SUDAN'S OIL SECTOR

CSIS Background Paper

J. Stephen Morrison and Jennifer G. Cooke
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Introduction

Oil will inexorably figure both as an obstacle and an opportunity to achieving peace. Large-scale oil production is a relatively new phenomenon in Sudan, and the present realities and potential future scenarios of Sudan's young energy sector are not always well understood.

If there is to be a durable peace accord, the parties to Sudan's war will have to determine and agree on how national wealth – including the oil sector – is to be managed and monitored equitably and effectively in a post-war setting. Settling on a workable strategy to divide and distribute revenue will likely be an arduous and complex process, for which there is no historical precedent in Sudan's experience. How that strategy is devised and implemented could influence future decisions in regard to Sudan's unity and the south's right of self-determination. Under the best of circumstances, realizing big, mutual material gains in expanding Sudan's oil sector will require several years.

Nonetheless, a durable and convincing peace settlement could eventually allow Sudan to expand its total oil revenue levels by $1 billion per year for at least a decade. An equitable division of expanding oil-revenues could help consolidate a durable peace, contribute to a broader reconstruction process, and possibly encourage the more rapid arrival of concessionary donor flows. In turn, a durable peace could ensure that the Sudan's energy revenues continue to grow.

Present realities

As long as war continues in Sudan, the growth of Sudan's oil sector will be highly constrained, while the sector itself will remain a potent negative factor.

National production will be confined to first-phase exploitation in the western Upper Nile (WUN) oil fields (blocks 1,2,4,6) which have an estimated reserve of approximately 1.7 billion barrels. Work at new exploratory sites in and around current WUN producing areas will remain at a standstill for security reasons.

In 2002, $1.7 billion in pipeline and production field investment costs were finally retired, and earnings to the Government of Sudan consequently rose to the range of $1 billion per annum. In the near term, current production of 250,000 barrels per day may rise to approximately 300,000 barrels per day, but production will fall below 250,000 barrels per day by 2010 and thereafter taper off sharply.

If war persists, there will be little prospect of bringing into production the multiple scattered fields, conservatively estimated to total 1.2 billion barrels, that lie in the southern Sudd zone, outside of government control and dominated by opposition movements.

In the opinion of most industry experts, TotalElfFina will remain inactive in its 120,000 square kilometer concessionary bloc in the Sudd, until an enduring, negotiated peace has been achieved. Insecurity and lack of capacity will similarly likely block other current external partners (Petronas, China National Petroleum Corporation) from becoming active in the Sudd. No Western major oil corporation will likely entertain entry into any area of Sudan until, at a minimum, the war has ended.

If war persists, current production areas will continue to attract concentrated military activity by the government of Sudan and the SPLA. Recently intensified military action in and around the WUN oil fields will sustain insecurity and uncertainty and continue to generate displacement, disruption of humanitarian access, continued credible allegations of war crimes, and other human rights abuses.

These factors in turn will sustain doubt among Sudan's external partners and instability in current production arrangements, prompting periodic suspension of exploration and production activities and possible sale of operations. These factors will also sustain intense international NGO activism surrounding Sudan's oil sector, and otherwise impede normalization of Sudan's international status and image.

Oil in peacetime

If a negotiated peace is achieved, Phase II exploration and production in the Sudd (blocks 5A, 5B and B) could increase Sudan's oil earnings by $1 billion per year for a decade. However that will require substantial patience and determination to surmount several formidable hurdles over several years.

Once war has ceased, an immediate and complex transitional challenge will be (i) to review existing pipeline and production arrangements; (ii) preserve international confidence that the parties to the peace accord will honor the sanctity of commercial contracts; and (iii) enlarge the consortia of external partners, including new Western major oil firms, in order to bring the Sudd zone into production and increase overall energy sector competitiveness.

An essential precondition to success is a durable political compact among the parties to a peace accord that builds external confidence among external investors that the Sudanese partners are sufficiently reliable and predictable to justify major capital risks.

A credible accord will require that the government of Sudan and the SPLA convince the international energy community that they have moved definitively beyond their current, polarized positions vis-à-vis Sudan's oil endowment and have achieved a workable consensus on joint future management of Sudan's energy sector. How management modalities are defined, and how power is divided politically and constitutionally are less important issues than how quickly the parties raise external confidence.

Phase II exploration and production is likely to require $2.5-3 billion in up-front capital investment. If that production is tied into the existing pipeline, it will require an estimated $400 million in additional capital. If a new, separate southern pipeline is constructed, that might require as much as $1.2 billion.

Success at doubling national production will also require:

(i) Managing delayed financial returns.

Both parties should recognize that increased returns from Phase II will be some time in coming. Production in the Sudd will not likely come on stream for at least 3-5 years, under the most optimistic projections. In the meantime, any arrangement to share current oil earnings between the GOS and the south will result in an objective loss to GOS accounts for that 3-5 year period.

(ii) Managing continued political uncertainty at the national level, and the simultaneous shift to southern dominance in the oil sector.

Even if a unified Sudanese scheme is devised for exploitation of Sudan's oil wealth, two questions will remain:

- How will the oil sector be managed – or possibly put at risk – should the South opt for independence, through a self-determination referendum to be held at the end of the proposed six-year transition period? How to guarantee that production contracts remain in effect – and external confidence in Sudan's oil sector is preserved – should the south secede?

- In Phase II, when the South will suddenly account for over 80 percent of Sudanese production, how might incentives and management modalities be structured to favor and sustain an integrated national system?

(iii) Managing local security and environmental challenges.

The parties will be under pressure to demonstrate their joint capacity to guarantee elementary security across the expansive geographic area of present and future production. This will be essential to lowering risks and logistical costs and raising external confidence. In all likelihood, there will be a need for a provision in the demilitarization agreements to take account of the special security requirements of the present and future oil producing areas.

Exploration and production in the Sudd swamplands will also involve complex new environmental considerations.

(iv) Defining an effective wealth-sharing formula.

Oil did not figure in the Sudan's 1972 Addis Ababa Agreement, and there is no historical precedent in Sudan for negotiating oil-revenue distribution. A national wealth-sharing formula with special provisions for oil may be required that has adequate specificity, simplicity, and transparency, has provisions for negotiated adjustments, includes some form of strong third-party verification, and rests on competent revenue management structures. A number of models are possible, including for example, a simple negotiated division between north and south based on relative population sizes, or a division among the federal government and smaller federal units, with bonus allocations for producing regions. The parties could contemplate the establishment of one or more national funds with independent oversight that could promote national development, macroeconomic stability, and reservation of funds for future generations. The selection of an appropriate formula will be shaped significantly by the political and constitutional design of the peace accord.

An important step in this process may be to determine accurately the actual size of the government of Sudan's total income from oil production, a base analysis perhaps best undertaken by an independent third-party audit.

Critical to any formula's success will be building new managerial capacities in the south, clarifying lines of control in the north, ensuring relative parity in negotiating competencies, and minimizing the protracted delays and follow-on controversies seen in other sharing arrangements attempted in conflicted settings.

(v) Devising possible interim steps.

Increasing Sudan's total oil revenues to the benefit of all parties will be a slow, multi-year process. To bring about accelerated benefits to all parties, the strategy to increase Sudan's overall energy revenues will need to be tied effectively to a broader process of economic reconstruction that involves debt relief, economic reform, and new bilateral and multilateral concessionary flows. In the interim, should the government of Sudan make a good-faith effort to put substantial amounts of current oil revenues into development of southern capacities, Sudan may be able in the short-term to leverage matching resources from multilateral donors. As part of the negotiations, the parties may choose to discuss, formally or informally, mutually agreeable intermediate measures of this kind.