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SUBJECT: UK DEFENDS OIL EXPLORATION IN FALKLAND ISLANDS WATERS
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Classified By: Economic Minister Counselor Richard Albright for reasons 1.4 b & d

1. (SBU) Summary: Tensions between the UK and Argentina have risen over the past week over a new drilling campaign in the Falkland Islands Outer Conservation zone following the arrival of the Ocean Guardian oil rig in the North Falkland Basin. Argentina contested the right of the Falkland Island's Government to license drilling for oil off the coast of the islands, a British Overseas Territory. UK Foreign Secretary David Miliband firmly defended the oil exploration as being in accordance with international law. Desire Petroleum, a UK-headquartered company, started drilling the first well on February 22 following five years of preparation, including acquiring production licenses. Exploration and production licenses are approved by the Governor of the Falkland Islands, following consultation with the UK's Foreign Secretary. The new drilling campaign is expected to last approximately eight months, as at least two other companies with E&P licenses within the Falklands Conservation Zone make use of the rig sequentially. Desire confirmed that Argentina's actions will not disrupt its activities and said it had worked closely with the UK's Foreign and Commonwealth Office (FCO) to try to avoid inflaming tensions. With the exception of the Falklands, HMG seeks to continue a normal relationship with Argentina. End summary.

UK Defends Oil Exploration in Falkland Islands

2. (U) Tensions mounted between the United Kingdom and Argentina ahead of a drilling operation in the Falkland Islands conservation zones by a UK company, Desire Petroleum. Argentina contested the UK's right to drill for oil off the coast of the Falkland Islands, a British Overseas Territory, and introduced a requirement that vessels traveling to the Falklands through Argentine waters obtain permits. Foreign Secretary David Miliband strongly defended the oil exploration during a February 18 BBC radio interview, saying it is being conducted in accordance with international law. In a statement February 23, Chris Bryant, the UK's Foreign Office Minister with responsibility for the British Overseas Territories, reiterated UK support for the oil exploration. He said the Falkland Islands government is entitled to develop a hydrocarbon industry within its waters. He said the UK will continue to support the islands in developing this "legitimate business in its territory." The Falkland Islands' Legislative Assembly also asserted its right to develop a hydrocarbon industry within the Islands' waters in a February 18 press release.

3. © Andrew Allen, Head of the Southern Oceans, team in FCO's Overseas Territories Directorate, told us February 24 that no UK government would negotiate the sovereignty of the Falklands with Argentina without the approval of the islanders, who overwhelmingly opposed any such discussions. He emphasized HMG desire to continue cooperation with Argentina on all other issues. He said that Argentina appeared to be taking a similar same stance, noting a GOA statement that it would proceed in legal, diplomatic ways. Allen said the Argentine Government had so far applied its decree requiring permits for shipping between the mainland and the Falklands only to one ship and that cruise ships were continuing travel between Argentine ports and the islands. In any event, he said there was little shipping and air traffic between the Falklands and Argentina. Allen noted that the main supply links to the islands were a weekly flight to Chile and cargo shipping to and from Uruguay and Brazil. He expressed some concern that these countries could in the future be tempted to restrict those links out of solidarity with Argentina.

4. (SBU) Desire Petroleum started the new drilling campaign on February 22. Drilling on the "Liz" well in the North Falkland Basin is expected to last 30 days. An oil rig platform, the Ocean Guardian, which is owned by U.S. based Diamond Drilling, was towed from Scotland and arrived approximately 62 miles north of the islands

in the South Atlantic on February 19. Desire said the rig is firmly inside British waters and that Argentine protestations would not disrupt its activities. (Note: Julia Painting, Head of the Falkland Islands section within the FCO's Overseas Territories Directorate, said the Falkland Islands' waters extend 200 nautical miles off the coast of the islands and consist of the Falkland Interim Conservation Zone of 100 nautical miles (FICZ) and the Falkland Outer Conservation LONDON 00000439 002.3 OF 003 Zone of 200 nautical miles (FOCZ). There are several "kinks" in the conservation zones where they meet the Argentinean Exclusive Economic Zone. End note.) Another official in the same office explained to us that the FOCZ is the Falkland's Exclusive Economic Zone, in all but name. Earlier governments had decided to use FICZ and FOCZ to avoid arousing tensions over the term. The official noted that a drilling rig had operated in the FOCZ in the late 1990s, provoking no protests from Argentina. According to FCO, this was a period when then President Menem was seeking cooperation with the Falklands.

Falkland Islands Oil Licensing System

5. (SBU) Oil exploration and production within the Falkland's conservation zones require licenses granted by the Islands' government. Plans to drill must be approved by the Governor of the Falkland Islands. The Governor grants approval having consulted with the UK's Foreign Secretary. All applications are scrutinized by both the Falkland Islands and UK authorities. The Falkland Islands' Department of Mineral Resources advises the Islands' Governor with regard to local exploration concerns. Officials from the UK's Department for Energy and Climate Change (DECC) told us DECC only offers technical advice to the UK's Foreign and Commonwealth Office (FCO). However, they noted that decisions regarding the development of the Falkland Islands' hydrocarbon industry are ultimately a matter for the Falkland Islands government.

6. (U) The licensing system consists of exploration licenses and production licenses. Exploration licenses allow companies to gather seismic, gravity, magnetic, geochemical, and sea-bed data and do not allow drilling deeper than 350 meters below the sea-bed. They are not area-specific and can apply to all of the designated area) which covers 400,000 kilometers squared, approximately 50 percent bigger than the UK's North Sea. Licenses are typically awarded for one year, but can be renewed for up to three years. Production licenses are area-specific and provide exclusive rights for surveying, drilling and production. They are awarded through occasional competitive rounds or, more typically, under an open-door system. Bids for open-door production licenses can be made at any time for any number of whole blocks (12' longitude by 10' latitude) up to a total of 30 continuous blocks in any one license. Applicants can determine the size and shape of the area they bid for and there is no limit to the number of licenses that can be applied for at any time.

7. (U) The Falklands' fiscal system comprises a variable acreage rental, 9 percent royalty on production, and 26 percent corporation tax on profits. Acreage rentals are payable annually in advance. Rents vary depending on the license phase and whether the license was awarded as a result of a competitive licensing round or as the result of an open-door invitation. There are no signature bonuses, no production sharing contracts, no back-rights and no local market discounts. The Falkland Islands welcome applications from companies worldwide. However, according to the Department of Mineral Resources, the Falkland Islands government is unlikely to grant a license to any applicant in which Argentine interests hold more than a 49 percent stake.

8. (U) Existing production license holders are: Desire Petroleum, Argos Resources, Falkland Oil and Gas Ltd/BHP Billiton, Borders and Southern Petroleum, and Rockhopper Exploration. Previous operators have included Shell, Amerada Hess, Lasmo and IPC/Lundin Oil. Most of the current license holders are listed on the London Stock Exchange's Alternative Investment Market (AIM). All combined, they have raised in excess of GBP 250 million in recent months to fund drilling operations.

Desire Petroleum

9. (SBU) Desire Petroleum, which has started the new drilling campaign, is dedicated to explore for oil and gas in the North Falkland Basin. It was founded in 1996 and is listed on the London Stock Exchange's Alternative Investment Market (AIM). It participated in the first round of drilling in the North Falkland Basin in 1998 and currently operates six licenses in the area. It estimates recoverable oil potential in the region at 3.5 billion barrels, with gas reserves of over 9 trillion cubic feet. (Note: ExxonMobil International Chairman Brad Corson told us he does not LONDON 00000439 003.3 OF 003 believe there is enough oil on the Falkland Islands Continental Shelf to be profitable, citing Shell's earlier oil exploration attempts which they abandoned. End note.)

10. (SBU) The current drilling campaign is expected to last approximately eight months, according to Ben Willey, a spokesman for Desire. Willey told us that if all runs smoothly, the Ocean Guardian rig will drill between six and eight wells. The first well, already underway, is for Desire in the North Falklands Basin. The drilling is expected to last 30 days. After this, the rig will start on a second well, also in the North Basin, for Rockhopper Exploration. The third well will be drilled for the Falkland Oil and Gas/BHP Billiton joint venture, the fourth for Rockhopper and the fifth for Desire. Depending on the success of these wells, Desire may decide to drill up to three additional wells. Its contract with Diamond Drilling, the rig owner, allows for up to eight wells.

11. (SBU) Willey stressed that Desire worked very closely with the UK's Foreign and Commonwealth Office (FCO) over the past five years throughout the planning stages of the drilling campaign. During the past few weeks, while tensions with Argentina have mounted, he said Desire has sought further advice from the FCO and cleared all statements with the department to ensure the company does not further inflame the situation. Willey said Desire has also built good relations with the Falkland Islands government. He confirmed that the rig passed entirely through international waters on its journey from Scotland to the North Falkland Basin.

Additional Companies Operating In The Falklands

12. (U) -- Rockhopper Exploration, also AIM-listed, has licenses to explore for oil and gas in the North Falkland Basin. It raised GBP 50 million through an equity placement in late 2009 to finance its 2010 drilling campaign in the Falklands.

Falkland Oil and Gas, which is also an AIM-listed UK company, focuses on oil and gas exploration in the undrilled South and East Falkland Basins. It is involved in a joint venture with BHP Billiton.

BHP Billiton is an Anglo-Australian natural resources company. It is one of world's largest mining companies and its products include petroleum, aluminum, iron ore, diamonds, manganese and coal. BHP Billiton owns a 51 percent stake in its joint venture with Falkland Oil and Gas. The joint venture was agreed in October 2007.

Borders & Southern Petroleum focuses on emerging hydrocarbon systems. Its first project is based in an untested basin to the south of the Falkland Islands. The company was awarded its first exploration license in the Falkland Islands in 2004 and in 2005 listed on the AIM, raising GBP 10 million.

Argos Resources is a private exploration company and holds a production license in the North Falkland Basin.

13. © Comment: UK government officials have made public statements asserting the right of the Falkland Islands to issue exploration and production licenses in its conservation zones in accordance with international law. However, they have sought to downplay the row and the impact it could have on the UK's relationship with Argentina and other Latin American countries. HMG has attempted to avoid escalating tensions and has stressed HMG's desire to pursue normal relations with Argentina in all other matters. FCO hopes that Argentina will proceed similarly.

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