Persia and Iraq 1933 - Persian Concession Negotiations and Visit to Iraq Petroleum Co (IPC) Pipe Line Area

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A BASIS OF ROYALTY PAYMENTS.

The problem under examination has been to find a royalty basis which satisfies the following conditions:

1. A minimum annual payment to the Persian Government, of a substantial nature.
2. An annual payment which under normal working conditions will avoid violent fluctuations.
3. An annual payment which shall be in reasonable ratio to the Company's total profits.
4. A scale of payment which will remove the incentive from the R.O. to press for ever-increasing tonnage.
5. A method of payment which carries no shareholding but will give the R.O. some share in the prosperity of the Company without depriving them of a substantial minimum in lean years or in the event of a declining Persian tonnage.
6. A method of payment which obviates the necessity for an examination of the Company's accounts.

The following three schemes go a long way to meet this combination of requirements, point No. 6 being alone unprovided for. It is hoped, however, that even in this respect the field of suspicion or dispute would be confined to narrow limits and, consequently, the cause for any desire to examine the accounts would disappear.

All schemes depend on the same fundamental principles, namely a combination of a tonnage Royalty and a Royalty tied to the profits of the Company, derived from all sources. A tonnage Royalty alone must necessarily increase with increasing production and provide the urge to the R.O. to press for increasing tonnage. A means has therefore been found to apply the "profit Royalty" in such a way that it exerts a counteracting influence on the increasing tonnage Royalty that is to say the "profit Royalty" on any fixed profit decreases as the tonnage increases. Moreover the "profit Royalty" though dependent on the profits from all sources has been purposely linked up with the Persian production on the assumption that it is sound in principle to express the total Royalty payable to the Persian Government in terms of the Persian production.
In order to explain clearly the methods that have been adopted to arrive at these suggested solutions, an explanation of the formulas which have been used is given in an attached note headed "Investigation of the problem in general terms."

To turn to an examination of the results obtained from the two schemes.

SCHEME 1.

To pay a fixed tonnage royalty plus a lump sum for every Shilling profit per ton made, above a certain minimum limit of profit per ton.

SCHEME 2.

To pay a fixed tonnage royalty plus a lump sum for every Shilling profit per ton, no minimum limit.

In each case profit per ton being the factor.

Total declared profits

Total Persian tonnage

and a payment is made in Table A, of £20,000 and operating for each Shilling over Shilling 50/- obtained from this factor.

(b) Alternatively in Table B £30,000 for each Shilling over Shilling 15/- obtained from the same factor.
EXAMPLE.

Declared profits £ 6,000,000
Persian tonnage 6,000,000 Tons

Factor = $ = £ 1.5.9 per ton.

Profit Royalty payable under (a) after deduction £ 1.1 = £ 30,000 x 5 = £ 150,000

Profit Royalty payable under (b) after deduction Sh.15/ = £ 30,000 x 10 = £ 300,000

These two Tables constitute reasonable negotiating limits but both Tonnege and Profit Royalties can, of course, be varied to produce in total, the Royalty which it is proposed to concede.

We have, in Tables A & B illustrating this scheme, arbitrarily fixed the tonnage Royalty at Sh.4/- per ton in view of the precedent created in the I.P.C. and K.O.C. Agreements and assuming that the P.D. would not be content with less. With tonnage Royalty on so high a scale, it has been necessary to introduce a limit to the Profit Royalty basis, below which no Profit Royalty will be payable.

This limit might be a source of contention in negotiating the point. But there is a perfectly logical answer in support of it, namely that the P.D. on their side receive a guaranteed sum on the Production, and the shareholders are equally entitled to a guaranteed first charge on the profits. The amounts obtained from these guaranteed minima between the most likely range of production 3 to 6 million tons would be:

Alternative (a) with Sh.20/- limit £ 3/£ 6,000,000
(b) Sh.15/- £ 2,000,000/28,000,000

which is in very reasonable proportion to the sums required to cover fixed interest dividends, Sh/10% on Ordinary Shares and operating expenses.

This scheme can be translated very simply into words and a draft clause is attached. It is appreciated that the wording "declared profits" may be susceptible to
improvement, and this point is left to accountancy experts.

Actually we have had in mind the total profit prior to appropriations to reserves etc. It is realised also that the introduction of "profit" in any shape or form opens up the risk of examination of the accounts; but it is claimed that the field of dispute is minimized and perhaps removed by reason of the fact that there are no complications on account of deductions. It would be possible, however, to base the "profit Royalty" on the ordinary dividend appropriation by relating this appropriation to the Persian Crude Tonnage on the same principle. In order to do so, however, it is necessary to know the proper proportion which the ordinary dividend appropriation should bear to the Gross Profits in order to produce a total Royalty figure which is in proper relation to the Gross Profits. This information is not available in Abadan.

In Tables A and B the practical application of this scheme is shown.

It will be seen that the total amount of Royalty payable for productions of 1 and 2 million Tons is disproportionately high. (In Table A this applies, strictly, to 1 million Tons only). It is necessary therefore to exclude these two productions from the "profit Royalty" scheme and this has been done in the Draft Clause. It is logical to do so, in view of the fact that the A.C. are given a minimum Royalty of £600,000; even though production falls below 3,000,000 Tons.

Similarly the Royalties derived from 7 and 8 million Tons Persian production are unduly high unless profits are in the order of £6,000,000. We presume, however, that such a possibility is remote and the production is, in any case, within the control of the Company.

Turning to Tables A and B, if the 1 and 2 million Ton production some is eliminated as impracticable...
(and safeguarded in the Clause) and the 7 and 8 million ton production scale eliminated as unlikely, we are left with a range comprising the most likely combinations of production and profits, namely 3 to 6 million tons per annum and 3 to 10 million pounds profit. In approximately 75% of these combinations (encircled with a red line) the total Royalty payable would be less than 80% of the Gross Profit.

In the remaining 25% of the combinations, the Royalty is derived from tonnage only and a higher percentage to the Royalty. The Royalty and is therefore unavoidable in any case, if the "Tonneage Royalty" is to be the main basis of payment.

Scheme 2. Judging the results of this scheme with the stipulations detailed at the commencement of this note, we have:

1. A guaranteed minimum Royalty of £6,850,000 per annum.

2. An annual payment which, within the likely combinations of tonnage and profit varies but slightly. Taking the 8 million ton scale as an example, in Table 1, the Royalty payable, when profits range from £4,000,000 to £2,850,000, increases only from £1,100,000 to £1,250,000.

3. An annual Royalty which is less than 25% of the Company's profits on the Table A scale; generally less than 20%. Expressed as a rate per ton, the Royalty varies between the ranges of 3 and 6 million tons per annum is almost in every case between 9s.4/ and 11s.6/ per ton.

4. The incentive for the P.G. to press for ever-increasing tonnage is very largely removed. It will not be seen-for instance it is as much to the advantage of the P.G. to see the Company remain on a steady "profit tonnage" and derive for increased profits as it is for them to keep profits steady and increase tonnage. Again, as an illustration, the Royalty payable with cable to profits of £4,000,000, from the scale Table B, would be:

- 3 million tons production £1,120,000
- 4 million tons £1,190,000
- 5 million tons £1,250,000
- 6 million tons £1,285,000

5. The method carries no shareholding rights but ensures for the P.G. a share in the prosperity of
the Company and a substantial minimum if Persian production declines.

whilst not removing the possibility of an annual examination of the accounts, the scale of
illustrations is distinctly limited since the profit
is linked to the profits from all sources
interest. It should be stressed that the scale of
has been arbitrarily fixed in these illustrations and could
be adjusted to suit the monetary consideration it is intended
to concede. As explained under Scheme A, Table B can be used
for the purpose of arriving at a royalty basis, within a reason-
able range of profit and production, to match whatever profit
monetary consideration is regarded as reasonable.

A basis can very easily be devised from the same

SOURCING.

In case the allowance of £0.15/- or £0.20/- per ton
of Persian Crude, as a first charge for the shareholders,
a total royalty which has been proved to be an insurmountable obstacle in negotiations,
an alternative Table C has been devised eliminating altogether
this allowance, and producing a total royalty which is in a
reasonable proportion to the gross profit.

The principles of this scheme are in all other
respects precisely the same.

The practical results have necessarily been to
reduce the tonnage royalty to £0.2/- per ton and we foresee
in this a more likely source of objection from the F.D.O. in
that it compares unfavourably with the tonnage Royalties
granted to the I.P.C. and E.I.O.C. A larger proportion of
the total royalty is also unavoidably thrown on to the
"Profit Royalty" basis.

It will be seen that the scheme is again inapplica-
table to the 1 and 2 million ton production range and the
necessary safeguard has accordingly been introduced into the
Draft Clause attached. It is suggested that this range would
also have to be covered by a minimum guarantee of any
£460,000 the equivalent of 3,000,000 Tons production.


...
Alternatively it would be a simple matter to prepare tables with a fixed tonnage royalty or a shilling per ton and while varying profit royalty to give a total royalty or fixed percentage of the total profits, although in some of the circumstances it would be simpler to dispense with profit royalty altogether and cover the point by stating that a royalty on profits will be equal to a fixed amount, added to the tonnage royalty, will give to the 7\% a total royalty payment equal to \( \frac{1}{2} \) of the profits.

(a) All substances used within Persia by the Company for its operations hereinafter.

(b) All substances returned to the natural reservoir.

The Company undertakes that the annual payment to the government by way of royalty shall not be less than £600,000.

NOTES—The following two safeguards could be introduced at this point but it may be considered desirable, on grounds of policy, particularly if the royalty payments cannot be made in all forms of taxation, be paid altogether.

Accordingly that the all substances of the Concessional Area pertaining to production of a maximum amount of 2,000,000 Tons during the year in respect of which Royalties are payable and that such Royalties can, with reasonable diligence on the part of the Company, be delivered at the convenient:

(a) The Company shall deliver the total of the Royalties due to it by the Company under the first paragraph of this Article, and less than £600,000 Tons, is the difference between the said total of the Royalties due to the Company and the sum of £600,000, shall be recoverable by the Company without interest in subsequent years of the Concession by way of deductions from the Royalty due to the government in any subsequent years of the Concession but shall not be otherwise recoverable.

Provided that the total tonnage of substances comprised in Article 1 (other than natural gas) won and saved at the seashore in any one year shall be not less than 2,000,000 Tons and that the profit per ton of the said substances exceeds twenty shillings then in that year the Company shall pay an additional royalty of £20,000.
In consideration of the privileges conceded, the Company shall pay to the Government a Royalty of four Shillings per ton of the substances (other than natural gas) comprised in Article 1 herein won and saved in storage at the seashore by the Company, but for the purpose of this provision the Company shall be entitled to deduct from the gross quantity so won and saved:

(a) all water and foreign substances,

(b) all substances used within Persia by the Company for its operations hereunder,

(c) all substances returned to the natural reservoir.

The Company undertakes that the annual payment to the Government by way of Royalty shall not be less than £600,000.

NOTE: The following two safeguards could be introduced at this point but it may be considered desirable, on grounds of policy, particularly if the Royalty payments be made for any or all forms of gas to omit them altogether.

1. “Provided always that the oil resources of the Concessional Area permit of the production of a minimum amount of 3,000,000 Tons during the year in respect of which Royalties are payable and that such quantity can, with reasonable diligence, be delivered at the seashore.

If in any calendar year the total of the Royalty due by the Company as herein specified, exceeds the amount of £1,000,000 and the Royalty due by the Company and the sum of £1,000,000 shall be recoverable by the Company without interest in subsequent years of the Concession by way of deductions from Royalty out of any excess over £1,000,000 of Royalty which may be due to the Government in any subsequent year of the Concession but shall not otherwise be recoverable.

Provided that the total tonnage of substances comprised in Article 1 (other than natural gas) won and saved at the seashore in any one year shall not be less than 3,000,000 Tons and that the profit per ton of the said substances exceeds twenty Shillings then in that year the Company shall pay an additional Royalty of £20,000
for every Shilling in excess of twenty Shillings profit per ton.

The profit per ton of the said substances for purposes of this provision shall be fixed in manner following.

The declared profits of the Company for the year shall be divided by the total tons of the said substances won and saved at the seaboard during the same year.

(a) All substances used within Persia

EXAMPLE.

Declared profits of the Company For the year = £5,000,000

Total of said substances won and saved = 3,000,000 Tons.

Assumes that the annual payment to the Government by way of royalty shall be £1,12.4 profit per ton.

Provided that the total output of substances in exceed of 1£ per ton is calculated as follows:

£1,000,000 of Total output at the seaboard in any one year shall not be less than £1 per ton.

Therefore the additional Royalty which the Company shall pay is, in this instance £82,000 x 12.3

The profit per ton of the said substances for purposes of the Company shall also pay a Royalty of two pence per thousand Cubic Feet of all natural gas won in Persia which it sells, calculated at an absolute pressure of one atmosphere and a temperature of 60 degrees Fahrenheit.

EXAMPLE.

Declared profits of the Company For the year = £5,000,000

Total of said substances won and saved = 3,000,000 Tons.

£1,12.4 profit = £1,000,000

Therefore the additional Royalty which the Company shall pay is, in this instance £16,000 x 12.3

The profit per ton of the said substances for purposes of the Company shall also pay a Royalty of two pence per thousand Cubic Feet of all natural gas won in Persia which it sells, calculated at an absolute pressure of one atmosphere and a temperature of 60 degrees Fahrenheit.
SCHEME A.
Draft Clauses.

In consideration of the privileges conceded, the Company shall pay to the Government a Royalty of three Shillings per ton of the substances (other than natural gas) comprised in Article 1 hereof won and saved in storage at the seaboard by the Company, but for the purpose of this provision the Company shall be entitled to deduct from the gross quantity so won and saved:

(a) all water and foreign substances,
(b) all substances used within Persia by the Company for its operations hereunder,
(c) all substances returned to the natural reservoir.

The Company undertakes that the annual payment to the Government by way of Royalty shall not be less than £450,000.

Provided that the total tonnage of substances comprised in Article 1 (other than natural gas) won and saved at the seaboard in any one year shall be not less than 3,000,000 tons the Company shall pay an additional Royalty of £0.15,000 for every Shilling profit per ton.

The profit per ton of the said substances for purposes of this provision shall be fixed in manner following.

The declared profits of the Company for the year shall be divided by the total tons of the said substances won and saved at the seaboard during the same year.

**EXAMPLE.**

<table>
<thead>
<tr>
<th>Declared profits of the Company for the year</th>
<th>£3,800,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total of said substances won and saved</td>
<td>3,000,000 Tons</td>
</tr>
</tbody>
</table>

£1, 15. 4 profit per ton.

Therefore the additional Royalty which the Company shall pay is, in this instance

\[ \frac{15,000 \times 3000}{5} = £500,000. \]

The Company shall also pay a Royalty of two pence per thousand Cubic Feet of all natural gas won in Persia that it
sells, calculated at an absolute pressure of one atmosphere and a temperature of 60 degrees Fahrenheit.
INVESTIGATION OF THE PROBLEM IN GENERAL TERMS.

\[ K = \text{Tonnage Royalty in Pounds per ton.} \]
\[ P = \text{Production in Tons.} \]
\[ A = \text{Gross Profit of Company in Pounds.} \]
\[ S = \text{Amount in Pounds paid as "Profit Royalty" for every \( \frac{16\lambda}{A} \) of total Gross Profit (all years) per ton production from formula.} \]
\[ L = \text{Limit in Shillings per ton of profit, below which no "Profit Royalty" is payable.} \]
\[ K = \text{Total payment (Tonnage Royalty plus Profit Royalty).} \]

SCHEME 1.

A tonnage Royalty plus a lump sum for every Shilling profit per ton made, above a certain minimum limit of profit per ton.

In this case \[ K = RP + SL \] \[ (a) \]

SCHEME 2.

A tonnage Royalty, plus a lump sum for every Shilling profit per ton, no minimum limit.

In this case \[ K = RP + SL \] \[ (b) \]

It is apparent in both \( (a) \) and \( (b) \) that whereas the tonnage Royalty \( RP \) increases with production, the profit Royalty \( SL \) or \( \frac{RP}{P} \) decreases with production.

The purpose of a limiting factor \( L \) is to cause the profit payment to cut out entirely if production increases out of proportion to profit.

In each case, if the total payment is to be uninfluenced by production, then \( K \) must remain constant for all productions. That means that the rate of change of \( K \) with production \( P \), must be Zero.

\[ \text{Continued} \]
By the differential calculus therefore, \( \phi = \frac{\partial z}{\partial x} \)

But \( \frac{\partial z}{\partial x} \) is the sum \( \frac{\partial a}{\partial x} \) and \( \frac{\partial b}{\partial x} \) from either (1) or (3).

Hence \( \frac{\partial z}{\partial x} = \frac{\partial a}{\partial x} + \frac{\partial b}{\partial x} \).

It is important to note that the condition to be satisfied if the total payment is to remain a constant irrespective of production.

The equations for Scheme 1 are therefore

\[ \frac{d}{dx} X = K + \frac{6(\alpha K)}{b^2} - 1 \]  \hspace{1cm} (1)

\[ X = \frac{1}{\alpha} \frac{d}{dx} \left( K + \frac{6(\alpha K)}{b^2} - 1 \right) \]  \hspace{1cm} (2)

And \( X = \frac{1}{\alpha} \frac{d}{dx} \left( K + \frac{6(\alpha K)}{b^2} - 1 \right) \) by Table (3).

The middle point in these limits is a production.

Combining these \( X = \frac{1}{\alpha} \frac{d}{dx} \left( K + \frac{6(\alpha K)}{b^2} - 1 \right) \) a production.

Combining these \( X = \frac{1}{\alpha} \frac{d}{dx} \left( K + \frac{6(\alpha K)}{b^2} - 1 \right) \) a production.

It is apparent that \( K \) and \( \alpha \) vary with production and profit with production.

In Tables D.1 to D.4 values of \( K \) and \( \alpha \) are tabulated over a wide range of production and profit in such a way that for any condition of production and profit selected the values of \( K \) and \( \alpha \) tabulated against this will give a total Royalty payment equal to 6% of the profits.

Table D.1 assumes profit payment operative with no lower limit on profit per ton and therefore corresponds to Scheme 1.

Table D.2 is based on a profit payment operative above a minimum profit per ton of Sh.1.50 per ton.

Table D.3 is based on a profit payment operative above a minimum profit per ton of Sh.1.50.

Table D.4 is based on a profit payment operative above a minimum profit per ton of Sh.1.50 at the expense of profits.
Table D.5 is based on a profit payment operative above a minimum profit per ton of £1.00 considered, and values of B and R vary with production and profit over the whole range of production and profit, yet, within narrower limits of these, it is possible to strike a fixed R and a fixed B which will give a total Royalty payment of approximately 20%.

As an example, if production varies from 4 to 6 m. tons and profit from 4 to 8 m. Pounds, take any Table D.4.

The middle point in these limits is a production of 5 m. tons and a profit of 6 m. Pounds which gives a tonnage Royalty of 9/-

and a Profit Royalty of £ 36,600 for each Sh.1/- over Sh.15/-.

On this basis total Royalty is tabulated below:

<table>
<thead>
<tr>
<th>PROFIT</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>800,000</td>
<td>1,000,000</td>
<td>1,200,000</td>
<td>1,400,000</td>
<td>1,600,000</td>
<td></td>
</tr>
<tr>
<td>Production</td>
<td>5 m. tons</td>
<td>6 m. tons</td>
<td>7 m. tons</td>
<td>8 m. tons</td>
<td></td>
</tr>
<tr>
<td>4 m. tons</td>
<td>20%</td>
<td>21.2%</td>
<td>21.3%</td>
<td>21.4%</td>
<td></td>
</tr>
<tr>
<td>5 m. tons</td>
<td>20%</td>
<td>21.2%</td>
<td>21.3%</td>
<td>21.4%</td>
<td></td>
</tr>
<tr>
<td>6 m. tons</td>
<td>20%</td>
<td>21.2%</td>
<td>21.3%</td>
<td>21.4%</td>
<td></td>
</tr>
</tbody>
</table>

Total Royalty varies, with the exception of the one case of 6 m. tons production and 4 m. Pounds profit (where total payment is 20.3% of profits, due to tonnage Royalty only) from 22.4% to 18.4% of the profits, which is reasonably approximate to 20%.

Furthermore, the Royalty for 6 m. tons production and 4 million Pounds profit is not so great as for 4 million tons production and 6 million Pounds profit, which fact counteracts the incentive for increased production at the expense of profits.
Similarly other tables can be compiled for whatever range of production and profits is to be considered, and values of A and B tabulated in Tables D to give total payment equal to 20%, can be pro rated for a total payment of any other percentage "X" of total profits.