, an effort by the government to assume some responsibilities that in private companies are the province of management.

Management and control over budget

The issue of who controls KPC is confused and confusing. The result has been paralysis of the company and its operations. Attempts to solve these problems by giving greater financial and operational autonomy to the subsidiaries have so far failed to be accepted and in any case would require a major revision of KPC's founding law. The financial system for KPC is based upon the upstream operations being financed on a budget basis from central government while downstream and midstream subsidiaries are profit centres. KPC appears to depend little on local content other than in terms of employment. It is under huge pressure to employ more Kuwaitis while the hiring and promotion policy is driven by political influence and interference. As will be developed below, procurement for KPC and its affiliates presents serious problems because of the auditing and control systems which operate at very low levels of spending.

Technology and resources

KPC controls all oil and gas reserves outside the Neutral Zone. There is considerable dispute over the actual size of the oil reserves although extreme claims that Kuwait's official reserves are overstated by a factor of two appear unlikely[3]. However, the picture is clouded because the geology is getting more difficult with heavier crude and serious water management problems. KPC lacks the necessary technical skills to address these challenges and is dependent upon assistance from the IOCs and field service companies. Regarding gas, the situation is more positive because the country, fortuitously, recently found its first major non-associated gas field[4].

b. MAIN FINDINGS

By most measures, including KPC's ability to meet its own targets, the enterprise performs poorly. Its failure reflects a series of accidents that reveal its inability to manage operations. There are two prime explanations for this weak performance.

- The whole oil sector, including KPC, is vulnerable to excessive political interference from a political system that is dysfunctional because the National Assembly does not appoint the government. Ministers constantly face aggressive scrutiny from the National Assembly, which leads to excessively cautious behaviour and undercuts attempts at crafting and applying long-term strategic

[3] Petroleum Intelligence Weekly made this claim in January 2006. See below for further details and analysis.
[4] See below

vision. The decision making process is complex, cumbersome, unpredictable and horribly bureaucratic. This lack of coherence also reflects vulnerability to the whims of the oil minister, a post where there has been much turnover since 1991. The minister is able to veto unfavourable decisions as he is both chairman of KPC and the senior government official. An obviously overdue reform would separate these functions to restore some control and authority to KPC's Board. Ministers have opposed such reforms, and no collection of interests has yet emerged to push for better performance.

- While KPC has some excellent senior managers with talent and a deep knowledge of the oil industry, middle level management in KPC and its subsidiaries is strikingly weak. This appears particularly true in the technical/engineering areas. People are given posts with insufficient experience and knowledge—a reflection of a governance system laden with political interference in the appointment and promotion of personnel and, increasingly, removed from the frontier of the industry.

In recent years these fundamental problems have been disguised by relatively high oil prices. The small population and large accumulated reserve funds have helped paper over the cracks, and thus these severe problems in the oil sector could persist for a long time without creating a crisis in the country. The prospects for the sector are not good because:

- Political interference will get worse as the National Assembly seeks a greater formal role in the operation of the sector, and the only effective remedy will require fundamental reform of the political system whereby the government is appointed by the National Assembly rather than the Emir—an outcome obviously that is politically even more difficult to implement than reforms in just the oil ministry.
- KPC is aware that it lacks the capabilities to manage the growing problems in the upstream as depletion of easy oil leaves more complex geology, heavier crude, and sundry water management problems. However, political gridlock has

deterred the entry of IOCs whose presence is essential if the field problems are to be managed. This exclusion of much needed technical help is likely to get worse as "resource nationalism" gains greater support in Kuwait, a pattern that is evident throughout the Middle East.

If oil prices slip as the cost basis rises and KPC lags in performance the problems could unfold quickly in a society where the population has become used to living in a rentier society with extensive and expensive benefits and pension rights.

2. HISTORY OF KPC

a. HISTORY

The history of the oil sector in Kuwait provides a crucial backdrop to the understanding of KPC's current role within the petroleum sector of Kuwait. This history has created the political environment—notably a deep suspicion of oil enterprises that seek autonomy from the state—within which KPC must operate.

The Kuwait Oil Company (KOC) was created in 1934 as a joint venture between the Anglo Persian Oil Company (BP in modern parlance) and Gulf Oil. The agreement was an old style concession agreement[5] and as such, in the post World War II context began to attract criticism within Kuwait—a pattern of scrutiny mirrored in the other oil-rich countries of the region. There were three sources of criticism. First, the concession covered the whole of the land area of Kuwait (except for the Neutral Zone, which was effectively excluded due to its more recent creation, in 1966, following negotiations between Kuwait and Saudi Arabia). Exclusivity offered no provision for relinquishment and thus no other company, foreign or Kuwaiti, could pursue oil within the country. Second, the agreement had a life of 93 years with no provision for renegotiation. Finally, apart from a requirement for "good oilfield practise" the company had complete managerial control over all operations. Thus it had the right to determine the extent of

[5] The following section draws heavily upon Stevens, 1975 and Marcel, 2006.

exploration, whether any find would be developed, and what production levels would be. As the 1960's progressed, these criticisms grew along with similar discontent in the rest of the region. Voices began to be raised that nationalization was the solution. However, the rulers in the region remembering the fate of Dr Mossadegh—who attempted nationalization in Iran, alienated Western powers, and soon found himself out of office—were wary about actually putting such a policy into practice.

In 1960, the Kuwait National Petroleum Company (KNPC) was created as Kuwait's national oil company. It was interesting because unlike all other national oil companies in the region, 40 percent of the equity was put out to public subscription thus giving a strong private sector flavour to the company. Its remit was to "engage in all phases of the petroleum industry, natural gas and other hydrocarbons, refining, manufacturing, transporting … and distributing, selling and exporting such substances" (Stocking, 1970, page 440). Among other projects, KNPC built the Shuaiba Refinery which was at the time of its construction the world's largest refinery, one of the most modern and the first built by an NOC in the region. In 1961, following some voluntary relinquishment by KOC, Kuwait opened acreage for exploration bids and some 13 potential bidders expressed interest. In May 1968, the National Assembly ratified a joint venture agreement (initialled in August 1965) with Hispanoil the Spanish national oil company[6]. Thus in the event of a commercial discovery a joint company would be created with KNPC to develop the find. The private shareholders of KNPC objected strongly to this agreement on the grounds that they felt KNPC should be exploring for oil in its own right without foreign partners. On ratification, the four private directors of KNPC resigned.

Several other important players in the oil sector came into being in the late 50s and early 60s. In 1963 the Petrochemical Industries Company (PIC) was formed by Amiri Decree to manage petrochemical and fertilizer plants—initially it worked mainly through a series of joint ventures, principally with BP and Gulf. However, in 1976 all the private sector's equity in the PIC ventures was transferred to the government. The Kuwait Oil Tanker

[6] Following the aftermath of Iraqi Law 80 where the Iraqi government unilaterally forced the Iraq Petroleum Company to relinquish acreage, KOC, like many other companies in the region began to return acreage to the government (Stocking, 1970).

Company (KOTC) was formed by private individuals in 1957 to transport crude and products. In 1976, the government decided to get involved and bought 49 percent of the equity and in June 1979 bought the remaining equity to give it 100 percent ownership. The Kuwait Aviation Fuelling Company (KAFCO) was formed in 1963 to supply fuel at Kuwait International Airport. This was a joint venture with BP with KNPC having 51 percent of the shares. In 1977, KNPC bought out BP's shareholding.

During this period, pressure for nationalization was growing across the region. This reached a peak following the Six-Day Arab Israeli war of 1967. In June 1968, following a series of public statements on the subject, Zaki Yamani, Saudi Arabia's oil minister, announced the details of his proposed ideas on "participation". The idea was for the governments to take a gradually increasing share of the equity of the operating companies until 51 percent was reached. In October 1968, Kuwait made a formal demand for participation based upon Yamani's ideas. In October 1972, the General Agreement on Participation was announced in which several governments, including Kuwait, would secure an immediate 25 percent of the equity, rising to 51 percent by 1982. Interestingly, the compensation to be paid by Kuwait for this initial 25 percent at $200 per barrel of capacity was much lower than others – Saudi Arabia at $351, Abu Dhabi at $580 and Qatar at $592. This outcome was related to Kuwait's very aggressive bargaining posture in the build up to the agreement. The Kuwait National Assembly immediately expressed its dissatisfaction with the terms of the General Agreement[7]. In June 1973, Kuwait announced that it had negotiated a revision of the terms to 40 percent with immediate effect; in January 1974 the figure was raised again to 60 percent. By mid 1974, the government announced a 100 percent takeover[8]. Thus KOC became a wholly state owned oil company.

As the 1970s ended, the Kuwait oil sector was populated by a number of separate companies, all state owned. In an effort to bring coherence and coordination to the sector and integrate the value chain, KPC was created through Law 6 of 1980 to act as a holding

[7] The original idea was that there would be a general negotiation to set the broad terms of the agreement and then, individual governments would negotiate with the relevant companies to fix the specific details.
[8] The terms on which the additional shares were bought by the Government was never made public

company for the operating companies[9]. KPC was to be "A public corporation having economic character and (being an) independent corporate entity". This was intended to give KPC a strong commercial orientation. The Board was to be created by Amiri Decree[10] and effectively the shareholder was to be the Supreme Petroleum Council (SPC). The SPC was created by Amiri Decree on 26th August 1974. In its early life it had relatively little influence over oil policy. Power for this lay, formally, with a Cabinet Committee that consisted of the Prime Minister and several other ministers including oil and finance that had neither the time nor the necessary attention to the strategic requirements of the sector. The result was that the Government expanded the SPC and included a growing number of private citizens in the hope of making the SPC a more effective controlling body, and it was on this basis that the SPC began to increase its role (PESD Interviews 2007). This culminated in the SPC being de facto the sole shareholder of KPC and therefore effectively the controller of KPC's operations.

This form of organization was to cause enormous problems in the future simply because the subsidiary companies were subject to normal Kuwaiti commercial law applicable to any company. KPC by contrast was ruled by Law 6, which meant that any change to KPC had to be accompanied by a change in the Law. This was to prove a major problem when it came to trying to reform KPC and improve its performance[11].

The SPC signally failed to develop a comprehensive strategy for the sector before 2003. One explanation for this was that the SPC had no permanent sub-committees to address major issues on any consistent basis and their contribution was therefore rather ad hoc (Al Atiqi, 2005). In 1993 it was proposed to form technical committees. In 1998, a

[9] Currently these include KOC; KNPC; PIC; KOTC; KAFCO; The Kuwait Foreign Petroleum Exploration Company (KUFPEC) established in 1981 responsible for all upstream operations outside of Kuwait; Kuwait Petroleum International Limited (KPI) established in 1983 responsible for all overseas downstream operations; and Kuwait Gulf Oil Company (KGOC) established in 2002 to manage Kuwait's share of upstream operations in the Neutral Zone.

[10] As will be seen later, the significance of an Amiri Decree is that is does not require approval by the National Assembly. Creating laws and regulations by such a route becomes increasingly controversial as the National Assembly seeks to increase its political influence in the way in which Kuwait is ruled.

[11] At one point as will be seen when the need for reform was regarded as urgent, there was a plan to turn KPC into a shell company and focus totally on the operations of the subsidiaries in an effort to by pass the need for a change in the law.

technical committee was formed chaired by the Minister of Oil. The delay illustrates the extraordinary length of time it takes in Kuwait for decisions to be taken and implemented.

In May 1999, the consultancy company Booz Allen and Hamilton was commissioned to produce a major study to consider restructuring the whole oil sector (MEES Vol XLII No 19 1999). In August 1999, an Amiri Decree reconstituted the SPC, reflecting changes in the new government appointed in July and identifying nine non-government members. In 2000, three sub-committees to oversee strategy, technical and financial aspects of the sector replaced the technical committee created in 1998. These changes were most likely in response to the consultancy study (PESD Interviews 2007).

The functions of the three new committees were to examine proposals from KPC and make recommendations to the full Council, in line with the growing realization that the SPC oversight role was becoming more complex and required greater levels of specialist knowledge to be effective (PESD Interviews 2007). The formation of the committees was also intended to deal with major new initiatives including performance evaluation, the development of a strategic vision to 2020 plus restructuring and commercialization of the whole sector (PESD Interviews 2007). The new initiatives emerged as the result of the appointment of Nader Sultan as CEO of KPC in 1998 – his objective was to create a much more commercially-oriented structure to KPC and its operations (see below). In effect, the SPC emerged as a body that set overall policy in the oil sector and also evaluated, in parallel, commercial projects that KPC itself was evaluating. It was by no means a “rubber stamp”. Indeed, management of KPC expressed a certain dread at having to go before the SPC and justify their proposals, with the private sector members of the SPC being notorious for giving the management a “hard time”.

In 1981 KPC bought Santa Fe, an American service company, for $2.5 billion. This was done with the explicit intention of helping KPC move into the international arena (see below in section 3b) and to encourage technical transfer. Through this acquisition, Santa Fe obtained the contract for the expansion of the Mina Abdallah refinery and became responsible for all drilling in Kuwait. However, the experience proved costly – between 1981 and 1990 the company lost a total of $2.89 billion (MEES XLIII No 16 2000) as a result of falling oil and gas prices after 1986. It was reported that Kuwaiti Government auditors concluded KPC had overpaid for the company (Myerson, 1994). Also after 1991, a review of strategy for KPC suggested that operations in exploration and development abroad were much less of a priority, since it made little sense for the government to spend national resources to create a "cash cow" for another government to milk (PESD Interviews 2007). Also Santa Fe's expansion plans had been held back by the aftermath of the Iraqi invasion in 1990 (Myerson, 1994). As a result KPC gradually sold off its interests although it did retain a percentage of the equity.

b. ATTEMPTS AT REFORM

i. MOTIVES

KPC's attempts to control its subsidiaries immediately faced problems. The subsidiaries were separate and different companies with very different cultures and philosophies. KOC gave up its refineries to KNPC, but the three Kuwait refineries had had three separate owners and were very different. In effect it took almost ten years for KNPC to "absorb" these units into its operations. At the same time KOC, which had been a major independent oil company, presented KPC management with significant problems to bring it under its control. KOC was unwilling to cooperate with KPC. This was compounded by the fact that each subsidiary as an independent commercial entity under Kuwait commercial law was answerable to its own Board, and thus commands from the center (KPC) were not always obeyed. This autonomous review by the subsidiaries created considerable delays in implementing plans and projects. The result was that throughout the 1980s the sector was highly fragmented, and efforts to try and integrate the elements of the value chain yielded little success.

These problems were compounded in the 1990's by a number of factors. First, there was the growing encroachment of bureaucracy and political interference, which will be discussed in detail in section 4bii. Second, there were growing problems over management competence and a serious lack of technical skills as will be discussed in detail in sections 4 and 5. Third, within KPC decision making became too slow. The view was that far too many small projects were arriving at KPC for decisions which were then examined in great detail with much of the basic project evaluation being redone. The period was also subject to discrete crises. In 1993-94 a major public scandal broke over the finances of the KOTC subsidiary. It appears that there were two sets of books in use, and one set allowed senior management to skim off funds. There were also rumours of higher-level involvement in the fraud. The result of this was that in 1998 all state enterprises came under much greater financial controls (described in section 4bii) which seriously hampered the ability of KPC management to implement projects. Also, the fallout made management very risk averse, and KPC and its subsidiaries started to go backwards operationally. Also, in the late 1990s and early 2000s there were three major refinery accidents which caused serious outrage and eroded trust in the oil sector, not least within the National Assembly. These incidents became symbolic of the "laxness of the sector". One positive outcome, however, was that they helped KPC management wrest a degree of control away from the politicians who now became rather more frightened of the consequences of being held accountable for their decisions.

Faced with these problems, which were glaringly obvious to the senior management of KPC, there was much discussion of reform of the sector. To this end, many high level consultancy firms were employed with the goal of determining the optimal means to reform KPC and its operations. The main thrust of these efforts was to try and give the subsidiaries greater autonomy in financial and decision making terms. In the mid 1990's, there was talk of replacing the subsidiaries with business units. Attempts were made to reduce the number of projects coming to KPC for approval. Thus from 2004, only "national projects" were referred to KPC headquarters, along with the instruction for the assessors not to "redo the numbers" but rather to assess the project in terms of how it fits the corporate strategy, the track record of the subsidiary company proposing the specific project, and compliance with health, safety and environment (HSE) goals. At the same time there was a concerted effort (see section 4b) to reduce the number of steps and levels of approval needed for projects. The blueprint for reform, which is formally in force today, is the “Strategic Management Model” (Whittington, 2001), which pushes many functions to the subsidiaries and separates, completely, the marketing function from KPC.

ii. IMPACT OF REFORMS ON STRATEGY AND PERFORMANCE

Despite much effort and many consultancy reports, the oil sector’s performance has not improved. First, as will be developed in section 4, a major constraint to the sector’s performance is political interference in KPC’s decision making processes. This interference has actually become far more intrusive not least because of the growing role of the National Assembly in the way in which Kuwait is ruled. Second, the reform attempts have not addressed what is needed most, which is a change to the original founding Law—an unlikely proposition given the current state of Kuwaiti politics.

c. CURRENT GOVERNMENT STRATEGY CONCERNING THE NOC AND THE OIL SECTOR

Arguably, a major problem facing KPC is that the Kuwaiti government has failed to ever create a coherent strategy for KPC. For the most part, and certainly since 1991, KPC’s strategy has come from within the company. KPC has spent a great deal of time and effort creating and re-visiting strategy. Unfortunately, they have been relatively unsuccessful in actual implementation. This will be discussed in greater detail below.

To be sure, KPC’s self-devised strategy has had to face the scrutiny of the SPC, which is the ultimate authority on such matters,[12] but the government’s role in this process is far from clear. Part of the explanation for this is that the Kuwaiti system of government is unable to identify and apply a strategy. Senior administrative positions—the Prime

[12] As far as the SPC’s decisions are concerned, the Cabinet is effectively a rubber stamp.

Minister and the Ministers who constitute the Cabinet—are appointed by the Emir. But those positions bear no relationship to the National Assembly (parliament). Often, the parties that control government are in the minority in the National Assembly—government is unable to assume parliamentary support. One outcome is the periodic spectacle of successive Ministers in various portfolios being called to account before Parliament and receiving a public (televised) and often vicious dressing down by members of the National Assembly[13]. The result has been a policy paralysis of massive proportions in all sectors which has dominated Kuwaiti politics since the recall of the National Assembly in 1991[14].

A major problem is that the National Assembly, like any rational elected body, plays to popular decisions. This is especially prevalent in Kuwait because most National Assembly members serve constituencies that are populated by small numbers of voters. Members are thus particularly concentrated on demanding benefits for their constituents, and the principal concern of successive governments has been to "keep the National Assembly off their backs". Increasingly attentive to Kuwaiti political life and to doling out benefits, the Assembly has generated a large backlog of legislation and delay. The current (March 2007) Assembly which began sitting in October has a logjam of 114 Laws awaiting approval, 88 Amendments to existing laws and 26 draft laws to consider (MEES 49:43 2006).

Within this confused and confusing system, the key government players in determining the strategy of KPC are the Minister of Oil and the Oil Ministry more generally. The Minister's role is central because as Minister he is also Chairman of KPC. This effectively gives him veto power over any decision taken by the KPC Board. Indeed, recent history has seen a number of occasions when the KPC Board with the Minister as Chair has made a decision, only to have it subsequently overturned by the Minister with

[13] During the field visit to Kuwait in March 2007 upon which much of this narrative is drawn, the Minister of Health was due to face such an experience. In the event, the whole government resigned in order to prevent the questioning of the Minister.
[14] Interestingly, before 1991 the paralysis was solved simply by the Emir suspending the National Assembly. However, after the liberation from Iraqi occupation, described by some observers unkindly as "making the world safe for feudalism", such behaviour was not a realistic option.

his Ministerial hat on. For example, the recent decision to sell KPI's refineries in Europe was reversed by the Minister (PESD Interviews 2007). Of itself this could have presented a positive outcome if the Oil Minister had a clear and coherent vision for the sector. The problem is that such vision has been lacking simply because of the fact that between 1991 and 2001 there have been eight Oil Ministers and since 2000 there have been five Ministers. Not surprisingly, on a number of occasions there have been "personality clashes" between the Minister and the Chief Executive Officer (CEO) of KPC. Since 1998, there have only been two CEOs of KPC, both of whom have managed to secure considerable political support, making their removal by the Minister difficult if not impossible.

These problems in government stewardship of KPC are further compounded by the role of the Oil Ministry, which is effectively required to act as advisor and secretariat to the Oil Minister in his role as minister. There are two difficulties with how this functions in practice. The first is that the Ministerial salary scales are significantly below those of KPC, which means the Ministry has great trouble attracting good people who are knowledgeable about the sector. Second, the role of the Ministry has frequently been extremely unclear.

At the start of the 1970's, the Oil Ministry played a major role given its direct contact with the operators. In 1973, Law 19 formalized the obligation of the Ministry of Finance and Oil to inspect the operating companies. In 1975, the Ministry of Oil was created as a separate entity and Sheik Ali Khalifah, who was Minister from 1978 to 1990, dominated its activities. During his period in office the sector strategy was clear and for the most part implemented. Several factors explain this. First, Ali Khalifah had a clear personal vision that KPC would become a major international oil company to compete with the Majors in all stages of the value chain. The earlier period of his "reign" coincided with the huge increase in oil revenues following the second oil shock of 1978-81, so the government had the money to indulge in empire building. Second, his position within the ruling family made him extremely powerful in the Kuwaiti political system. Finally, between 1976 and 1981 and again between 1986 and 1992, the National Assembly was suspended and Kuwait was governed by Amiri Decree. Thus unlike his predecessors, Ali Khalifah was not hampered by political interference from the Assembly. Decisions of KPC and the Ministry might be questioned within the various Diwaniyas (informal local gatherings) held by the (suspended) Assembly members, but dissidents had no ability to block decisions.

Since 1991, within the government formed after the liberation of Kuwait, the Ministry sees its role as having several dimensions. First, it claims to provide supervision to KPC in terms of both technical issues (good oil field practise and HSE) and financial matters. However, this is not how other players see the Ministry. There has been a long-running dispute between KPC and the Ministry over the Ministry's regulatory role based upon Law 19 of 1973, which will be discussed in detail in section 4bii. Second, the Ministry believes its additional role is to suggest policies to the SPC for approval, and then to direct the implementation of these policies after they are approved. KPC, on the other hand, thinks that the function of proposing strategy and policy to the SPC is within its own purview. Indeed, one senior manager in KPC, when asked, "What is the role of the Ministry?" replied, "I have no idea!" The only Ministry role over which there is no dispute is the management of relations with international bodies such as OPEC.

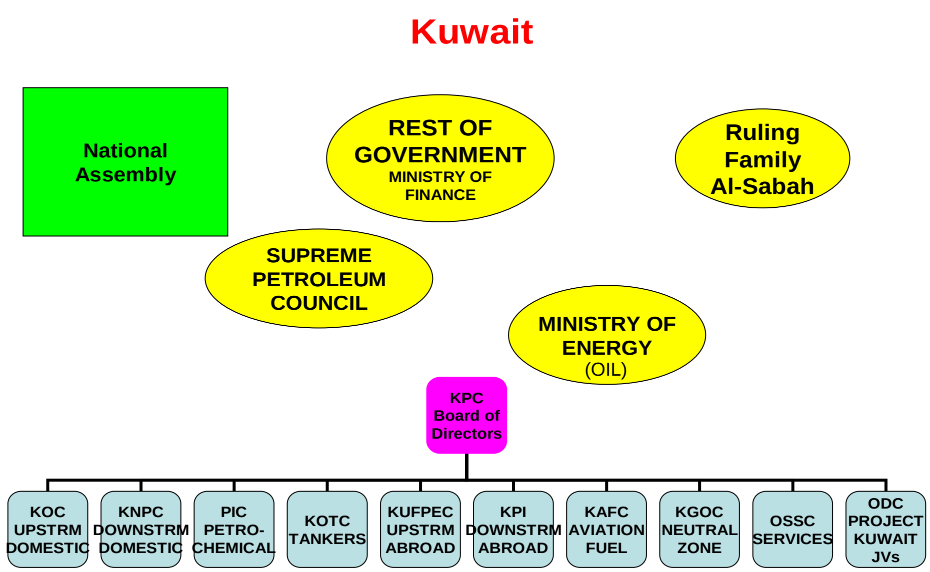
In this context, it makes little sense to talk about a unified "government strategy" towards KPC although as will be developed in detail in section 4 this does not prevent government interference in the way in which KPC is allowed to operate.

d. CURRENT STRUCTURE AND OPERATIONS OF THE NOC

Figure 1 outlines the players within the Kuwaiti petroleum sector, and Table 1 identifies the membership of the Supreme Petroleum Council and the KPC Board.

KPC's role as set out in Law 6 of 1980 was to take over the State's ownership of KOC and the other subsidiaries which had emerged. It was given the sole right to market crude oil and products abroad although KNPC kept the right to supply the local market. At the same time, certain key executive powers were granted not to KPC but rather to the SPC. Crucially, KPC could only make recommendations to the SPC on personnel and budget matters; the SPC alone was given the authority to actually set personnel regulations and send the budget to the government and National Assembly.

Figure 1 Organizational Structure of the Kuwait Petroleum Sector



Note The details of KPC's subsidiaries have already been described above except for the last two. OSSC was created in 2005 to carry out various service functions for the subsidiaries, and ODC was created to manage the hoped-for Project Kuwait joint ventures.

A key point to remember in this structure is that KPC's activities are governed by Law 6, whereas the subsidiaries are governed by standard Kuwaiti commercial law. For KPC to create a new subsidiary requires SPC approval. However, KPC subsidiaries simply need the approval of their own Boards. In a similar vein, the subsidiary employees are treated as private sector employees while the employees of KPC are in an uncertain limbo between the private and government sectors, with their salaries set by the Civil Service Commission.

The memberships of the SPC and the KPC Board are given in Table 1. As already pointed out, private sector representation in the SPC is significant, constituting a majority of the body.

Table 1 Memberships of the SPC and the KPC Board

SUPREME PETROLEUM COUNCIL	Chair = Prime Minister Deputy chair = Head of KPC Governor, Central Bank Five Ministers Nine non-government members
KPC BOARD	Chair = Oil Minister Deputy chair = Head of KPC Minister of Finance Seven Managing Directors plus subsidiary heads (except of KUFPEC)

3. KPC PERFORMANCE

a. KPC PERFORMANCE

KPC and its affiliates, in contrast to many NOCs, do produce fairly comprehensive information on a regular basis. Annual reports are prepared for KPC and its subsidiaries to international standards, and these reports are subject to both internal and external audit. The KPC consolidated accounts simply represent the sum of the subsidiaries including allowances for head office costs. However, despite this it has proved extremely difficult to develop a comprehensive picture of the companies' performance.

i. REVENUES

The "national mission" for KPC, to the extent that it exists, lies in the provision of revenue to the government to be spent on a welfare state and saved for future generations. Thus in many ways, the fiscal linkages between the sector and the government are the top priority.

The Kuwaiti fiscal system in the oil sector is organized around a budget system for KOC and a more corporatized approach for the other subsidiaries. KOC receives its capital expenditure allocation in a budget set by the government. This is then spent in maintaining and developing oilfield capacity that produces crude. KOC then turns around and buys this produced crude oil from the government, deducting from the purchase price its operating expenses plus 10 percent for a legal reserve, a requirement for all Kuwaiti companies to cover possible claims against the company. A committee consisting of KPC, the Ministry of Oil and the Ministry of Finance sets the price at which KOC purchases the crude on an annual basis. KOC then sells the oil in the international market at the going price and returns the sales revenue to the state less 10 percent for the Reserve Fund for Future Generations, in the process taking a 50 cents per barrel marketing fee. Alternatively, KOC can refine the crude through its refinery subsidiary KNPC and sell the products. Thus KOC is treated as a cost centre in which there is no incentive whatever to reduce operating costs. Any difference between the set price at which it purchases the oil and the market price at which it sells, whether negative or positive, falls to KPC. Although normally this is a small difference, if the oil price is changing dramatically and quickly it can amount to a considerable sum. Since it does have access to sufficient capital funding this inevitably creates a system to encourage gold plating and significant rent seeking by KOC.

KPC's other subsidiaries are allowed to earn profit – thus by refining and selling products, KPC can create earnings for itself. One obvious consequence of this system is a strong incentive for KPC to maximize its downstream operations, especially those selling into the international market since domestic product prices in Kuwait remain subject to a degree of subsidy. (Any resulting losses for KNPC from domestic sales are compensated directly to the company by the government, although it was difficult to obtain details on exactly how this arrangement works.) Obviously, profits from refinery operations abroad pay tax to their host government rather than the government of Kuwait. Another consequence of this system is that KPC has a keen interest in getting the "Pricing Committee" to set the internal oil price at a level that is low relative to the world market, which allows KPC to sell more crude (thus increasing marketing fees, which are based on volume) and also reducing its crude costs for refining (increasing refining margins, which accrue in the part of the company that is allowed to earn a profit). Given the clear weaknesses in this system of financing KPC there is talk of reform including the suggestion that price targets should be replaced with revenue targets to try and reduce gold plating and rent seeking. There has also been discussion of splitting off the marketing role from KPC into a separate organization. Nonetheless, this emphasis on downstream activities is built in to KPC's corporate structure and regulatory environment and helps explain why KPC has invested especially heavily in downstream and overseas operations compared with its peers in the region.

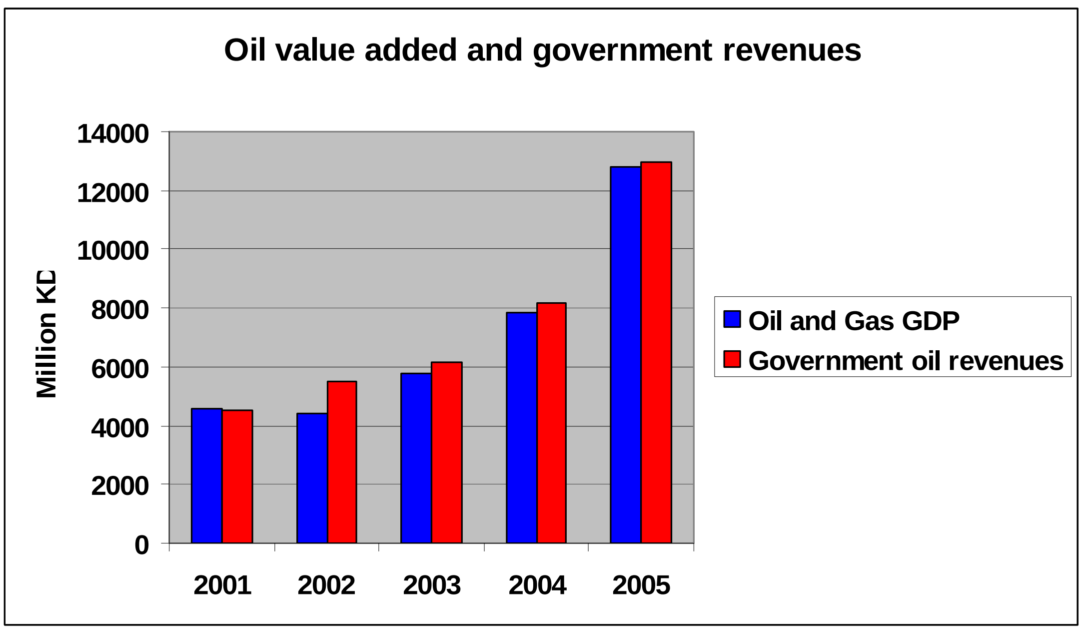
There is very little detail given in the central government's budget accounts beyond the heading of "oil revenues". The exact composition of these "revenues" is unknown. However they are substantial and in 2005/6 accounted for over 94 percent of total government revenue[15]. Nor is there any indication of how the costs of subsidies on oil products sold domestically are treated, although it is known that KNPC receives central government funding to cover the difference between domestic and international product prices. Certainly, domestic oil product prices are below international prices. In 2005, domestic prices for ultra-unleaded were 30.8 cents per litre and for gas oil/diesel 18.8 cents per litre (OAPEC). This compared to the Rotterdam spot prices at the end of 2005 of $1.59 and $1.47 per litre (IEA), respectively, for ultra-unleaded and gas oil/diesel.

Figure 2 compares government revenues from oil with the contribution of the oil and gas sector to GDP. Certainly the size of the slice appears to be very high but this gives us little or no idea of the size of the cake from which the slice is taken.

[15] In 2005, oil exports accounted for 94 percent of total merchandise exports.

The Government Budget for 2006-7 was based upon an oil price projection of $36 per barrel, giving revenues of KD 8.52 billion but with expenditure of KD 10.87. The figures for 2007-8 were KD 8.32 billion and expenditure KD 10.45 billion (MEES 50:8 2007). While this appears to indicate a deficit, the figures for the Kuwaiti Budget are notoriously misleading because contributions to the Reserve Fund for Future Generations (RFFG) are included on the expenditure side. Unfortunately, figures for the RFFG are regarded as highly secret[16] and so it is impossible to try and construct accurate numbers. Also the Government has a tendency to raid the RFFG without consultation. For example, in 2002, the Government announced to the Budgets and Closed Accounts Committee of the National Assembly that it has "withdrawn" $5 billion from the RFFG without legal authorization to contribute to the rebuilding of Kuwait after the liberation in 1991 (MEES Vol XLV No 49 2002).

Figure 2 Kuwait Government Oil Revenues



Source: Central Bank of Kuwait. (Note that while the GDP data is for the calendar year, the revenue data is for the budget year. Thus 2001 is 2001/2, which effectively creates a lag in the GDP which explains why revenue appears to exceed value added.)

[16] It is actually a criminal offence in Kuwait to divulge details of the RFFG.

ii. OPERATIONAL COSTS

The production costs per barrel are given in Table 2 below. Of themselves these numbers indicate relatively little. This is because benchmarking in the upstream is extremely difficult given the differences in geology facing different producers[17]. Costs appeared to be rising, although most companies have seen even steeper increases in recent years due to a global scarcity of service industry capacity. KPC may have been less exposed to these trends because of its favorable geology.

Table 2 Production Costs in Kuwait (Per Barrel Kuwait Dinars)

	2001/2	2002/3	2003/4	2004/5	2005/6
Costs	0.373	0.411	0.410	0.449	0.426

Source: KOC Annual Report 2005-2006. (Data uses 0.426 KD = $1.47)

However, there have been many statements by senior officials in the sector to the effect that one of the reasons for Project Kuwait and the entry of the IOCs was to try and reverse rising costs seen as the result of declining efficiency in the sector—notably where more complex geology has been involved, such as in the Northern Fields. As Nader Sultan, the former CEO of KPC, said in 2002

> "… our cost of production is increasing. These costs are divided into three major categories: one third for salaries and employment benefits – and this item is difficult to touch because we can not make our nationals redundant as IOCs do with their employees; one third for depreciation; and one third for contracts. It is expected that the cost of production will increase in the future because we are moving towards the difficult reservoirs." (MEES 45:16 2002)

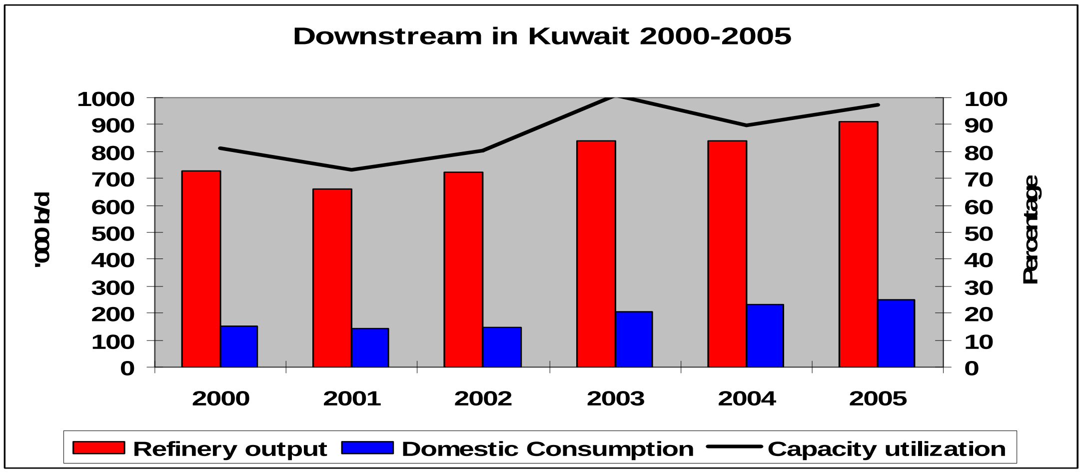
[17] Clearly also any assessment of the efficiency of the upstream sector, whether qualitative or quantitative, must take account of the necessity to recover from the massive physical destruction on the sector as a result of the Iraqi invasion of 1990 and its aftermath.

The managerial capacity of the sector was significantly diminished by the loss of KOC expatriate managers following the Iraqi invasion of 1990. In particular, the loss of the Palestinian contingent among the sector's management and professionals was a serious blow. While efforts have been made to replace the losses, the political and personal pressure to employ and promote – what Marcel calls the Diwaniya-Wasta culture (Marcel 2006 page 61) – is having a very negative effect on the capacity of the sector. Nepotism is rife which means many are being employed and promoted well above their capabilities. This will be examined in section 5. Interestingly, generally managers "rise from the ranks" within KPC and its subsidiaries. There is relatively little lateral movement by managers within the organization, which impedes development of an integrated oil company[18]. Put simply, managers tend to stay in the same bit of the value chain.

It would appear reasonable to assume that at least on the basis of qualitative analysis, the Kuwaiti upstream oil sector is not particularly efficient. Nor is such efficiency high on the list of sectoral priorities, which is not surprising in light of the generally low costs that stem from the country's favourable geology. The low priority is also reinforced by the relatively high-price world experienced since 2002. However, the way the sector is structured also does not create an incentive for KOC to contain costs in the upstream.

[18] There is no obvious explanation for this lack of movement across businesses. Possibly it reflects the fact that managers in the sector expect a "move" to involve a promotion and raise in salary. However, promotion to a higher level in which the manager has little or no previous experience makes little sense.

Figure 3 Downstream Output



Source: OPEC Statistical Bulletin 2005

As for the performance in the downstream the sector does appear to be delivering in terms of supplying the domestic market with product. Figure 3 indicates that the sector is well able to supply the continued growing demand for oil products in a context where demand growth is strong. Details of the existing domestic refineries are given in Table 3 below.

Table 3 Kuwait Refinery Capacity (b/d)

	Primary Distillation Capacity	Catalytic Hydro-treating	Catalytic Cracking	Residue Desulphurization
Mina Al-Ahmadi	450,000	100,000	40,000	132,000
Mina Abdullah	250,000	73,000	34,000	88,000
Al-Shuaiba	200,000	85,000	82,000	88,000

Source: KNPC Annual Reports

As the table indicates these are relatively sophisticated refineries. Mina Abdullah is regarded as the refinery to supply domestic markets, Mina Al-Ahmadi is for exports and Al-Shuaiba provides a balance between the two markets. Plans had been agreed to build a fourth refinery but as explained in Section 3bi these have had to be postponed as the cost of the project soared following initial bids. Meanwhile, the Chairman of KNPC announced in November that there were plans to expand Mina Al Ahmadi and Mina Abdallah with contract dues to be awarded in the 4th quarter of 2007 (MEES 49:49 2007)

Refinery capacity utilization is sound although the figures for 2001-2 were distorted by the loss of refinery capacity following a series of fires. However, there are no signs whatever of shortages and, according the KNPC's annual reports, the sector appears to be financially sound[19].

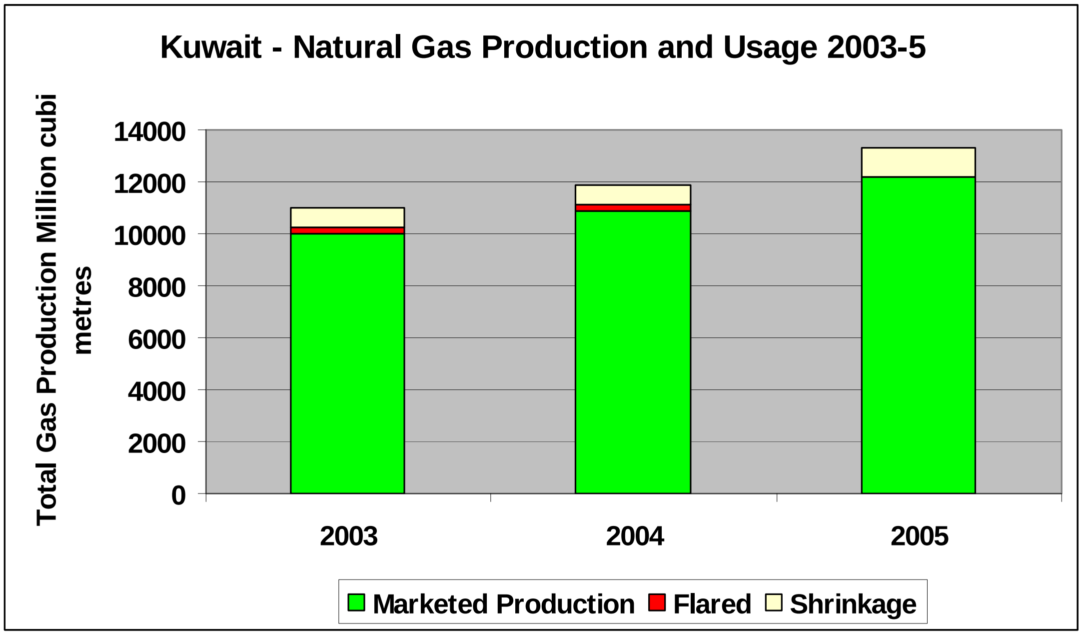
The only appreciable natural gas production to date has been associated gas; the first non-associated fields are just coming on-line. As seen in Figure 6, the utilization of associated gas has improved a bit due to the end of flaring. However, over the years Kuwait has suffered from gas shortages. Before 1990, Kuwait was becoming increasingly dependent upon gas imports from Iraq. Since the invasion in 1990 and subsequent events this source of gas disappeared. Other plans for importation from a variety of sources including Qatar and Iran have periodically emerged since 1990. However, given the availability of cheap fuel oil for energy and naphtha for petrochemical feedstock this cannot be construed as a problem or indeed a failure of the sector. If the geology is not conducive to finding and producing non-associated gas then gas supply is a function of crude production[20].

As for KOTC, 6 new tankers were ordered to be built in 2007 to add to the existing fleet of 25 tankers, which have a combined capacity of some 3 million dwt (MEES 50:8 2007).

[19] In 2005 KNPC posted a gross profit of 653.2 million KD compared to 128.0 million KD in 2004

[20] This situation is likely to change with the discovery of major non-associated gas fields at Umm Niga and Sabriya field. Further details are given below.

Figure 6 Natural Gas Production



Source: OPEC Statistical Bulletin 2005. Shrinkage is a term used to describe gas either consumed within or lost from a transporter's system.

In an effort to improve efficiency, a capital tracking methodology together with a post project evaluation process was introduced after 1998 to monitor the performance of projects. Also, in an effort to improve managerial performance, senior managers are increasingly offered salary bonuses based upon profits. These can be very significant, amounting to some 40 percent of final salary. Finally, throughout KPC and its subsidiaries, a "balanced score card" approach to assessment was introduced using financial, operational, HSE and human resources criteria to asses performance making extensive use where possible of benchmarking. It is too early to assess whether these reforms are actually improving performance. Casual conversations within KPC suggest things are getting better (PESD Interviews 2007) but this may simply reflect the triumph of hope over experience. Also, given possible changes to strategy it is difficult objectively to assess performance if the targets and objectives keep on changing.

iii. COSTS OF SOCIAL OBLIGATIONS

As the largest supplier of revenue in the country, KPC is often seen as a source that can be tapped for various local benefits. Other than issues to do with employment, KPC is reticent on the issue of "local content" in the Kuwaiti oil sector. Thus it supplies no data regarding how much of the supply chain comes from Kuwaiti companies. It is claimed that local vendors get priority in procurement but it is not clear that much can be supplied from within Kuwait and thus local content may be fairly limited. However, given the relatively limited scope of the rest of the Kuwaiti economy[21] such limited linkages are hardly surprising. The Oil Services Sector Company, the KPC subsidiary aimed at providing construction and security services for the sector, was only created in 2005, which implies local content was relatively low down the priority list for KPC. Although an indigenous petrochemical sector has emerged, which offers a modicum of local diversification and content, it depends heavily on the availability of cheap feedstock rather than good local suppliers and services.

However, the company is much more open with information about employment. While the oil sector accounts for some 50 percent of GDP, it accounts for less than 3 percent of direct employment. An important consequence of the Iraqi invasion of 1990 was that the oil sector lost a very large number of key managerial personnel when Palestinians and Algerians were declared *persona non grata* as a result of their government's support for Saddam. A consequence has been that the sector, under government pressure anyway to provide more jobs for Kuwaitis, has been increasingly employing workers who, to put it simply and brutally, are not competent to perform the job. This process has been seriously compounded as various interested parties within Kuwait have been putting pressure on KPC to show preference to certain individuals. For example, it is well known in Kuwait that members of the National Assembly have a strong tendency to promote the interests of their "clients". Hiring substandard employees, in turn, has raised serious concerns about the quality of KPC's management—concerns that will likely grow as the less competent younger generations are promoted from within. In part, Project

[21] In Hirschman's terms the "technological strangeness" of the oil sector.

Kuwait to develop the Northern oil fields with the help of IOCs was seen as a mechanism to fill that skills gap. The problem of course is that Project Kuwait has become mired in internal Kuwaiti politics and looks as far away from fruition as it did 10 years ago.

In 2005, as a means to be seen to be employing more Kuwaitis, the Minister decided that security and fire fighting for KPC, which previously had been to responsibility of the military, should be performed by KPC employees. Thus, while in 2004 KPC headquarters employed 800, by 2005 this number had risen to 1,900, which was accounted for entirely by these new security personnel who were now on KPC's books at an estimated cost of KD 12 million annually.

At the end of 2002/3 KPC and its subsidiaries employed 12,963, of which 75.4 percent were Kuwaiti Nationals. In 2003/4, KPC introduced a Five Year Kuwaitization plan. In addition, KPC introduced a requirement that KPC contractors must employ at least 25 percent Kuwaiti nationals. Several years later, KPC employment was at 20,340, according to Petroleum Intelligence Weekly's Supplement (PIW December 18 2006). However, as suggested above, some of this apparent gain may have been less than substantive.

iv. FINANCIAL FLOWS AND THE GOVERNMENT

A great deal of the financial information that is included in the other case studies is not available in Kuwait, where the government often lacks transparency. KPC and its subsidiaries do produce audited accounts, summaries of which are provided in Appendix 1, but these accounts do little to clarify detailed financial flows. What is clear is that Kuwait has been highly dependent upon KPC for revenue and for foreign exchange earnings.

b. STRATEGY

i. THE ALLOCATION OF INVESTMENT CAPITAL AND PERSONNEL AND THE FORMS OF INVESTMENT

Before the Iraqi invasion, KPC had a clear strategy derived from the vision of Ali Al-Khalifah as Minister. This was to convert KPC into a major international oil company competing with the IOCs. Following Kuwait's liberation, as will be developed below, the strategy became much less clear. Indeed there seemed to be a constant revisiting of strategy. In particular there was a constant questioning of KPC's overseas operations. The current state of KPC activities is presented below in Table 4.

<u>TABLE 4 – Activities of KPC and Subsidiaries</u>

(Source: Annual Reports and Websites)

KPC – Kuwait Petroleum Corporation

(Overall Holding Company)

<u>Home Market</u> (no specific subsidiary)

Capital Projects (In progress):

- Expansion of Onshore Production Facilities Project for Khafi Oil
- Expansion of Onshore Production Facilities Project for Al-Hout Oil
- Revamping of the Offshore Loading Terminals of the Divided Zone
- Onshore Divided Zone Project to Maintain the Current Production Status
- Calcified Coal Project was transferred to the private sector
- Plans to partially privatise the "New Refinery Project"

Capital Projects (Implemented):

- A series of Health, Safety and Environment projects including publicity campaigns, preservation projects, organisation of training workshops, auditing and studies.

Studies:

- Memorandums of Understanding for R&D between KPC and Kuwait, Cambridge (UK), Imperial College (UK) University, plus T.U Dhalfatt (Holland) and the FPI (France). 2 million KD allocated for research projects.

Abroad (no specific subsidiary)

Activities:

- KPC signed contracts with DESC International Company to provide it with 450,000 metric tons of aviation fuel
- Lebanon received 485,000 metric tons of gas oil

KOC – Kuwait Oil Company

(Domestic Upstream)

Home market

Discoveries:

- Free gas in North Kuwait (Sabriya and Umm Naqa fields)
- Rawdatain Northwestern Field
- Kra'a Al-Maru Field

Capital Projects (Implemented):

- Re-building of Gathering Centre (15) and Gas Booster Station (131)

Capital Projects (In Progress):

- "Crude oil export terminals at the two northern and southern tank farms, Mina Al-Ahmadi and tanker fuelling facilities" Project in association with Korean Hyundai Heavy Industry
- "Revamping of KOC oil installations (Group A) – South East Kuwait" Project in association with Petrofac Company
- "Revamping of KOC oil installations (Group B) – South East Kuwait" Project in association with SKEC

Studies:

- Bahra area – assessment of gas production
- Najma/Sarjelio Reservoir to develop the Manaqish Field reservoir
- Zrif Field, Marat– pumping water into the reservoir – joint study with BP

KNPC – Kuwait National Petroleum Company
(Domestic Downstream)

<u>Home market</u>

Activities:
- Controls 3 oil refineries (Mina Al-Ahmadi, Shuaiba and Mina Abdulla)
- Gas liquefaction plant at Mina Al-Ahmadi
- 73 operating filling stations (47 are self-service)
- 40 filling stations transferred to the "OULA" fuel company

Capital Projects (Implemented):
- Setting up a new building (Dar Al-Wataniya – entrance of Ahmadi City) for senior management and all employees from main office in Kuwait city
- Revamping of the two vacuum distillation units of Mina Abdulla refinery
- Unifier units – installation of an additional compressor

Capital Projects (In progress):
- Building a new oil pier, rehabilitation of the Northern and Southern Shipping Piers at Al-Ahmadi Refinery
- Building a new refinery in Al-Zoor
- Ethane Recovery Unit Project
- Modernisation of Obsolete Instrumentation at Old Refinery and RMP area
- Tail Gas Treating Unit at Shuaiba Refinery
- Enhancement of local supply and distribution – including cross country pipelines and new facilities at refineries
- New ATK Merox Unit at MAB
- Revamp of effluent treatment facilities

KGOC – Kuwait Gulf Oil Company
(Neutral Zone Operations)

<u>Home market</u>

Activities:
- Managing share of resources in the divided zone
- Al-Khofji and Al-Hout offshore oil fields are main production areas in the divided zone

Studies:
- Updating data of productive offshore fields in the Divided Zone
- 2D seismic survey project covering all offshore divided areas

- 3D seismic survey for Dorra and Lulu fields

Mergers:
- The management of Wafra Joint Operations transferred from KOC.

Capital Projects (In Progress):
1.8 billion US$ in various projects including new crude oil transmission line, gas transfer line and various construction and upgrading projects

ODC – Oil Development Company
(Run "Project Kuwait" Joint Ventures)

Home market

Capital Projects (In progress):
- Contract with pre-qualified international oil firms consortium for the development of 4 oil fields in North Kuwait (Al-Rawdatain, Sabriya, Ratqa and Abdali)

Management:
- Development of reservoirs by improving management, labour and extraction practices cost-effectively

PIC– Petrochemical Industries Company
(Petrochemicals)

Home market

Capital Projects (In Progress):
- The Aromatics Project – Aromatics plant to be constructed with PIC controlling 80% of the company. To be completed by Jan 2009. Will produce Paraxylene and Benzene.
- 2nd Olefins Project – Kuwait Olefins Company (TKOC) was established with PIC owning 42.5%. Will produce Ethylene, Ethylene Glycol, Polyethylene and Propylene.
- The Styrene Project – Styrene plant finished by August 2008.

Abroad

Activities:
- Meeting growing demand in Australia, US and some European countries
- Egypt and UAE have been the main markets for Petrochemicals this year

Capital Projects (In Progress):
- Building a petrochemical complex in China – a Memorandum of Understanding has been signed with the government of Guangdong Province.

KAFCO – Kuwait Aviation Fuelling Company
(Aviation Fuel)

Home market

Activities:
- Provided 27,031 aircraft with fuel

Capital Projects (Implemented):
- Main supply line for the company's depot and a new supply network for the cargo area at the airport

Capital Projects (In Progress):
New KAFCO Depot – target completion mid-2008

KOTC – Kuwait Oil Tanker Company
(Tankers)

Home market

Activities:
- Carried 67% of the total cargoes from Kuwait
- Partial privatisation (76%) of each of the marine fleet operations activities and gas cylinder filling plant

Capital Projects (In Progress):
- Marine Fleet revamping projects – delivery of oil supertanker Kazma as well as a further 3 tankers. 9 new double body tankers are also in production
- New Building for KOTC – new headquarters in Shuwakih area
- New Plant for Filling Liquefied Gas Cylinders – In Umm Al-Aish area
- Building 6 Underground Tanks for Liquefied Gas

KPI (Q8) – Kuwait Petroleum International
(Downstream Abroad)

<u>Abroad</u>

Activities:
- Memorandums of Understanding were signed with BP,Total and Shell for cooperation in research and defining joint investment opportunities in markets in Asia
- High ranking delegations visited China, India, South Korea and other Asian countries for holding talks, exploring and defining the joint investment opportunities with the local oil companies there.

Existing Activities (KPI):
- More than 4000 Q8 stations across six European countries including Italy, Sweden, Denmark, Holland, Belgium and Luxembourg
- International Diesel Service concept – for national and international transportation companies throughout Europe

Existing Activities (Q8 Oils):
- Lubricant blending plants in Belgium, Italy and the UK

Existing Activities (Q8 Aviation):
- Q8 Aviation supplies the four main UK airports as well as regional airports. The Italian network spans 10 international and regional airports. Frankfurt and Charles de Gaulle are also supplied
- Q8 Aviation are part of a consortium supplying fuel for Hong Kong
- Q8 Aviation supplies 15 of Thailand's airports

Activities 2005-06 (KPI):
- Selling operations in UK and Thailand
- Rise in aviation fuel sales to Italy and Spain
- Sold a small retail network in Germany to Westvalin Company
- Memorandums of Understanding were signed with BP, Total and Shell for cooperation in research and defining joint investment opportunities in markets in Asia
- High ranking delegations visited China, India, South Korea and other Asian countries for holding talks, exploring and defining the joint investment opportunities with the local oil companies there.

KUFPEC – Kuwait Foreign Petroleum Exploration Company
(Upstream Abroad)

<u>Abroad</u>

Activities:

- Total gas and oil production rose by 48%
- Reserve base dropped by 8.32%
- 48 exploration and production interests distributed in 14 countries that include Australia, Pakistan, China, Qatar, Yemen, Egypt, Indonesia, Malaysia, Tunisia, Algeria, Sudan, the Philippines, Syria and Ivory Coast
- Privatised by an initial 30%

Capital Projects (In Progress):

- 5 new exploration opportunities in Syria, Philippines and Yemen
- Looking at opportunities in North, West and South Africa

The web of subsidiary activities chronicled in Table 4 is the result of a long and complex history. In the early days of KPC after its creation in 1980, the main "strategy" was simply to try and incorporate the various subsidiaries into something resembling an integrated oil company. This strategy arose less from a careful analysis and more from the chaos of events—in a brief period the country had nationalized its oil industry and it feared that important services that previously had been provided by the IOCs would be lost. At the same time, the newly nationalized company became a basket to hold any and all elements of the industry that the state had found in its hands. As indicated earlier this was a difficult task since the various subsidiaries had very different histories and very different cultures—even when they performed similar functions in the value chain. This approach—accumulation without strategy—created a host of immediate managerial problems with little vision for how the company would operate as a synergistic whole.

At this stage – around the 1980s – Ali Khalifah as Oil Minister and Chairman of KPC began to try and think longer term and develop some form of strategic vision. There were two drivers. The first was to try and internationalize KPC's activities. This was intended to "… diversify the asset base of the company, [develop] new markets for crude, bring in new technology and maximize the returns for the company" (Marcel 2006 page 196). In effect, Khalifah wanted KPC to become an IOC. In 1981, he spearheaded the creation of KUFPEC to manage overseas upstream operations. In 1983 at an OPEC meeting, Ali Khalifah was approached by the CEO of Gulf Oil. He offered to sell to Kuwait Gulf's downstream operations in Netherlands, Belgium and Luxemburg. These were offered to Khalifah at the magnificent sum of $1! The reason for the sale was that the aftermath of the First Oil Shock – a world of dampening demand even as tranches of new refinery capacity came online – erased the profitability of refineries, especially in Europe where established refineries protected market share and aggressive efficiency measures killed demand for products. (In the middle 1970s, spare refining capacity sat at 30%.[22]) Many IOCs were looking to try and divest themselves of loss-making downstream operations that tied up large amounts of capital—in the form of physical equipment as well as working stocks—that could be used elsewhere[23]. KPI was created in 1983 to manage this acquisition and subsequently bought downstream assets in Denmark and Sweden. In 1984 KPI bought Gulf's interest in Italy and in 1986 expanded to the UK. In 1987, it bought BP's downstream operations in Denmark and in 1990 bought Mobil's operations in Italy. Further acquisitions followed. All of these assets market under KPI's trademark: "Q8".

The second driver to Ali Khalifah's vision was the impact of the Iran-Iraq war. By 1982, Kuwaiti crude production had fallen to 862,000 b/d compared to 2,623,000 in 1979 (BP, 2006). The central barrier to production was securing tankers willing to move Kuwaiti

[22] Based on data from the BP Statistical Review of World Energy in 1975, there was almost 30 percent spare refining capacity in the OECD and the Emerging Market Economies. The high fixed cost component of refinery operations means that profitability requires full capacity operation. Such high levels of unused capacity, which carried on into the 1980s, were a disaster for refinery profitability. In 1982, the year before Gulf's offer, the figure reached a record 47 percent excess capacity.

[23] In more recent times, very low sales prices for refineries (for example, Enron bought a Chevron refinery for $1) have been driven more by concerns over the environmental costs of decommissioning a refinery.

crude in a war zone. To fix the problem, KOTC needed to obtain its own secure transport infrastructure tankers.

This two-pronged expansion outside Kuwait's borders was greeted with some scepticism and reservations from within Kuwait. Many saw it as Ali Khalifah "empire building". The financial state of KPI's downstream operation in Europe was unattractive (as were all downstream operations in Europe). In particular, KPC was accused, after its first purchase from Gulf, for paying well above market prices for the further acquisitions[24]. As one observer remarked they "paid top dollar for third rate assets". As for the upstream, many felt it inappropriate to invest national resources in the creation of a "cash cow for another host government to milk". However, to counter this, some pointed out that there was little point in further investing in the Kuwaiti upstream whose production was severely constrained by OPEC quotas after 1983. Rather, investing in non-OPEC countries meant that Kuwait could indirectly increase its production, although much of the benefit did accrue to host governments.

On balance, a measure of diversification was probably wise, especially since the operations within Kuwait were under tight political control. However, those who had expressed reservations about Ali Khalifah's strategy for KPC found their arguments reinforced when allegations appeared of financial impropriety by Ali Khalifah. In 1996, three senior executives of KOTC were convicted and sentenced for fraud. A Ministerial Court dropped related charges against Ali Khalifah for "technical reasons" on two occasions. However, in May 2001, the Government announced it was to file fraud charges against him (MEES XLIV No 22 2001).

The country's liberation after 1991 was seen as an opportunity to reconsider the whole of KPC's strategy. However, there was a basic problem. In the words of one interviewee, "Strategy means vision but in Kuwait it means the vision of one person". Thus given the large number of oil ministers in the post after 1991 it was hardly surprising that the vision

[24] Subsequent investigations by Government Auditors confirmed that KPC had paid well above market prices (PESD Interviews 2007)

kept on shifting. To be sure, the CEOs of KPC, who turned over relatively infrequently, provided more stable guidance and direction, but they remained at the whim of successive ministers and found it difficult to devise and implement a coherent and consistent strategy. At KPC, strategy develops through a multi-level negotiation – between the company and its varied masters as well as between KPC headquarters and the subsidiaries. What emerges from this is a five year plan/budget. Once a version of the five year plan has been drafted it must go to the KPC Board for approval then on to the SPC sub-committee responsible for approval of plans. Each of these stages involves still further negotiation. Finally, with the SPC's blessing the plans go to the State Audit Bureau (see below section 4bii) and the National Assembly. These further stages all involve greater analysis, questioning and challenges.

The latest strategy which is driving KPC and its operations is "Vision 2020". This plan emerged in 2001 and attempts to set a wider context for the five year operational plan/budgets. It covers all aspects of the sector from core to non-core and provides specific targets for the subsidiaries. The Vision was revised in 2005 and is currently undergoing further review; a new strategic vision is expected to emerge within the next year.

As noted by senior KPC management, the company is good at producing strategies but poor at implementation. There is a general acceptance by all within the sector that project implementation is not going well and that targets are regularly missed. In November 2006, a report from the State Audit Bureau was leaked to the press (MEES 49:49 2006). The report was extremely critical of KPC for trying to revise what were in effect missed targets. Thus the capacity target of 3 million b/d by 2004-5 had now been pushed back to 2008-9 and the target to reduce gas flaring to 1 percent by 2004-5 was now set to 2010-11 because of "technical problems at the gathering stations". In addition the planned fourth refinery had been postponed because of serious cost overruns[25] and an apparent

[25] The original cost estimate of $6 billion had risen to $15 billion.

dispute with Saudi Arabia over the location at Al Zour (MEES 50:8). The plant of 615,000 b/d was due on-stream by 2010[26].

Within this strategy, the attitude to overseas projects remains ambivalent. The original approach to the downstream was based upon providing market access for Kuwait crude and products. In recent years, given the growth of Asian oil demand it is hardly surprising that Asia has received special attention, and the official line within KPC is that it seeks to target countries characterized by strong economic growth and growth in domestic oil consumption.

More recently, senior KPC management have a strong preference for joint ventures. This is because joint ventures are seen to strengthen operations and marketing capabilities and also provide local political support (PESD Interviews 2007). This view departs from the very strong antipathy that Ali Khalifah had towards the IOCs when he was Oil Minister. After the liberation in 1991 and the technical assistance agreements with the IOCs, the KPC management had a far more positive attitude to working with the IOCs. The current basis for strategy, which also relates to domestic activities, appears to be a triangular approach. KPC feedstock can be linked through an IOC – who can bring management skills, technology and risk management – to a local company that can provide market access.

However, despite much effort, there has been relatively little success in the Asian markets and it has been suggested this is because KPC has been unable to secure the necessary channels to engage a local partner[27]. This has led to some extent to a growing disillusion with KPC's overseas operations and for a time in recent years there appeared to be a policy of divesting some of the overseas assets. Thus in 2004, KPI sold its UK retail service station networks and direct fuel distribution operations and in 2005 the

[26] The plant was to operate in two stages. In phase 1 it would produce 225,000 b/d of heavy fuel oil for power generation and 375,000 b/d of light and medium "high quality" products. In phase 2 when gas was able to replace the fuel oil, the fuel oil would go through upgrading kit to increase light product production.

[27] It is perhaps surprising that Kuwait did not try to entice access to the downstream in Asia by offering upstream access to some Asian NOCs in Kuwait. Possibly the negative experience with Project Kuwait inhibited KPC from offering this and the Asian NOCs from considering it.

retail service network in Thailand. However, in October 2006, the Oil Minister cancelled the sale of the 80,000 b/d Europort Refinery in Rotterdam. The reversal of this decision, which had been previously approved by the KPC Board, came as a surprise to KPC management who actually learned about it from press reports (MEES 50:8 2006). The Minister justified his decision by saying that the "country's strategy" was to "expand its downstream assets" (MEES 49:43).

4. GOVERNMENT GOALS, CAPABILITIES AND THE RELATIONSHIP BETWEEN THE STATE AND THE OIL SECTOR

a. GOVERNMENT STRATEGY AND MISSION FOR THE OIL SECTOR

Any plans for an oil sector in a country where oil dominates cannot be set in isolation from the wider development strategy of the country. In Kuwait, the process of setting a development agenda has been somewhat haphazard, which has not helped in setting the objectives for the petroleum sector. In 1987, the Government created a 26 man Supreme Planning Council including eight ministers, which by 1999 had experienced five reformulations[28]. In 1989, it produced a document entitled "Long-Term Strategic Development of Kuwait". In 1992, it produced a National Document for Reformation and Development covering the period up to 1995. In February 1994, a Five Year Plan emerged covering the period 1995-2000 whose main objective appeared to be balancing the budget, which had suffered badly due to low oil prices. These documents are laden with aspirations, hopes and slogans with little by way of specific targets and nothing by way of policy instruments. They had essentially no effect on the policy of government or of KPC.

[28] This reflected a combination of Government uncertainty over the role of the SPC and the result of a series of consultancy reports on the sector (PESD Interviews 2007).

In March 2004, a new Higher Council for Planning and Development was launched. This was intended to produce "goals and development programmes" and was expected to ensure "coherence and harmony" with decisions by the Cabinet. The launching speech pointed to the need to develop the oil sector by establishing oil industries which could compete globally and provide Kuwaiti manpower with "productive working opportunities". Little appears to have emerged since the launch and it seems likely that the very high oil revenues experienced since 2002 have pushed concerns over the general nature of development off the policy agenda.

Putting these goals into action—even if the government made an earnest effort—would be difficult because policy directives arrive on the doorsteps of KPC and its subsidiaries from multiple and often conflicting sources ranging from the SPC to the Cabinet—thanks to the system of divided government in Kuwait. Moreover, on matters related to oil there is a strong lack of trust between the National Assembly and the Government. This partly reflects the importance of oil in Kuwait but also the involvement of some of the Al-Sabah family in the role of the "agents" of the Government who in the early stages of Project Kuwait acted as the link between the IOCs and the Government (MEES XLIV No 12 2001). As previously discussed, the situation has been aggravated by a series of accidents at plants. The general confusion is further compounded because of the uncertainty over the nature of the regulatory function of the Ministry vis-a-vis KPC as discussed below. In this context, while there are objectives for the sector, their nature is often vague[29] and prioritization is far from clear. An area of particular uncertainty discussed in section 3b relates to the strategy of KPC's domestic operations in relation to its overseas operations. In particular, there is a suspicion that KPC's overseas operations are simply a device to disguise from the Government what they are doing.

The official plans for KPC approved by the SPC are embodied in the strategy plan known as "2020 Vision". These include increasing crude producing capacity from 3 mbd in 2005 to 4 mbd by 2020[30]. In the downstream the Strategy envisages increasing refinery

[29] The web pages of KPC are littered with Mission Statements and Vision and Value Statements.
[30] In 2005/6 KOC's Annual Report gives actual capacity as 2.337 mbd.

capacity to 1 mbd (including upgrading kit to convert the heavier ends of the barrel into lighter products) by 2010 and further increasing to 1.5 mbd by 2020[31]. The rest of the subsidiaries have targets expressed as non-quantified aspirations[32].

These targets, which are now Kuwait's official policy, have uncertain provenance, but their origin appears largely drawn from internal discussion. The determination of the crude capacity target illustrates. According to Marcel, the decision to raise crude producing capacity appeared "… to go back and forth between institutions with a degree of confusion for all" (Marcel 2006, page 80). Thus KPC's Corporate Planning Department projected a possible call on Kuwaiti crude (within the OPEC quota context) of 7 mbd by 2020. KOC indicated that 4 mbd was the maximum sustainable capacity under prevailing conditions. KPC presented this as the target but was overruled by the SPC who wanted a target of 5 mbd although it is not clear that there was any analytical basis for such a number. In the event, the SPC backed down and reverted to 4 mbd for 2020.

A system with such an ad hoc structure is clearly very vulnerable to shifting and uncoordinated priorities, which confers flexibility but also lack of rigorous vision. Thus for example, the series of bad fires in the refineries led to a major HSE campaign within KPC. In similar vein, privatization of parts of the sector move up and down the agenda depending upon the political atmosphere. Elements in successive governments have been very keen on privatizing elements of the oil sector that, as discussed in section 2a, already have a strong private sector dimension. A major impediment to privatization is the influence of the trade unions, which fear job losses. In Kuwait these are a powerful force, which is unusual for countries in the Gulf Cooperation Council (GCC) where governments generally don't tolerate independent dissent. Thus for example, two-thirds of gasoline stations have already been privatized but the proposed privatization of the remaining third was "postponed" by the Minister in late 2006 under union pressure via the National Assembly.

[31] The KPC Report actually says 2010 but this appears to be a typographic error.
[32] The only exception is for KUFPEC where it is stated overseas production should reach 100,000 b/d by 2010 and 200,000 b/d by 2020.

Another official objective which is being driven by both KPC and the Ministry concerns the promotion of Project Kuwait. The origins of Project Kuwait go back to the immediate aftermath of the liberation of Kuwait in 1991. At that point, the Kuwaiti oil sector was in a desperate state with much of the producing capacity in flames and KOC facing serious shortages of management at all levels following the departure of many expatriates in the face of the Iraqi invasion plus the expulsions of Palestinian and Algerian managers who had been significant in KOC management.

At this point Kuwait sought technical assistance from the international oil companies (IOCs), which was forthcoming. Between 1994 and 1997, five technical service agreements were signed with Chevron, Shell, BP, Exxon and Total. The IOCs were willing to do this because they focused on an implied quid pro quo that when things had settled, the Kuwaiti upstream might be opened to those who had assisted. In 1993 a decision was taken to extend the opening to allow the IOC's to invest in the upstream sector under the terms of "Project Kuwait". This was driven by several factors. There was the need to secure military support from the West. This could be guaranteed better if their nationals were exposed on the front line. There was also a need to secure expertise and technology both in terms of engineering and management to fill the still remaining post-invasion manpower gaps in KPC. This was strongly reinforced because there was a growing realization that maintaining production levels would become increasingly complex as the crude reserves became heavier. In particular there was concern over water management in the fields. Production of 4 million b/d of crude in 2020 per targets would entail handling some 12 million b/d of water.

Finally, there was a growing belief in some quarters within Kuwait that KPC had been engaged in classic rent seeking behaviour and its level of efficiency was suspect. The entry of the IOCs it was believed would provide a benchmark to allow the performance of KPC to be assessed. This view was very much supported by Nader Sultan. In 1993, he returned from Europe having been President of KPI, which managed Kuwait's overseas downstream operations in a context that he described as being "intensely competitive". Initially he was made KPC deputy chairman and managing director for Planning and Projects and then in 1998 was appointed CEO of KPC. His prime objective was to create a performance culture within KPC at the same time as increasing the commercial orientation of the company and its subsidiaries. The example that illustrated the point was the experience of PIC. In 1997, PIC had formed a joint venture operation with Union Carbide. The result was that within two years, PIC had significantly improved its corporate and managerial performance with Union Carbide acting as the example to be followed. Thus there was support for involving IOCs both within KPC and amongst other sections of the Government and the elites[33].

Initial proposals from KPC to create Project Kuwait were rejected in 1995 by both the National Assembly and the SPC. A major barrier was the fact that the Kuwaiti Constitution explicitly rejected the possibility of foreign "ownership" of the oil reserves. Article 21 stated "Natural resources and all revenues therefrom are the property of the State. It shall ensure their preservation and proper exploitation, due regard being given to the requirements of State security and the national economy". Even larger barriers arose in Article 152, which stated, "No concession for exploitation of either a natural resource or a public service may be granted except by a law and for a limited period. In this respect, the preparatory measures shall facilitate the operations of prospecting and exploring and ensure publicity and competition".

To get around this problem the concept of an "operating service agreement" was developed whereby the Kuwaiti government retained full ownership and the IOC would be paid a "per barrel" fee, along with allowances for capital recovery and incentive fees for increasing reserves. This workaround was very similar to the multiple service contracts (MSCs) devised in Mexico to get around similar restrictions on foreign title to hydrocarbon resources in that country.

[33] During the 1990s, there were some voices in Kuwait who began vocally to advocate the privatization of all elements of the oil sector (PESD Interviews 2007).

During 1998-99 new details emerged for the terms of these "operating service agreements". Three consortia—involving 12 companies that included a number of Russian, India and Chinese enterprises—were accepted for bids. In November 1999 a major international conference was held to launch the process but effectively this turned into a bitter debate about who inside Kuwait should govern the process. Interestingly, many of the National Assembly opponents did not, in principle, object to IOC involvement, but in the process they found many troubles. At the center of these disputes was an emerging debate between the National Assembly and the Emir's Al-Sabah family over who rules Kuwait. In addition there was a subset of concerns over the potential for corruption if the family retained exclusive control over awarding contracts. The National Assembly pressed for a specific law, which the government initially rejected until after the 1999 conference when it relented. In February 2000, the Assembly considered a law, which it quickly rejected for lack of detail. A new law was presented in April but failed to even get on the agenda as the broader crisis between the Assembly and the government deepened. In January 2001, despairing of progress, KPC sent out Initial Process Protocols to the IOCs, with the hope that the legislative process would fall into place. It also announced the "data room"—the repository of geological information that the outside companies would need to formulate bids—would open in February 2001. However, without legislation the process was effectively frozen.

Since then, despite numerous changes of government and several elections, the situation remains unresolved. Variations on the legislation have been presented to the National Assembly and the relevant committees but without success. Parliamentary timetables, once set, keep slipping; periodic optimistic statements by officials have lost credibility. In addition, as part of a more general rise of resource nationalism, there is growing opposition to IOC involvement as a matter of principle. In November 2006, the then Minister of Energy publicly stated that he would not be submitting Project Kuwait to the National Assembly unless "appropriate measures" could be agreed upon for preserving Kuwait's oil wealth. Meanwhile, in the shadow of indecision and a tide that has turned against foreign involvement, much of the original IOC interest has disappeared. Project Kuwait presents a classic example of what happens when a government tries to push an agenda without attention to assuring the necessary political support. By the time they had acceded to the need to consult, the damage had already been done.

b. GOVERNMENT POLICIES FOR THE OIL SECTOR

i. INDUSTRIAL STRUCTURE

The original intention behind the creation of KPC in 1980 was to create a vertically integrated oil company to manage the various state-owned stages of the value chain. Ever since, the enterprise has suffered from the simple fact that KPC's activities are governed by a specific law while the subsidiaries are governed by Kuwaiti commercial law. The result has been tensions not least because the subsidiaries represented a very different set of histories and cultures.

A particular issue has been the nature of vertical integration, which can take two forms—financial and operational. Financial vertical integration is when different stages in the same value chain are owned by one holding company. The same company owns all the crude producing affiliate, the refinery and the marketing network or, alternatively, the electricity generator owns the transmission network and the local distributor. Hence the holding company effectively controls the cash flows of the affiliates. Operational vertical integration obviously requires the presence of financial vertical integration but the reverse is not true and markets can replace operational vertical integration.

The difference between financial and operational vertical integration for the oil industry has been significant (Bindemand, 1999; Stevens, 2003). The major private oil companies, before the second oil shock of 1978-81, were both financially and operationally vertically integrated. Transaction and information costs made operational vertical integration superior to markets which were non-existent or highly imperfect. Operational vertical integration also had the benefit for the companies of inhibiting competition. In theory, at least, an operationally vertically integrated oil company provides significant barriers to entry. If the companies only exchange crude between their affiliates, there is no access to crude for third parties. Also, it is possible to practise price discrimination by integrating into the low priced market preventing arbitrage. Finally, operational vertical integration enabled the companies to reduce their tax liabilities through the use of transfer prices.

After the second oil shock, the private IOCs moved away from operational vertical integration, preferring instead to use markets. The increasing use of markets reflected several factors. The nationalizations of the 1970s plus the discrediting of long-term contracts[34] increased the number of arms length transactions, which meant both a greater number of buyers and sellers and greater market transparency. Transaction costs fell, which encouraged still more transactions and a further decline in costs. This larger market, in turn, lowered the barriers to entry as new non-integrated crude producers entered the market and as the majors began to sell off refineries to smaller petropreneurs. In such a world, integration was no longer an effective barrier to competition. For nearly all participants, hedging could be achieved more efficiently in the markets than through self-integration. Finally, the tax authorities began to constrain transfer pricing and other tax manipulations, such as through requiring a greater use of arms-length transactions and the marking of products to markets. Operational vertical integration among the private IOCs, except in certain specific cases, largely disappeared.

Several NOCs nonetheless preferred to sustain operational vertical integration. This was especially true for the two NOCs that were pioneers in moving into the downstream abroad—KPC and Venezuela's PdVSA. Officially, as described in section 3b, KPC did this to lock in market share. To an extent this did make sense given that Kuwait crude was heavy, sour and generally difficult to refine. However, an additional explanation was to deepen the information asymmetries at the heart of the principal-agent relationship between the government of Kuwait and KPC, thereby allowing the enterprise to capture a greater share of the rent for itself.

[34] Before the second oil shock, the IOCs marketed crude on behalf of the host governments (despite the nationalizations of the mid 1970s) on the basis of long term contracts (three years) at government official sales prices. When spot prices began to rise after the Iranian oil workers strike and the Iranian Revolution, the host governments, invoking the "force majeure" clause, simply ripped up these sales contracts.

The government – both the administration and the National Assembly – saw KPC's "going downstream" strategy for what it was, and the result was growing distrust and various efforts through the 1990s to expand monitoring and control (described below in section 4bii). As crude prices fell in the 1990s, the spiral of distrust and oversight accelerated, all of which seriously inhibited KPC's ability to operate. The SPC, too, became concerned that KPC was operating without attention to its strictures. However, unlike the government's lack of trust—which remains to the present day—the SPC was able to try and readjust its oversight. This was done partly with the creation of the three sub-committees in 2000 and also with a new monitoring system that tries to ensure KPC follows up on SPC decisions. This together with an ability to focus purely on the oil sector[35] has given the SPC greater confidence that it now understands better KPC's operations (PESD Interviews 2007). Whether this is actually the case remains to be seen.

ii. REGULATION

The story of the regulation of the oil sector in Kuwait is long and complex and holds the key to understanding why KPC has had difficulties in performing effectively and efficiently[36]. The story begins with Law 19 of 1973—a simple (two page) piece of legislation. It was intended to outline the responsibilities of the Ministry of Finance and Oil with the respect to BP and Gulf Oil's control of KOC and focused basically on "good oilfield practice" issues. However, the Law did give the Ministry the power to issue regulations, and in 1975 a set of regulations duly appeared (Al-Atiqi, 2005). However, it emerged that these regulations were just an Arabic translation of some Canadian regulations with no attempt to adjust them to the context of Kuwait[37].

When KPC inherited KOC following the nationalization in April 1976, it also inherited this uncertain (and unwelcome) regulatory context. In October 1976 it wrote a letter to

[35] This is an option not available to other elements of the Government who must take a wider brief.
[36] What follows draws heavily on Al Atiqi, 2005.
[37] In the regulations, the glossary in Arabic which normally would be expected to be in alphabetical order appears random. However, closer inspection reveals that it is in English alphabetical order illustrating the rather limited attention which was paid to formulating these regulations.

the Oil Ministry challenging the validity of Law 19 of 1973 giving the Ministry control over KOC's operations[38]. The reply, which came more than three years later (in November 1979) reasserted Ministry control and demanded compliance from KPC. In 1989, some of the regulations associated with Law 19 were revised to account for technical advances in the industry. In October 2002, KPC again challenged the Ministry's position and in November 2002 the ministry again rejected KPC's case. Interestingly the arguments used were identical to those used in the early exchange in the 1970's—when BP and Gulf sought to reduce government scrutiny of their operations—when the Ministry's supervisory and audit activities were particularly disputed by the industry. In effect, KPC was behaving like any private company trying to avoid too close government scrutiny.

In 2000, the government appointed a new Under Secretary in the Ministry with the explicit remit to "regain ministry control in terms of supervisory and regulatory roles" (PESD Interviews 2007). This was allegedly because both the Prime Minister and the SPC felt that KPC was "taking them for a ride". It was felt that the ministry needed new systems and procedures to monitor, control and supervise the sector. It hired a major consultancy firm to revise the regulations derived from Law 19 and create a technical audit control system. In 2001, the Oil Ministry had developed a new strategy and action plan which was finally approved by the SPC in August 2002. The Ministry tried to get KPC cooperation with the plans but this was not forthcoming. At the same time, the Ministry following the consultancy report redrafted the regulations derived from Law 19 but with minimal consultation with KPC. When KPC saw the proposals it was "horrified", not least because the new regulations appeared to allow the Ministry to control all spending. Rather than create clarity about roles and operations, a classic turf war unfolded between the Ministry and KPC, and the specter of continued uncertainty further paralyzed the sector.

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[38] For example, KOC had to secure Ministry approval before drilling wells and secure approval for a field development.

At this point the SPC stepped in to try and clarify the situation, and a series of secret meetings took place away from the public gaze to try and reconcile the various positions. The outcome was the view that Law 19 was still applicable but that the regulations were effectively unworkable. The result was to dilute Ministry control over KPC's operations but to maintain its auditing responsibilities. In an effort to clarify the situation in March 2005, a draft law was proposed to try and align KPC and the Ministry in terms of their future direction. However, this is still under discussion and there are conflicting views. Interviews with the players involved (PESD Interviews 2007) have identified three problems which remain to be addressed. First, the Ministry has been tempted to apply different regulatory rules for competing operators, which in practice would create an unpredictable regulatory environment. Second, the current proposals would unnecessarily duplicate KPC functions in the Ministry while eviscerating other crucial functions from KPC and its subsidiaries. Third, the much more rigorous regulatory oversight would allow regulators to interrupt or delay projects already approved, which would undermine the financial viability of large complex projects—exactly the kind of investment that the country most needs to attract. Until these issues are resolved, the prospects for the performance of Kuwait's oil sector are poor.

The regulatory context of the sector and its ability to function is further complicated by the role played by general government intervention. The SPC is the most effective institution overseeing KPC, but SPC is the shareholder and not the regulator. Some regulatory functions—those related to HSE—are applied by other national regulators, and the Civil Service Commission provides "back up regulation" if the existing regulations do not cover the issue. In short, there is no clear regulatory strategy and the result is a degree of chaos that inhibits KPC's operational effectiveness.

The area where government regulatory oversight is strongest—and most problematic—is in procurement policy, which involves the State Audit Bureau (SAB) with additional oversight by SPC and the Parliament.

Purchases by KPC and its subsidiaries are subject to the rules laid down by the Central Tenders Committee (CTC). According to these rules, any purchase over 5,000 KD (some $17,000, a figure actually set in 1964 and not adjusted since) requires a public tendering process. This is extremely elaborate and can add up to a year to the time required for procurement. In 1979, the SPC decided that all KPC's subsidiaries must abide by the CTC process. This amounted to creating a complex and long winded set of processes simply to "buy the pencils". In 2003 the SPC asked KPC why so many of the targets for the sector were not being met and in reply KPC pointed to the problems with the procurement policy. In recent years, it appears the SPC has become more sympathetic to KPC and its implementation problems—with the result that KPC is no longer so rigorously accountable to its self-declared targets—but SPC is unable to fix the root of the problem, which resides in Law 6 and cannot vary without a change in the Law. SPC, which as shareholder protects the interests of the enterprise, does what it can to adjust the rules to the limit of Kuwait's rigid law. A good example relates to the hiring of consultants. Within the Kuwaiti state sector, a practice had emerged that all consultants should be hired via the Ministry of Planning. In fact, KPC had been hiring via its own subsidiaries. On discovering this, the Ministry of Planning objected and demanded it should be involved in the hiring process. However, when KPC appealed to the SPC to prevent this, the SPC was able to overrule the Ministry simply because it could do so without getting alterations to the law.

In 2005, KPC went to the SPC proposing a new strategic model to increase the power of the subsidiaries and in particular give them much greater autonomy over procurement. Specifically KPC proposed that the limit for a referral to the CTC should be raised to 1 million KD. Less than that would be managed under KPC regulations which required purchases of over 250,000 KD to be subject to an internal tender committee. In the event, the SPC not only accepted the recommendation but actually proposed to increase the threshold to 5 million KD. However, to actually get this implemented would require a change in the Law, which has not been forthcoming, so KPC and its subsidiaries have labored under the old system.

There is a similar story with the State Audit Bureau. The SAB was created in 1964, reports directly to the National Assembly, and has two functions. The first is a pre-authorization process to allow spending and the second is a post-project review of spending. Until 1998, all state-owned enterprises including KPC were exempt from these requirements, but that year the government adopted a new regulation that required such enterprises to submit projects over 100,000 KD to the SAB for approval. The law requires the SAB to respond to a pre-authorization within one week but in practice on day 6 or 7 the SAB comes back with some "query which effectively stops the clock" (PESD Interviews 2007). The final decision can often take "a couple of months". KPC's subsidiaries, because they are subject to Kuwait commercial law, are exempt from this process. For KPC, this split in oversight has become a major source of tension because SAB has expansively sought to become involved in KPC's business decisions where it can assert authority, yielding a culture of "second guessing" by the auditors. The post review process is also timing consuming and can be traumatic requiring up to a 300 page report which is then subject to scrutiny and criticism. The process is further slowed because the SAB process, itself, is not complete until it reports to a Committee of the National Assembly which meets only 8 to 10 times per year.

Finally, there is the problem of managing the budget between the SPC and the National Assembly. The KPC budget and those of its subsidiaries must be approved by the SPC. The consolidated budget is then sent to the Budget Committee of the National Assembly which goes through the budgets in great detail. Several years ago this process would take 2 to 3 weeks involving the top management of KPC justifying the details of the budget. In 2005, the process actually took over 7 weeks involving 27 meetings. An interesting parallel can be drawn between this process and a similar one for a typical IOC. In the case of the IOC, all the work on the project appraisal is done before proposals go to the Board where it is then accepted or rejected. Upon approval the company springs into action to implement the specifics of the project. In the case of KPC, the real work in terms of the project specifics begins after the proposals go to the Board (the SPC), and the outcome is very difficult to predict. The process can become especially complicated when the National Assembly and KPC are in dispute over matters or if the country is already in political gridlock for other reasons. For example, in 2006 because of the political stalemate between the government and the National Assembly, the SPC only met once at the end of the year. Thus KPC had to take the budget straight to the National Assembly without prior approval from the SPC, which added considerably to the approval process. Thus projects face delays because of finance constraints (PESD Interviews 2007).

iii. COMPETITION

In the upstream, competition is not an issue since all of the exploration acreage and producing operations outside of the Neutral Zone[39] are the exclusive responsibility of KOC.

In the downstream, there is competition in the marketing of products with the privatization of gasoline stations, an LPG bottling plant and an oil lube filling plant. The process of privatization has been drawn out over more than a decade, with the first decision by the government to privatize the gasoline stations in 1992 and actual privatization of two-thirds of the stations achieved only in 2005. Of these 40 were sold to the Oula Company and another 40 to the Al-Sour Company. The rationale for downstream privatisation was the "Washington Consensus" kind of argument in favour of markets: the private sector convinced the Government of the need to move to a more market orientation, a process also possibly encouraged by Kuwait's liberators (PESD Interviews 2007). At the same time, the downstream lacked the political sensitivity of the upstream and so was feasible. KPC, still recovering from the invasion and its aftermath, appeared to offer little or no resistance. However, it is clear that there was little thought given to the implications of privatising the downstream in the context of the very low product prices compared to international prices (PESD Interviews 2007).

[39] When the border between Saudi Arabia and Kuwait was established by the Uquir Convention of 1922, an area was left undefined. This "Neutral" Zone, also known as the "Divided Zone" was shared between the two countries. In 1965 the two countries agreed to partition the Zone between them.

These privatizations were done before agreement had been reached over the regulatory framework under which the newly privatized downstream would operate. The World Bank had been commissioned to come up with recommendations for the creation of a regulatory body. After some delay it presented a report to the government in November 2006. However, the approach suggested by the Bank involved a system that would be created by Amiri Decree. In KPC's view such a an approach would actually be illegal under the Constitution; even if formal constitutional barriers did not appear, it is extremely unlikely that the National Assembly would accept such a route for what is seen as important legislation that would affect consumer welfare in Kuwait. In the event, the sale of the last third of the filling stations due in 2006 was postponed. The National Assembly wanted a review with great concern over the employment implications for selling off the gas stations[40]. The Minister duly complied and so further privatization appears to be on hold.

iv. FISCAL CONTROL - TAXATION; SUBSIDY; STATE BUDGETING

Reference has been made extensively to the nature of the fiscal relationship between KPC and the governments, notably in section 3ai. Briefly summarizing, KOC buys its crude (underground) from the government, produces the crude, and then sells it to users (including its own refineries) at market price. The revenue from the final sales, less a 50 cents marketing fee, is then returned to the Ministry of Finance. Thus KOC is simply a budget centre from the government's perspective[41]. By contrast the subsidiaries are profit centres with the profit accruing to KPC. From this profit, KPC pays a dividend to the government along with 10 percent for the government's Reserve Fund. The SPC has the

[40] It appears that the gas stations employed some 500 (relatively highly paid) workers while it was estimated that only 200-300 would be required implying forced redundancies (MEES 46:50 2003).

[41] The situation is different in the context of the Neutral Zone because there are other players. The Al Kafji and Hout joint operation is a 50 percent joint venture between Kuwait (KGOC) and the Aramco Gulf Operating Company which was the Saudi successor to the Arabian Oil Company's (AOC) operations which ended with the expiry of its concession in 2000. KOGC has a five year technical service contract with AOC which replaces the AOC concession with Kuwait which also expired in 2003. In January 2006, KGOC also took over Kuwait's interest in the onshore Wafra Field which was operated by Saudi Arabia Texaco. In both cases, KGOC lifts the crude which is then treated in the same way as KOC crude from KPC's perspective.

authority to take some of KPC's profit and put it aside for asset replacement although why the SPC as shareholder should do this rather than KPC is not at all clear.

As for KNPC, as described earlier, it buys its crude from KPC at market prices but must sell into the domestic market at prices well below international levels according to a pricing scheme set some years ago and administered by the government. In recent years, the fact that KNPC's crude costs have been rising and its retail prices have remained static implies that KNPC should post a loss. The extent of this loss in not clear but KNPC is supposed to receive direct government money to offset such losses (PESD Interviews 2007).

5. MANAGEMENT

a. CORPORATE GOVERNANCE

The SPC – as shareholder and board – is the ultimate authority in the enterprise[42]. However, what is less clear is who and what influences the SPC. Certainly the Cabinet plays no role in controlling the sector and simply acts as a "rubber stamp". The CEO has operational control over the company but is unable to make significant decisions without the backing of the KPC Board. The subsidiaries are particularly difficult for the CEO to control because they require approval from their own Boards.

Even less clear are the roles of the Oil Ministry and the National Assembly. KPC Board decisions must be ratified by the Oil Minister. The Minister also appoints the CEO of KPC and the members of its Board. Since the Minister is also Chairman of KPC this might be expected to make the Ministerial ratification a mere formality. However, as explained earlier, this is far from the reality and there has been a history of Ministers approving a decision as Chairman of the Board and then unilaterally rescinding it as Minister. In part this reflects the fact that the Minister is responsible to Parliament and

[42] It would appear that within this role, the private sector members of the SPC play an important role in ensuring the SPC has not become just a rubber stamp (PESD Interviews 2007).

frequently leaked decisions of the KPC Board can then create political pressure on the Minister for a reversal (PESD Interviews 2007). Furthermore this threat of Parliamentary sanction tends to make any Minister extremely cautious in his decisions. The Ministerial role and the constant changing of ministers present a serious problem for KPC. As Nader Sultan, then CEO of KPC, said in 2002:

> "It is crucial that the oil minister stays in his post in a supervisory capacity for as long as possible, because this means continuity of long-term policies. The role of the minister is important and crucial in the interpretation of government policies…It is important to explain here that every minister needs time to understand the oil sector and to implement government policy. Because of the continual changes of ministers, one should not be surprised that there are substantive or minor… differences in interpreting public policies. There are also differences in priorities. This, of course, halts the work of KPC. We go ahead, and then we stop…If you ask any KPC official about this issue, he will tell you that he wants ministers to be stable in their posts. And if they cannot keep ministers in their post, then they have to think of other solutions." (MEES 45:16 2002)

The role of the National Assembly in KPC's decision-making is confused and confusing. It has no formal role in developing strategy for KPC, but it is required to approve KPC's budget and thus, de facto, it can have a large role in assigning spending priorities. Its role has been increasing in recent years, and the senior management in KPC fear ever greater political intervention through the National Assembly. The Assembly has already stalled Project Kuwait, and there are moves to pass a law to restrict KOC production to a percentage of the reserves, an issue developed further in section 6a. In KPC, trades unions are viewed by some as quite a powerful force although there role tends to be in terms of blocking decisions rather than promoting initiatives (PESD Interviews 2007)[43].

[43] The Kuwait Trade Union Federation is the sole national trade union center and was formed in 1968. Only domestic servants (which constitute some 453,000 out of a total workforce of 1.6 million) and maritime employees are not allowed to join. In fact only 80,000 workers are members. Although strikes are legal under certain circumstances, all unresolved disputes are subject to compulsory arbitration (US Dept. of State, 2005). There is a suspicion that those in Kuwait who regard the unions as "quite powerful" do so on grounds of ideology rather than the reality on the ground.

As for accounting, KPC and its subsidiaries comply with international standards, including internal and independent external review. A variety of international accountancy firms are used ranging from KPMG to Deloitte & Touche and Ernst and Young.

What is absolutely clear is that KPC management desperately wants greater financial authority and autonomy for the subsidiaries to allow a far more commercial approach. Again from a statement by Nader Sultan:

> "… we abide by performance indices that we monitor every three months with international companies, and we have clear strategic plans etc. But the difference between us and commercial companies is the existence of many obstacles as exemplified by external supervisory measures imposed by bureaucracies outside KPC. In the end, we find it difficult working as a commercial establishment in the true sense of the word because of these outside restraints. For example, in approving the KPC budget we have to go through several stages. We begin the budgetary procedures in September and we end in July the following year. We start by presenting a draft budget to the KPC board, then it goes to the specialized committee of the Supreme Petroleum Council, to the Ministry of Oil, to the Ministry of Finance, then to the Budgetary Committee of the National Assembly, and then to parliament itself. Whereas approving the budget of a commercial company requires nothing more than the draft budget being presented to the board, *i.e.*, one stage only, our budget takes nine months to get approval. Frankly, it takes KPC executives a long time to carry out a task which other institutions can complete in a much shorter time. We tell those who monitor our work: if you want KPC to act as a commercial organization, then give it the flexibility and authority it needs. When we compare ourselves with Gulf and international companies we find that their rules are different from ours." (MEES 45: 16 2002).

b. INVESTMENT DECISIONS

The investment budget of KPC and its subsidiaries are set in the context of a five year plan and approved by the National Assembly based upon the recommendation of the SAB. Thus capital expenditure is funded out of state funds and issues of financial markets and debt equity issues are not relevant.

c. ORGANIZATIONAL STRUCTURE AND CULTURE

The way in which the sector is organized is shown in Figure 1. As already indicated in section 4bii there is serious confusion over the respective roles of the Ministry, the SPC and KPC. In general, as already described, KPC senior management is extremely frustrated at the lack of implementation of decisions because of government interference and political wrangling. This is a process aggravated because (as has been claimed) KPC has a culture of “open debate and self examination” (Marcel, 2006 page 11) which encourages such criticality. Given the Diwaniya - Wasta culture common in Kuwait[44] this then feeds those outside the sector, critical of the sector and wishing to intervene. It thus creates a self-destructive vicious circle. In February 2002, when the Oil Minister submitted his resignation (which was rejected) following an explosion and fire at the Raudhatian oil field in Northern Kuwait, the Minister, Dr Adel al-Sabeeh, made the following statement:

> “It is clear from the above that there are many matters hindering the running of KPC on a purely commercial basis, and this is contrary to the aims and goals for which it was established. In the absence of the application of radical solutions guaranteed to give the oil sector a commercial and economic character, and similar measures to review the structure of this sector by separating the chairmanship of KPC from the rank of oil minister, and removing all the burdens of government regulations from it, in addition to preventing any outside

[44] The concept of “wasta” is that of the relationship between client and patron with the patron proving wasta or influence for their client in dealing with others. The diwaniya process is when the patron effectively holds court often on a weekly basis to anyone who is interested.

> interference or pressures on the methods and regulation of work in this sector, then the level of performance of operations in the oil sector will continue as it is at the moment, a state of affairs that is impacting negatively on safety issues in the Kuwaiti oil industry.” MEES 45: 16 2002).

Nader Sultan also commented that:

> “The difference between us and commercial companies is the existence of many obstacles as exemplified by external supervisory measures imposed by bureaucracies outside KPC. In the end we find it difficult working as a commercial establishment in the true sense of the word because of these outside restraints…. Some time ago, we asked an international consultant to prepare a study to evaluate the work of KPC. It reached the conclusion that one of the challenges faced by KPC was the delay in implementing capital projects. In noting the internal and external stages that KPC needs to pass through to take a particular decision, the study found that there are approximately 36 steps that need to be taken for a project worth KD0.25mn, whereas international companies need only four steps.” (MEES 45:16 2002)

There is also a view that in KPC it is more difficult to identify a clear corporate culture. This weakness of a corporate culture in part reflects the earlier dominance of expatriates within KPC before 1990[45].

There are problems with management within the sector. A key problem is that Kuwaitis are given scholarships to study in universities both in Kuwait and abroad. However, once they secure their degree they are often placed into the management structure far above the level their actual experience can justify. This is a process reinforced by political interference in the hiring process within KPC and its subsidiaries. Furthermore, it is very

[45] This is a contentious view but it was repeated by a number of those interviewed (PESD Interviews 2007).

difficult to reverse decisions on managerial appointments once they have been made. In 2002, at a conference in Kuwait at which the author was present, Nader Sultan publicly lamented, “How can I be expected to run a major corporation when I cannot sack people?”

Since 2004, there have been efforts to at least improve incentives for senior management. Thus an annual incentive system leading to performance contracts has been created for senior management based upon 7 different criteria. The process includes quarterly individual meetings at which performance is assessed.

For the sector generally, pay levels remain a serious problem. As already indicated, pay levels in the Ministry are below those in KPC. However, KPC salaries, which are set by the Civil Service Commission, are also well below those available in the private sector. As a result, there has been a serious hemorrhage of skilled manpower out of the sector. Even for those that remain there are strong pressures to find “other sources of income” which at best involve personnel effectively doing two jobs.

6. TECHNOLOGY AND RESOURCES

a. TYPES OF RESOURCES CONTROLLED

KPC, through KOC, controls all of Kuwait’s oil and gas reserves[46]. The size of these reserves is a matter of considerable uncertainty and debate. The problem emerged in the 1980’s in the context of negotiations over the OPEC quota. OPEC quotas were essentially arrived at as the outcome of bargaining. However, the size of reserves was a key factor in those negotiations. There was therefore a strong temptation for governments to overstate the reserves. Thus, based upon the OPEC Statistical Bulletin, between 1985 and 1988, OPEC country’s reserves grew from 535.8 billion barrels to 760.5 billion barrels, an increase of 42 percent in three years. In the case of Kuwait, the

[46] In the Neutral Zone between Saudi Arabia and Kuwait the situation is slightly different because upstream oil operations there arise from joint ventures and Kuwait’s role there comes from the role of KGOC which was established in 2002 after the Arabian Oil Concession with Japan was renegotiated.

change had been made in 1984 when Kuwait's reserves rose from 67 billion barrels in 1983 to 92.7 billion barrels in 1984[47]. Quite clearly such changes raised serious suspicions about the accuracy of the numbers[48].

In January 2006, Petroleum Intelligence Weekly (PIW) claimed that based upon an internal KOC document examined by the paper, Kuwait's reserves were only half those officially stated. At the time Kuwait's official reserves were stated at 99 billion barrels. It claimed the document put reserves at 48 billion barrels of which only 24 billion were fully proven. Not surprisingly this caused KPC considerable embarrassment. The problem was compounded because KOC could not identify which document PIW had allegedly seen. KPC claimed that its new reserves figures were based upon extensive studies which had been carried out in the mid 1990s in order to support claims against Iraq following the destruction of the well heads in 1991. A study was quickly organized by KOC to assess the reserves to provide a rebuttal to PIW's claim. Apparently this new study shows the reserves are actually higher than the official reserves challenged by PIW although the two numbers are not strictly comparable because the new estimates included areas and strata not previously included – namely the Jurassic, residential and offshore reservoirs (MEES 49:5 2006)[49]. For reasons which the KPC management itself cannot understand, the report has not yet been issued by the Government despite a promise to do so in the second half of 2006.

The reserve issue has now been further complicated by the intervention of the National Assembly. For some time there have been attempts to introduce a law to restrict production levels based upon reserves. The current proposal is to limit production to 1

[47] There is no evidence to explain how such dramatic increases in reserves could be justified but almost certainly they were achieved by simply increasing the recovery factor in the existing reserves. Thus in the late 1970s the overall recovery factor was 27 percent and this officially had risen to 45 percent now with a target to increase this to 60 percent (MEES 49:5 2006).

[48] BP estimates of Kuwait's oil reserves (BP, 2006) basically had them at 96.5 billion barrels throughout the 1990's rising to 115.0 billion barrels in 2003 and falling back to 101.5 billion barrels in 2004 and 2005.

[49] It is difficult to come to a view on the state of Kuwait's reserves. This is compounded by allegations that KOC is in the process of damaging recovery from Burgan in an effort to disguise the failure of production targets from other fields (PESD Interviews 2007). This is clearly a difficult and sensitive issue but the author has been told this by more than one source.

percent of proven reserves. The general consensus is that this is simply a ploy to force the government to reveal the reserve figures (MEES 50:11 2007).

The official plans for crude production called for capacity including the Neutral Zone reaching 2.643 million b/d during 2006-7 and 2.636 in 2007-8, rising to 3.054 in 2008-9 and 3.213 in 2009-10. Field by field analysis of these targets is presented in Table 5, and the locations of the fields in the context of Project Kuwait as it stood in 2006 are shown in Figure 7.

Table 5 Production and Plans by Field

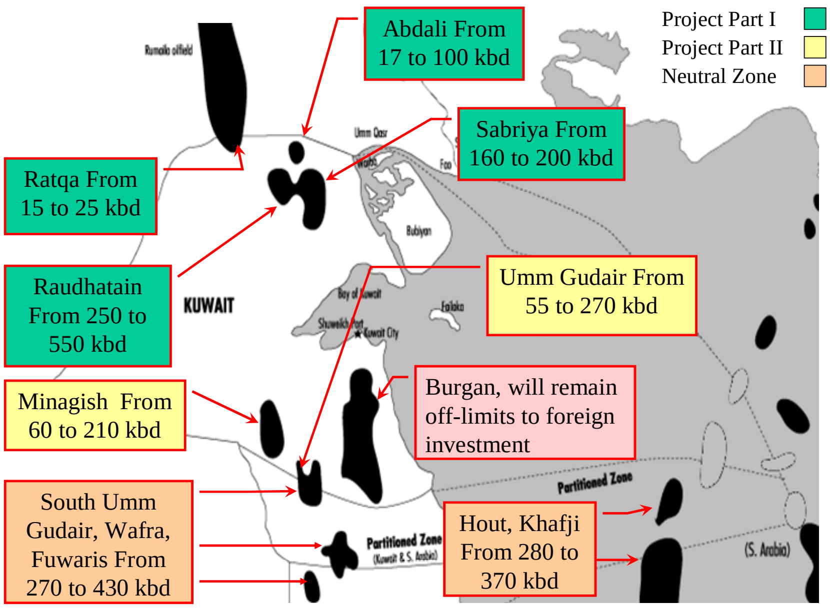
Oil Fields	API	Production	
		2003	2005-2020
Greater Burgn	31	1,580,000	2,150,000
Raudhatian	34.4	225,000	515,000
Sabriya	36	160,000	200,000
Abdali	22	17,000	100,000
Ratqa	30	15,000	25,000
Minagish	34	60,000	210,000
Umm Gudair	27	55,000	270,000
Total b/d		**2,112,000**	**3,470,000**
API		**31.6**	**31.4**

Source: Al Attar (undated)

A press report as of October 2007 suggested that the government's target for reserves was to see an increase of 825 million barrels in 2006-7, 500 million in 2007-8, 600 million in 2008-9 and 130 million annually in subsequent years (MEES 49:45 2006). This should imply a considerable exploration effort by KOC, but it appears this is not taking place, although differences in geology always make comparison difficult[50].

[50] The OAPEC Statistical Bulletin list the number of "exploration and development" wells drilled. The 2007 edition only has data for Kuwait up to 2003 which shows 55 such wells drilled. This compares to 290 in Saudi Arabia, 174 in Algeria, 130 in Libya, 115 in the UAE, 104 in Syria and 75 in Qatar. Furthermore the Kuwait figure is declining from 100 in 2001 and 77 in 2002.

Figure 7 Project Kuwait by Field and Phase



Source: Al Attar (undated)

There are also plans for gas reserve development although there are uncertainties associated with the size of some recent gas discoveries. In March 2006, the government announced a major non-associated gas field at Umm Niga and Sabriya field with reserves estimated at 35 trillion cubic feet (MEES 49:11 2006)[51]. It was announced in March 2007 that these fields would be developed by KOC with technical assistance from Schlumberger to produce 600 million cfd by 2010 rising to 1.3 billion cfd by 2012 (MEES 50:11 2007). Currently, KOC is negotiating with the IOCs to develop deep horizon gas in the Northern fields under technical service agreements.

The government wanted to see gas capacity raised to 1.325 billion cfd during 2006-7, 1.396 billion cfd in 2007-08, 1.728 billion cfd on 2008-9 and 1.806 billion cfd in 2009-10. To help achieve this, the government has adopted rules requiring KPC to reduce

[51] It appears from the KOC Annual Reports that there is no explicit exploration programme for gas but that the discoveries have occurred as a result of exploratory drilling for oil.

flaring from 5.2 percent in 2006-7 to 1 percent by 2010. This has been reported to imply a switch of strategy to give gas exploration greater priority (MEES 50: 14).

The prospect of being able to produce non-associated gas domestically for the first time is extremely attractive. Kuwait currently consumes 1.2 billion cfd of gas (all of it associated gas) and projections put gas consumption in 2010 at 2 billion cfd. Previously it was assumed this could only be managed by importing gas. Initial plans for a sub-sea pipeline from Qatar were shelved, in part because Qatar has put a moratorium on gas projects while it re-assesses its reserves in the North Field, the country's largest gas field and the location of its prodigious export projects. Then it was hoped that gas could be imported from Iraq (35 million cfd per day rising to 200 million cfd) and Iran (300 million cfd). However, continued chaos in Iraq tabled that option, and negotiations with Iran were proving extremely slow and difficult. Meanwhile, there have been suggestions that Kuwait would try and fill the immediate gap by recourse to spot purchases of LNG. This is particularly important because in the summer of 2006, Kuwait experienced an increasingly unreliable power supply system, including several blackouts that provoked considerable political backlash. To forestall future problems it has imported several gas turbines, but it needs gas to fire them[52].

b. R&D IN THE OIL SECTOR

When BP and Gulf Oil left in 1976, a chairman of KOC remarked that – "they left the body but took the brains". This was a direct reference to the fact that when the two companies controlled KOC, all of the sub-surface work associated with reservoir management was done outside Kuwait. Thus the oil sector has continually struggled with a serious shortage of technically competent management. There is an R & D division within Headquarters whose work is driven entirely by the needs of the subsidiaries but it is not clear from the KPC Annual Report how active this group is and it appears to be a

[52] Significantly, in the cabinet reshuffle at the end of March 2007, electricity and water were given back to a separate ministry. Oil and power and electricity had been merged in July 2003.

linkage to others (such as KISR – see below) rather than a division actually undertaking its own research.

The subsidiaries themselves have extensive contact with both the IOCs and the service companies and therefore are exposed to the latest technological developments. In addition, there is the Kuwait Institute for Scientific Research (KISR). KISR was formed in 1967 by the Arabian Oil Company (Japan) as part of its concession commitment. In 1981, it was created as an independent public institution. Its focus was on petroleum, desert agriculture and marine biology. It has a Petroleum Research & Studies Center whose function is:

> " … to be the primary source and focal point of R&D and technical support for the oil-based industry in the country, with the aim of assisting the industry in increasing oil reserves, improving product qualities and optimizing the cost-effectiveness of oil production, refining, petrochemicals and further downstream operations, and generating and maintaining relevant databases for the petroleum and energy industries" (KISR Web site).

The extent to which the sector depends upon KISR for an R & D input is not clear but it seems probable that KISR's input is rather limited.

7. CONCLUSION

KPC has always had a great deal of strategy but in general it has been poor at delivering on that strategy. Targets have consistently been missed and recent years have seen a series of accidents in both the upstream and downstream which reflect on this inability to manage the sector well. There are two prime explanations for this relatively weak performance by KPC and its subsidiaries.

- First there is the fact that the sector and KPC's role in it suffers from excessive political interference in a political system which to all intents and purposes is dysfunctional. This is because the National Assembly does not appoint the government, with the result that government ministers constantly face attack from the National Assembly which in turn makes them excessively cautious and discourages the development of vision. This political context has several dimensions. The decision making process in the sector is complex, cumbersome, unpredictable and horribly bureaucratic. Thus the oil sector strategy lacks coherence and is at the whim of successive oil ministers. The role of the oil minister is particularly unhelpful given the extraordinary number of ministers appointed since 1991. In particular, the minister's key role as chairman of KPC and the veto power as minister means the strategy and decision making processes within KPC are at best whimsical. They lack consistency and coherence. A key reform needed would be to separate the roles of Chairman of KPC and oil minister which would restore a degree of control and authority to KPC's Board.

- Second, while KPC has some excellent senior managers with talent and a deep knowledge of the oil industry, middle level management in KPC and its subsidiaries is for the most part weak. This appears to be particularly true in the technical and engineering areas. People are given posts with insufficient experience and knowledge, a process strongly reinforced by political interference in the appointment of personnel.

However, in recent years these fundamental problems have effectively been disguised by the relatively high oil prices. In particular, the failure to meet crude producing capacity targets has not resulted in problems for central government revenue. Also the relatively small population and the size of the accumulated reserve funds have helped to paper over the cracks which characterize the oil sector in Kuwait.

However, the prospects for the sector are not good as a result of several factors:

- All the signs suggest that the political interference is likely to get worse as the National Assembly pursues its own interests and seeks a greater formal role in the operation of the oil sector. This is especially evident, already, in the Assembly's large and growing role in the approval of KPC's budget as well as its oversight of the audit and procurement policies. Combined, these factors—lack of a predictable and efficient budget process as well as a culture of political second-guessing—make it hard for the enterprise to pursue a coherent long-term strategy for development. These problems are compounded by the lack of a clear administrative framework for the government itself, which leaves many crannies of ambiguity that the National Assembly has filled as it tilts at populist goals and as the feeling grows that the oil enterprise is a "state within a state". The only certain solution would be a fundamental reform of the political system whereby the government is appointed by the National Assembly rather than the Emir. This would effectively reduce the role of the Emir to that of a constitutional monarch[53]. However, there is a need to consider perhaps less dramatic solutions which can assist KPC to improve its performance.

- In addition, the problems facing the upstream in terms of maintaining producing capacity at current levels, let alone effecting any increase, will become increasingly difficult. This is simply because the geology is becoming more complex, the crude heavier and the water management problems more demanding. KPC simply does not have the technical capability to manage these growing problems. Furthermore, the political system has effectively stalled the entry of IOCs whose presence is essential if these looming field problems are to be managed[54]. This exclusion of much needed technical help is likely to get worse as resource nationalism gains great support in Kuwait as it has throughout the Middle East.

[53] It has been rumoured that this is what the current Emir has actually proposed. However, while it appears older members of the family supported this idea, the younger members were horrified by what appeared to be selling out on their birthright.

[54] It is possible to argue that maybe better access to the service companies might be a solution rather than the involvement of the IOCs. However, while this may help it is worth remembering the old adage that to get the best out of consultants, the client needs to know as much as the consultants.

Thus KPC faces very serious challenges which it will find difficult to manage. If oil prices slip in the future—or production costs continue to rise—then Kuwaiti society will find itself accustomed to an expensive lifestyle that it is unable to afford.

Appendix 1 Financial Data from Annual Reports

Note this data is extremely incomplete reflecting the difficulty of securing annual reports despite the web sites of KPC and its subsidiaries. (Unavailable data is denoted by "**")

KPC PERFOMANCE	2006 (KD'000)	2005 (KD'000)	2004 (KD'000)	2003 (KD'000)	2002 (KD'000)
(a) REVENUES	19,904,673	13,703,569	9,863,152	8,427,421	7,045,143
COSTS	17,803,332	12,211,207	9,026,783	7,750,634	6,474,015
(b) Operational Costs	17,803,332	12,211,207	9,026,783	7,750,634	6,474,015
(c) Social Obligations	**	**	**	**	**
(d) Royalty Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(d) Extraction Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(e) Special Charges or Other Adjustments	**	**	**	**	**
(f) NET PROFIT (before tax)	2,412,882	3,827,070	814,689	493,346	531,937
(g) Taxes from Profits	96,511	51,685	20,014	7,948	6,590
Total Assets	14,997,625	13,613,709	11,685,200	9,984,483	10,457,953
Current Liabilities	4,724,036	3,660,328	2,148,798	2,064,723	1,725,749
Capital Employed (Total Assets - Current Liabilities)	10,273,589	9,953,381	9,536,402	7,919,760	8,732,204
RETURN ON CAPITAL EMPLOYED	23%	38%	9%	6%	6%

KOC PERFOMANCE	2006 (KD'000)	2005 (KD'000)	2004 (KD'000)	2003 (KD'000)	2002 (KD'000)
(a) REVENUES	**	**	**	**	**
COSTS	**	**	**	**	**
(b) Operational Costs	**	**	**	**	**
(c) Social Obligations	**	**	**	**	**
(d) Royalty Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(d) Extraction Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(e) Special Charges or Other Adjustments	**	**	**	**	**
(f) NET PROFIT (before tax)	**	**	**	**	**
(g) Taxes from Profits	**	**	**	**	**
Total Assets	1,839,923	1,673,475	1,470,706	1,366,263	1,237,022
Current Liabilities	189,828	143,048	126,044	94,827	103,596
Capital Employed (Total Assets - Current Liabilities)	1,650,095	1,530,427	1,344,662	1,271,436	1,133,426
RETURN ON CAPITAL EMPLOYED	**	**	**	**	**

KNPC PERFOMANCE	2006 (KD'000)	2005 (KD'000)	2004 (KD'000)	2003 (KD'000)	2002 (KD'000)
(a) REVENUES	6,816,212	4,814,089	3,443,942	**	**
COSTS	6,118,953	4,160,853	3,315,937	**	**
(b) Operational Costs	6,118,953	4,160,853	3,315,937	**	**
(c) Social Obligations	**	**	**	**	**
(d) Royalty Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(d) Extraction Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(e) Special Charges or Other Adjustments	**	**	**	**	**
(f) NET PROFIT (before tax)	647,813	628,358	92,014	**	**
(g) Taxes from Profits	**	**	**	**	**
Total Assets	1,669,598	1,525,595	998,450	**	**
Current Liabilities	800,507	703,221	175,007	**	**
Capital Employed (Total Assets - Current Liabilities)	869,091	822,374	823,443	**	**
RETURN ON CAPITAL EMPLOYED	75%	76%	11%	**	**

PIC PERFOMANCE	2006 (KD'000)	2005 (KD'000)	2004 (KD'000)	2003 (KD'000)	2002 (KD'000)
(a) REVENUES	505,001	261,054	**	**	**
COSTS	418,711	199,351	**	**	**
(b) Operational Costs	418,711	199,351	**	**	**
(c) Social Obligations	**	**	**	**	**
(d) Royalty Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(d) Extraction Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(e) Special Charges or Other Adjustments	**	**	**	**	**
(f) NET PROFIT (before tax)	152,968	184,137	**	**	**
(g) Taxes from Profits	6,658,347	10,556,743	**	**	**
Total Assets	976,445	896,570	**	**	**
Current Liabilities	246,320	383,040	**	**	**
Capital Employed (Total Assets - Current Liabilities)	730,125	513,530	**	**	**
RETURN ON CAPITAL EMPLOYED	21%	36%	**	**	**

KOTC PERFOMANCE	2006 (KD'000)	2005 (KD'000)	2004 (KD'000)	2003 (KD'000)	2002 (KD'000)
(a) REVENUES	**	**	**	**	**
COSTS	**	**	**	**	**
(b) Operational Costs	**	**	**	**	**
(c) Social Obligations	**	**	**	**	**
(d) Royalty Payments to Governments	**	**	**	**	**

home government	**	**	**	**	**
overseas government	**	**	**	**	**
(d) Extraction Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(e) Special Charges or Other Adjustments	**	**	**	**	**
(f) NET PROFIT (before tax)	**	**	**	**	**
(g) Taxes from Profits	**	**	**	**	**
Total Assets	**	**	**	**	**
Current Liabilities	**	**	**	**	**
Capital Employed (Total Assets - Current Liabilities)	**	**	**	**	**
RETURN ON CAPITAL EMPLOYED	**	**	**	**	**

KGOC PERFOMANCE	2006 (KD'000)	2005 (KD'000)	2004 (KD'000)	2003 (KD'000)	2002 (KD'000)
(a) REVENUES	**	**	**	73,746	**
COSTS	**	**	**	49,019	**
(b) Operational Costs	**	**	**	49,019	**
(c) Social Obligations	**	**	**	**	**
(d) Royalty Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(d) Extraction Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(e) Special Charges or Other Adjustments	**	**	**	**	**
(f) NET PROFIT (before tax)	**	**	**	73,746	**
(g) Taxes from Profits	**	**	**	**	**
Total Assets	**	**	**	136,850	**
Current Liabilities	**	**	**	63,890	**
Capital Employed (Total Assets - Current Liabilities)	**	**	**	72,960	**
RETURN ON CAPITAL EMPLOYED	**	**	**	101%	**

Q8 PERFOMANCE	2006 (KD'000)	2005 (KD'000)	2004 (KD'000)	2003 (KD'000)	2002 (KD'000)
(a) REVENUES	**	**	**	**	**
COSTS	**	**	**	**	**
(b) Operational Costs	**	**	**	**	**
(c) Social Obligations	**	**	**	**	**
(d) Royalty Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(d) Extraction Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(e) Special Charges or Other Adjustments	**	**	**	**	**
(f) NET PROFIT (before tax)	**	**	**	**	**
(g) Taxes from Profits	**	**	**	**	**
Total Assets	**	**	**	**	**

Current Liabilities	**	**	**	**	**
Capital Employed (Total Assets - Current Liabilities)	**	**	**	**	**
RETURN ON CAPITAL EMPLOYED	**	**	**	**	**

KUFPEC PERFOMANCE	2006 (KD'000)	2005 (KD'000)	2004 (KD'000)	2003 (KD'000)	2002 (KD'000)
(a) REVENUES	**	245,387	105,924	94,097	73,093
COSTS	0	26,834	17,724	15,599	11,997
(b) Operational Costs	**	26,834	17,724	15,599	11,997
(c) Social Obligations	**	**	**	**	**
(d) Royalty Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(d) Extraction Payments to Governments	**	**	**	**	**
home government	**	**	**	**	**
overseas government	**	**	**	**	**
(e) Special Charges or Other Adjustments	**	**	**	**	**
(f) NET PROFIT (before tax)	**	117,630	45,156	32,311	14,177
(g) Taxes from Profits	**	46,701	14,960	6,308	1,070
Total Assets	**	384,719	345,715	291,012	263,119
Current Liabilities	**	64,102	32,878	20,638	22,723
Capital Employed (Total Assets - Current Liabilities)	**	320,617	312,837	270,374	240,396
RETURN ON CAPITAL EMPLOYED	**	37%	14%	12%	6%

SOURCES

PESD Interviews 2007

(Paul Stevens research trips to Kuwait: February-March 2007 and December 2007)

The following were interviewed during the research trip. While many were willing to be quoted, others preferred to talk under the Chatham House Rule of non-attribution. Therefore it was felt better to quote no individual.

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