Middle East Policy, Vol. XIX, No. 1, Spring 2012

The Politics of Kurdish Crude

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The entry of ExxonMobil into the Kurdish oil market has sent shock waves throughout Iraq's energy sector and its political classes. The presence of one of the world's largest international oil companies (IOCs) in the Kurdistan Region not only challenges central government authority but gives the Kurdistan Regional Government (KRG) greater leverage in developing its own oil market. More super-major IOCs are likely to follow, which will further enhance the recognition and financial rewards for the KRG and its business partners.

Still, is the Exxon deal really a game changer? The IOC may be considered "too big to fail," but can it alter the deep-rooted tensions between Baghdad and Arbil over territory and national identity? At the crux of these disputes are different views of power distribution in the Iraqi state and control over the country's resources. Baghdad seeks greater authority than the enumerated powers given to it in the 2005 constitution, a document essentially written by the Kurds and some Shias, while the KRG wants as much autonomy as possible. Power struggles have spilled into the petroleum markets. As Baghdad insists on Iraqi oil for Iraqis, the KRG demands Kurdish crude for Kurdistan.

These disputes will continue to stifle passage of a national hydrocarbons law in the near future and encourage the development of two competing oil sectors. Baghdad has blacklisted Exxon from its fourth bidding round, which has been postponed again until May 2012, and continues to refute the legitimacy of KRG oil contracts. The KRG, in turn, has confirmed it will "absolutely" continue to sign new contracts and bring in more oil majors. Yet, in the absence of an independent revenue source and control of the pipeline export infrastructure, the KRG may eventually have to compromise with Baghdad to assure IOC payment and the viability of its oil market. Given the ongoing political distrust between Baghdad and Arbil and the potential value of Iraqi petroleum to world markets, it is in the U.S. interest to encourage such a compromise. Promoting Iraqi oil exports through the northern corridor via Turkey will not only boost Iraq's emergent energy sector, but strengthen U.S. energy security in an otherwise volatile region.

LEVERAGING THE OIL SECTOR

Although the Kurdish oil market has only emerged since the overthrow of Saddam Hussein, it has spurred an economic metamorphosis in the Kurdistan region. With a dysfunctional central government, large regional autonomy, and a revenue base that more than quadrupled overnight (from $100 million in 2003 to over $10 billion in 2012), the KRG has transformed its once marginalized region to a new frontier for oil exploration, multi-million-dollar construction contracts, and cheap imports from China.[1] The KRG's purse strings and prestige further expanded with the dozens of production-sharing contracts (PSCs) it signed with IOCs since 2009, all of which offered lucrative sign-on bonuses, revenues for local development, and political party-family wealth at no government cost.

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The Kurds also have benefitted from Baghdad's internal weakness and foreign-policy missteps. As Iraqi Prime Minister Nouri al-Maliki has opted to tolerate unpopular regimes such as those in Iran and Syria and give Baghdad's support to Shia uprisings in Bahrain, Sunni Arab Gulf states have increasingly turned to the Kurdistan Region as an alternative arena to assert their influence and check Iranian-Shia power, as well as to pursue commercial opportunities in general. Newly established consulates from Egypt, Kuwait, Jordan and Palestine attest to the KRG's expanding regional support base and its investment potential. Pragmatic Kurdish leaders also have solidified their ties with Turkey, which not only has become the KRG's most important trading partner but has assumed a guardianship role for the entire northern region. The result has been an outpouring of investment and political support that has propelled the Kurdistan Region onto the world's economic and diplomatic stage.

These trends have boded well for KRG officials, financial investment houses, IOCs and others dependent upon positive speculation to boost profits from emerging Kurdish markets. The Kurdish oil boom has generated a frenzy of foreign investment and construction projects while raising demands for tertiary-sector employment. Five-star hotels, first-rate highways, and near-24-hour electricity are some of the modern conveniences that can now be found in parts of the Kurdistan Region. For the first time in decades, Kurdish diaspora communities are returning to their homeland to help reconstruct it and reap the benefits of the region's security and economic prosperity.

Still, historical legacies, local politics and unresolved territorial issues with Baghdad threaten to undermine the KRG's ambitions, regional stability and Iraqi prosperity. The Kurds may have gained large external patronage, but they have insufficient leverage inside the Iraqi state to support their resource claims. Despite the politically expedient ties that have formed between the Kurdistan Alliance and Iyad Allawi's Iraqiyya bloc, including backing from the Iraqi Parliament's Oil and Gas Committee for a decentralized oil sector, the only Baghdad parliamentarians that have initialed the committee's draft hydrocarbons law have largely been the Kurds.

A parliamentary debate on Iraqi energy policy in August 2011 ended in a complete breakdown of discussions and postponement of the bill's reading.

New disagreements also have emerged over the source of oil legislation. While the Oil and Gas Committee insists on its authority over energy-sector legislation, real power has gravitated toward the cabinet, in particular, Maliki and his deputy energy minister, Hussain al-Sharistani.[2] The Maliki-Shahristani influence extends to the Iraqi Oil Ministry, which also insists on a centrist approach to managing the country's oil revenues, particularly in light of the recent Exxon deal. Frustrated with what Baghdad views as the KRG's blatant disregard for Iraqi unity, Iraqi Oil Minister Abdelkarim al-Luaybi recently called for the Kurds to decide "between Iraq or an independent state." Members of the Kurdistan Alliance, in turn, have become more openly critical of Shahristani, comparing him to Saddam Hussein.[3]

Shahristani's influence, however, has not waned in southern and central Iraq, particularly regarding Kurdish oil contracts. Despite Maliki's sporadic, private overtures toward Kurdish leaders, rank-and-file members of his State-of-Law Coalition, as well as other Shia and Sunni Arab groups, support Shahristani as a "patriot who does not betray Iraqis as others do." The Sadrists, who are the real kingmakers in the Baghdad parliament, continue to maintain their hardline view against all Kurdish contracts, the IOCs, and American influence in Iraq.[4] Personality conflicts between Shahristani and Kurdish Oil Minister Ashti Hawrami also run deep, reinforcing the dramatically different approaches to oil-sector management.

Further, as the KRG pursues its energy-sector development in *competition* with Baghdad, it has reinforced, at least in Baghdad's view, a maximalist nationalist agenda based on Kurdish territorial expansion. Even without the implementation of Article 140 of the Iraqi constitution, Kurdish leaders have gradually asserted their territorial claims by resettling populations and moving their *peshmerga* (militia) deeper into certain disputed areas and signing PSCs in disputed territories. Arbil's recent agreement to provide electricity to the oil-rich Kirkuk province using revenue earned by the petrodollar program has given the KRG further influence in parts of the disputed territories.

Territorial boundary-cum-oil issues have spilled over into debates about regional autonomy, creating new shifts in alliance structures. The fact that three of Exxon's six blocks, as well as those of smaller IOCs, are located in disputed border areas in Ninewa and Kirkuk provinces have added to Iraqi elites' suspicions of Kurdish political ambitions. Exxon's Bashiqa block is particularly contentious. It lies in the border town of Ninewa province that contains a heterogeneous population of Kurds, Sunni Arabs and Christian communities with mixed loyalties to the KRG and Baghdad governments.[5] Some Christians have even called for their own autonomous area in the province, a move that may further complicate ownership of local resources.

Unclear and competing territorial claims coexist with growing demands by Sunni Arabs for their own regional federalism, strengthening the influence of local elites such as the Nujaifi family of Mosul to Ninewa's border towns and its resources. Even though the chairman of the Oil and Gas Committee, Iraqiyya member Adnan Janabi, has been silent on the Exxon deal, his Sunni Arab colleagues in Ninewa have been more vocal. Some have referred to the contract as "void and illegitimate and "a violation against the borders of the province." Upon learning about the Exxon contract, the chair of the security committee of the Ninewa provincial council, Abd al-Rahim al-Shamri, called for the formation of a military force from the Sons of Ninewa to prevent the KRG from developing oil in the province.[6]

Similarly, while the governor of Ninewa, Atheel al-Nujaifi (a brother of Osama al-Nujaifi, Iraqi parliament speaker) has met with Kurdish political elites to discuss economic opportunities with the KRG and ways to mediate the recent crisis over vice president Tariq al-Hashemi, Sunni Arab members on the Mosul provincial council remain antagonistic toward the Kurds.[7] The Ninewa Brotherhood List (the Kurdish block in Mosul that won 12 seats in the last election) is still boycotting the Mosul provincial council while Nujaifi wants Kurdish peshmerga and *asaysh* (Kurdish security forces) removed from Mosul, which the Kurdish President Masud Barzani and his Kurdish Democratic Party (KDP) refuses.

Iraqiyya's relations with the Kurds will be further challenged by overlapping demands of Sunni Arab majority provinces of Salahaddin, Diyala and Ninewa for regional autonomy and claims to disputed border areas. In a meeting with officials from Salahaddin province in November 2011, Iraqi President and Kurdish leader of the Patriotic Union of Kurdistan (PUK) Jelal Talabani acknowledged the regions' rights for autonomy as "long as they did not include the disputed territories."[8]

Nor is the presence of an oil super major likely to alter Baghdad's view of the Kurdish contracts or how oil revenues should be distributed throughout the country. Not only do the Kurdish PSCs offer higher IOC profit margins than what Baghdad has offered companies working under its jurisdiction, but they challenge the notion of Iraqi sovereignty that informs politics in the southern and central regions, particularly after eight years of U.S. occupation.[9] Whereas the PSCs give IOCs partial ownership of discovered oil reserves, Baghdad's contracts assure that "Iraqi oil belongs to Iraqis." The central government may also fear that paying IOCs in the Kurdish north a greater profit margin than companies working in the south, despite the larger risks and costs of exploration for lower quality oil, would encourage an exodus of IOCs to the Kurdistan region and reinforce perceptions of regional inequalities.

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These distinctions take on added significance as popular movements in the Middle East and Iraq demand greater accountability and access to basic goods and services. They also come at a time when many Iraqis, particularly the political elites, view the KRG as having overstepped the constitutional boundaries of its autonomy since 2003. Baghdad will therefore be hard-pressed to convince its own populations that IOC-driven oil-sector development will benefit all Iraqis equally and that each region gets its "fair share" of oil profits.

The spoils of Kurdish crude are also tied to regional politics and, in particular, the Turkish government. Even though relations between Ankara and Arbil have markedly improved over the past several years, and Turkey is anxious to import Kurdish crude to supply its own domestic energy needs, Ankara has thus far indicated that it will negotiate with Baghdad and not the KRG over oil exports.

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To be sure, a Turkish-Iraqi-Kurdish oil-export arrangement seems to be a logical step forward in light of Baghdad's political blunders and the shifting regional balance of power. Relations between Turkish Prime Minister Recep Tayyip Erdogan and Maliki have further eroded over the past several months, giving the KRG greater appeal to Turkey as a direct oil-importing market. Still, these energy opportunities coexist with Turkey's concerns over border security and assuring state unity. Ankara — as well as Syria and Iran — has its own Kurdish problem to manage and would hardly be interested in creating an autonomous revenue source that would allow an independent Iraqi Kurdistan to emerge which, in turn, would reinforce similar demands from cross-border Kurdish groups.[10]

Turkey's concern over rising cross-border Kurdish nationalism has become salient in light of the regionalized Partiye Karkaren Kurdistane (PKK) problem, recent Turkish-Kurdish demands for "democratic autonomy" and growing Syrian Kurdish opposition movements. In the attempt to leverage Turkey's influence and obstruct the emergence of a Turkish-influenced Muslim Brotherhood-led government in a post-Asad Syria, the PKK and the Syrian regime have re-established ties, giving the PKK another regional foothold, alongside its base in Iraqi Kurdistan. At the same time, the KRG has become engaged in supporting Syrian Kurdish demands for autonomy, which if realized, could create three geographically contiguous autonomous Kurdistan regions. This possibility, or fear, could hinder bilateral energy ties between Ankara and Arbil, despite the economic logic of the oil market.

Transnational Kurdish mobilizations also pose challenges to the KRG, which must simultaneously protect its Turkish alliance, maximize the region's potential oil wealth and assure regional stability. Domestic opposition movements inside the Kurdistan region may exacerbate these challenges. Despite the lucrative deals between Iraqi Kurdish and Turkish elites and IOCs, some local populations, encouraged by the opposition movement Goran, are increasingly critical of the secretive nature of the Kurdish oil contracts and undisclosed distribution of revenues. It is also unlikely that the Iraqi Kurdish masses, particularly the youth, would accept the conditions of a Turkish-influenced statelet whereby the region's autonomy and Kirkuk would fall under Turkish authority and not KRG control.

A VIABLE OIL LAW?

While the idea of a prosperous, autonomous Kurdish oil market has instigated political feuding, it has also created new incentives for bargaining and back-door deal-making. Baghdad continues to reject Kurdish PSCs; however, it needs Kurdish exports and IOCs to help develop its energy market and increase government revenues, particularly as it jump-starts its southern fields and world petroleum prices remain at elevated levels. Oil exports through the northern corridor also help reduce the transit fees Baghdad is obligated to pay Turkey as part of its Kirkuk-Ceyhan pipeline agreement. Further, given growing world oil demand and Iranian threats to close the Straits of Hormuz, on which 80 percent of Iraqi oil exports are dependent, exporting Kurdish crude through the northern pipeline could assure a more viable and inexpensive energy route to European markets.[11]

Pressures for greater autonomy from Iraq's other oil-producing regions have encouraged central-government concessions. Shahristani has recently acknowledged the need for regional oil development and has incorporated the regions and provinces into the state's future energy schemes. Baghdad's fourth bidding round, unlike previous ones, will include provincial officials and has even received support from the Anbar governor.[12] The Iraqi cabinet's version of the draft hydrocarbons law also provides for a managerial and administrative role for the KRG in energy-sector development and includes Kurdish exports as part of Iraq's projected oil production. Of the Iraqi draft budget for 2012, the Kurdistan Region will receive over $10 billion and permission to export 175,000 barrels per day (bpd) of its crude, a 75 percent increase from last year's exports.

The KRG, in turn, has published parts of its PSCs and submitted receipts for two of its IOCs for Baghdad's audit and payment, although not for oil smuggled to Iran. It also continues to recognize that revenues from Kurdish oil sales will go directly to the State Oil Marketing Organization (SOMO) for deposit in the Iraqi national budget, 17 percent of which will be allocated to the KRG's annual budget. Still, the Kurdish oil sector remains stuck in a political quagmire. Baghdad is unwilling to recognize the PSCs, while the KRG continues to assert maximalist demands to territory, oil contracts and regional autonomy. How can the two sides move past this impasse so that Kurdish exports can flow freely through the northern corridor and help boost the overall production, exports and revenues of the Iraqi energy sector?

It is unrealistic to expect that a viable hydrocarbons law will be ratified or respected in the near future, until outstanding political issues are resolved. Different interpretations of the 2005 constitution — whether Iraq should be a decentralized or centralized state — will continue to define and frustrate oil-sector discussions. Negotiating a national oil law, therefore, will remain integrally tied to debates over what kind of post-Saddam state Iraq should become and how the federalist system can be fine-tuned to alleviate resource-based conflicts.

Although the outcome of this contentious issue will ultimately be determined by Iraqis at their own pace, the United States can help shape this debate by moving beyond its main objective of passing a national hydrocarbons law first. It can do so by encouraging alternative ways for Baghdad to guarantee the KRG a significant role in managing and developing its regional resource. While continuing to press for a national oil law, Washington can support an interim solution, such as bilateral agreements between Baghdad and Arbil or an asymmetrical form of federalism that accepts the special status of the Kurdistan Region and its oil sector, while assuring the central government a key overseer role in the national oil sector.[13]

The U.S. government also should revisit its approach and policy toward the security and development of the Kurdistan region. While assuring its commitment to the Kurdish alliance, Washington should stop acting as a safety net for the Kurds, as this is breeding resentment among Arab Iraqis. The United States should make clear to the KRG that its support is not unconditional, in light of the Kurds' maximalist position toward territory and a national oil law. Washington also should continue to affirm that it does not support KRG contracts signed in the disputed territories or Kurdish territorial aggrandizement in contested areas.

More specifically, the United States can mediate payment disputes by encouraging Baghdad to audit the KRG receipts in a timely manner and, similarly, nudging the KRG to submit all necessary information requested by Baghdad in full. Although the process is a complicated one, it would represent the Kurds' good-faith effort to demonstrate transparency in their contracts and Baghdad's commitment to payment. This process also could rectify some of the inherent weaknesses of Iraqi federalism¸whereby Baghdad acts as an ATM machine that distributes revenues to the KRG without receipts, declaration of taxes or transfer payments in return. Greater transparency on the part of the KRG and regular payments by Baghdad could lessen the mistrust between the two sides.

Further, although the U.S. strategy has been to encourage Iraqis to decide on contract terms themselves, it could communicate a clear policy position on contracts to help break the gridlock. Washington could nudge the central government away from its insistence on a per-barrel service fee and toward a contract model better suited to developing non-producing fields. This contract model could evolve from the exploratory contracts being developed for Baghdad's fourth bidding round, or could be a hybrid model that incorporates components of the Kurdish PSCs. Similarly, the KRG should be encouraged to be more transparent in its bidding processes and flexible on its PSCs. One option is to renegotiate profit margins to a rate that is acceptable to Baghdad but which guarantees profit for the KRG and IOCs. Another is to keep the PSC in some form but allow greater federal authority.

The KRG may balk at this option and continue to develop the Kurdish oil sector on its own terms. Kurdish officials have cleverly enticed IOCs to their region with attractive contract terms and are unlikely to jeopardize this strategy in the near future, particularly as oil majors enter the northern market. In fact, some Kurdish officials and IOCs think that higher crude-oil volume in the Kurdistan Region will ultimately assure contract sanctity and PSC cost and profit payment.

The amount of crude the KRG is actually exporting still is insufficient to significantly raise Baghdad's export levels or support an independent Kurdish state.

Yet, given their quasi-state status, the Kurds may have little alternative but to compromise with Baghdad, at least in the short and medium terms. Despite the IOC presence in the northern region, the central government still controls the national budget and pipeline-export infrastructure and, consequently, has ultimate authority over payments and Kurdish contracts. Although Turkey has recently indicated that it "cannot wait forever" for Baghdad to negotiate an oil law, its position about not importing oil directly from the KRG remains unchanged at this point.

Infrastructure weaknesses further challenge Kurdish energy and political ambitions. The amount of crude the KRG is actually exporting still is insufficient to significantly raise Baghdad's export levels or support an independent Kurdish state. Of the 150,000 bpd produced in the Kurdistan Region in 2011, about 60,000 bpd were retained for domestic consumption, leaving only 100,000 bpd for export. Even with an increase to 175,000 bpd in 2012 or 1 million bpd in 2020 projected by the KRG, the central government — or the KRG — would have to construct a second pipeline from Kirkuk or restore existing pipelines to be able to fulfill the northern pipeline's maximum capacity of 1.6 million bpd. Moreover, Baghdad is undergoing its own energy-sector expansion in the hope of increasing export levels to 4 billion barrels by 2013-14. If these levels are realized, the central government may have to renegotiate its export quotas with OPEC and determine the amount of Kurdish crude to include in this amount.

Indeed, as oil majors enter the Kurdistan region while political chaos continues in Baghdad, the idea of Kurdish concessions to the central government may seem absurd. It is the KRG, not Baghdad, which has maintained a strong security sector, positive investment climate and Western-friendly regime. Yet, the underlying issue of who pays the IOC contracts is determinative. The time will come when the KRG will be pressed to pay full IOC costs and profits, particularly after it auctions off all its blocks, the mergers-and-acquisitions phase ends, and production commences. Pragmatic Kurdish officials will either have to use their own revenues to pay the IOCs or do what they have been doing for decades to ensure their survival in Iraq: conduct another back-door deal with Baghdad and discretely renegotiate their PSCs. The outcome may be unwelcome for some, but in doing so, the KRG will have assured the legality of its contracts within the Iraqi framework, the profitability of its oil market, and the free flow of Kurdish crude to world energy markets.

[1] Denise Natali, *The Kurdish Quasi-State: Development and Dependency in Post-Gulf War Iraq* (Syracuse University Press, 2010), 82-83.

[2] Whereas the cabinet's version grants a large measure of authority to the Iraq National Oil Company and cabinet, the Oil and Gas Committee draft expands the roles of the provincial and regional authorities and seeks more regionalized representation on the Oil and Gas Council.

[3] "The Oil and Gas Debate," *Inside Iraqi Politics*, December 5, 2011, 2-3, www.insideiraqipolitics.com.

[4] "The Oil and Gas Debate," 3.

[5] Sean Kean, "Iraq's Disputed Territories: A View of the Political Horizons and Implications for U.S. Policy," The United States Institute of Peace (2011): 19-21. In addition, Ninewa includes small ethnic and tribal communities of Yazidis and Shebek, which also have been caught up in the Arbil-Baghdad disputes. Analysis of the 2010 election results in Ninewa reveal strong support for the KRG in Yezidi-populated areas of Sheikhan, but weak to moderate support in Bashiqa (as well as Tilkaef, most of Tal Afar, Hamdaniyua and Qaeyrrawan), which has no history of administrative ties to the Kurdistan Region.
[6] "The Oil and Gas Debate," 4. The chair of the security committee of the Ninewa provincial council, Abd al-Rahim al-Shamri, called on Baghdad and the armed forces to "prevent companies supported by the KRG from engaging in oil exploration."
[7] Adel Kamal, "Al-Nujaifi: Kurds Are Relaxed in Kurdistan, But Anxious in Ninewa," *Niqash*, January 20, 2011, http://www.niqash.org/articles/?id=2771. For instance, while al-Nujaifi stated that his meeting with Barzani was relatively positive, he needed to "convince the people" in Ninewa who are opposed to offering any concessions to the Kurds. The Tariq al-Hashemi crisis follows a series of central-government crackdowns and arrests of suspected sympathizers of Saddam Hussein's Baath party. On December 19, 2011, Maliki accused Hashemi of terrorism and issued an arrest warrant against him. Hashimi fled to the Kurdistan Region, where he is currently taking refuge.
[8] Yousef Bahadin, "Spectre of Iraqi Federalism Frightens Pro-Federal Kurdish," *Niqash*, December 1, 2011. http://www.niqash.org/articles/?id=2970
[9] Ben Lando, "Ministry Unveils Tough Terms for 4th Bidding Round," *Iraqi Oil Report*, September 11, 2011. The contracts are designed as such to encourage IOCs to keep costs low as they will allow for greater profits, which are proportionally related to overall costs. Accordingly, recoverable costs are converted to equivalent amounts of barrels of oil and subtracted from the production amount upon which the payment is based. Lower production costs can permit IOCs to invoice for higher barrels of oil. Also, unlike the TSAs that encouraged production within a given time period, the current contracts proposed for the January bidding round can limit the production levels according to demand, storage and transportation capacity.
[10] Khaled Al-Sharikh, "Erasing the Frontier: Turkey's Trade and Investment in Iraqi Kurdistan," *NIMEP Insights* (2011): 114-132, http://www.tuftsgloballeadership.org/files/resources/nimep/v5/NIMEP_Insights_2011_114-132.pdf. Turkey's investment and engagement in the Kurdistan Region reflects its larger objective of creating a sphere of influence in the region and increasing the region's dependence upon Ankara.
[11] Al-Sharikh**,** 116. According to energy experts, the Kurdistan Region of Iraq can provide 5-10 billion cubic meters of natural gas. The KRG claims it has 45 billion barrels of oil reserves, although this figure also includes the disputed territory of Kirkuk, which is not legally or administratively part of the Kurdistan Region.
[12] Lando, "Ministry."
[13] To this point, the primary U.S. Government objective has been passage of a national Hydrocarbons Law, and has frequently met with Iraqi officials in Baghdad and Arbil to stress the criticality of an agreement. See "A Review of U.S. Policy Relative to Petroleum-Sector Contracting in Iraq," Report of Inspection, United States Department of State and the Broadcasting Board of Governors, Office of Inspector General. Report Number ISP-S-09-28A. March 2009.