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How the KRG Quasi-State Built an Independent Oil Industry

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Although the Kurdish Regional Government (KRG) is not independent, it has managed to create an independent oil industry resembling that of a sovereign state. Oil revenues from the Kurd's independent oil exports, totaling over $3.2 billion between June 2015 and November 2015, have further solidified the KRG's quasi-state status. Scholars have explained facets of the Kurdish oil industry including: the Turkey-KRG energy relationship, the use of Kurdish oil as political leverage against the government of Iraq (GOI), and the minutiae of Kurdish oil contracts and law. However, little scholarship has focused on how the Kurdish quasi-state managed to sidestep Baghdad and construct an independent oil industry that exports to the international market. There are three factors that enabled a Kurdish oil industry to operate independent of Iraq. First, the Kurds attracted major international oil companies (IOC) with an investor-friendly legal regime. These IOCs brought investment dollars to develop Kurdish oil and provided important legitimacy to the Kurdish oil industry. Second, the involvement of Turkey and Israel in transferring and buying Kurdish oil has connected the landlocked KRG to the international oil market. Last, recent data indicates that the KRG is undercutting its competition by selling oil at a discount. Such a discount undermines the Iraqi legal campaign against the KRG's oil exports because it compensates buyers who face the possibility of the Iraqi government taking legal action against them.

From 2005 to 2015, the KRG successfully defied the Iraqi government. It has secured oil pipelines independent of Iraq, raised billions of dollars in oil sector investment, and established a major source of revenue independent of the GOI. However, the success of the Kurdish oil industry must be placed in the larger context of rising oil prices from 2005 to 2015, which coincided with the KRG's entrance into the oil market. With oil prices now falling by 70 percent to around $30 per barrel, from over $100 per barrel two years ago, the success and development of the KRG's oil industry are in jeopardy. The KRG is struggling to pay the international oil companies (IOCs), who could pull their investments and refuse to increase oil production. Furthermore, the KRG is dependent on the goodwill of Turkey, which provides the KRG with physical access to pipelines that bring KRG oil to the international market for export. Thus, the KRG's oil industry remains severely threatened by the decline in oil prices and it is heavily dependent on Turkey and the IOCs.

The Iraqi Kurds' push for independent oil exports is part of a larger and longer struggle for an independent Kurdish state. Led by Mustafa Barzani in the 1960s and 1970s, the Kurds repeatedly rebelled against the Baʿthist Iraqi government. Yet Kurdish strategy has shifted from rebellion towards a gradual process of increasing political and economic autonomy. In 1992, the semi-autonomous Kurdish Regional Government was established in the Kurdish areas of northern Iraq, with its capital in Erbil. The KRG gained additional autonomy under the 2005 Iraqi constitution and by 2011 the KRG had a GDP of $23.6 billion. In this context, the KRG has pushed for independent oil exports as a means of advancing Kurdish autonomy and ultimately statehood. As KRG Prime Minister Nechirvan Barzani stated in October 2015, "my ultimate objective is the economic independence of the Kurdistan region which gives us self-rule."

The Erbil-Baghdad Dispute

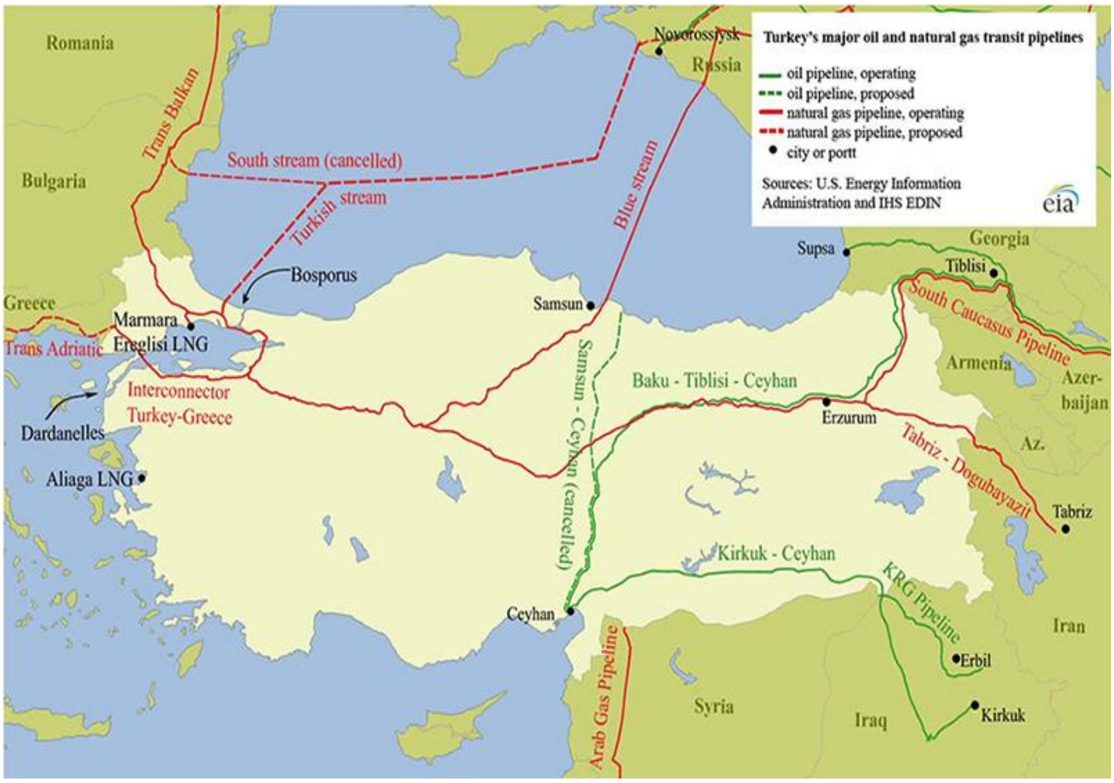
The history of the Kurdish oil industry is part of an ongoing dispute between Erbil and Baghdad. Since the signing of the 2005 Iraqi constitution, the right to develop and export natural resources located in Kurdish territories has been a source of contention. Nevertheless, for the past ten years, the Kurds have incrementally increased the capabilities and autonomy of their oil industry. Officially, the KRG supports a resolution with the GOI, however, post-June 2015 the KRG has been exporting vast quantities of oil independently and there is little evidence of any intention to solve the Erbil-Baghdad dispute.

KRG Minister of Natural Resources Ashti Hawrami underscored the nature of the dispute when he told *Reuters* in 2007, “It is the dream of some in Iraq to go back to centrally controlling the oil as before and that will never happen." KRG officials argue that the wording of “present fields” in Article 112 gives the KRG the right to manage oil fields established post-2005 in KRG territory. While the GOI, for its part, contends that Article 111, which states that “oil and gas are owned by all the people of Iraq,” grants exclusive hydrocarbon rights to the federal government. In the absence of a formal hydrocarbon law, Erbil and Baghdad entered into several revenue sharing agreements, such as the agreements that were struck in 2009, 2011, and 2014. However, they have all failed. Erbil accuses Baghdad of withholding the KRG’s 17 percent share of the national budget that the Iraqi constitution states the KRG is entitled to, while Baghdad, for its part, claims that Erbil does not send the central government the KRG’s monthly quota of oil.

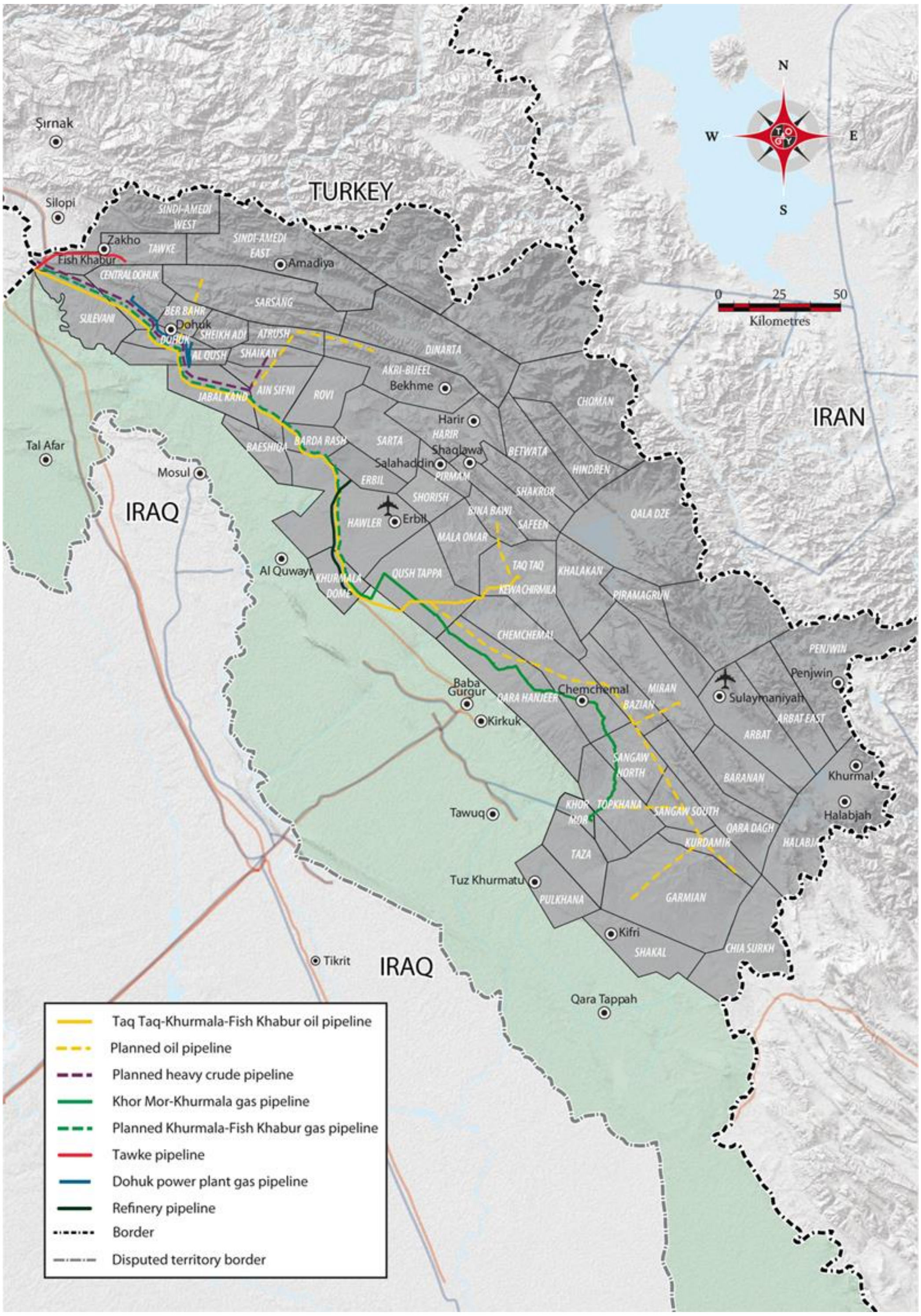
The first Erbil-Baghdad revenue sharing deal was struck in June 2009, in which the KRG exported from the Tak Tak and Tawke oil fields, located in northern and central KRG, at a rate of 100,000 barrels per day (bpd) (60,000 bpd from Tawke and 40,000 bpd from Tak Tak reserves). This marked the first official Kurdish oil exports, which were sent through the Iraqi controlled Kirkuk-Ceyhan pipeline and sold under the auspices of the Iraqi national oil company (SOMO) with all revenues deposited in the Iraqi federal account, “for the benefit of all Iraqi people,” according to the KRG. Although within the framework of the Iraqi state, this initial revenue sharing agreement forced Baghdad to incorporate the KRG's contracts with IOCs Genel and DNO, which were previously termed illegal by Baghdad. Subsequent revenue sharing agreements show that, post-2007, the KRG aggressively increased its oil exports. In 2011, the KRG agreed to export 175,000 bpd, and, in 2014, the export agreement increased KRG production to 550,000 bpd. Further, the KRG Ministry of Natural Resources released a 2013 roadmap to achieve 1 million bpd by 2015. Despite being around 400,000 bpd short of the goal, the plan’s existence highlights Erbil’s long-term ambition to become a major independent oil exporter.

In early 2014, the KRG, with Turkey’s help, finished construction of an oil pipeline that bypasses Baghdad’s control. The pipeline runs from KRG territory to Turkey’s

Ceyhan port, through southeast Turkey. Some controversy surrounded the independence of the pipeline as it linked with the pre-existing Kirkuk-Ceyhan pipeline. Yet with the KRG assuming control of Kirkuk after the rise of the Islamic State (IS) in June 2014, Erbil was able to export through the Kirkuk-Ceyhan pipeline without Baghdad's cooperation.



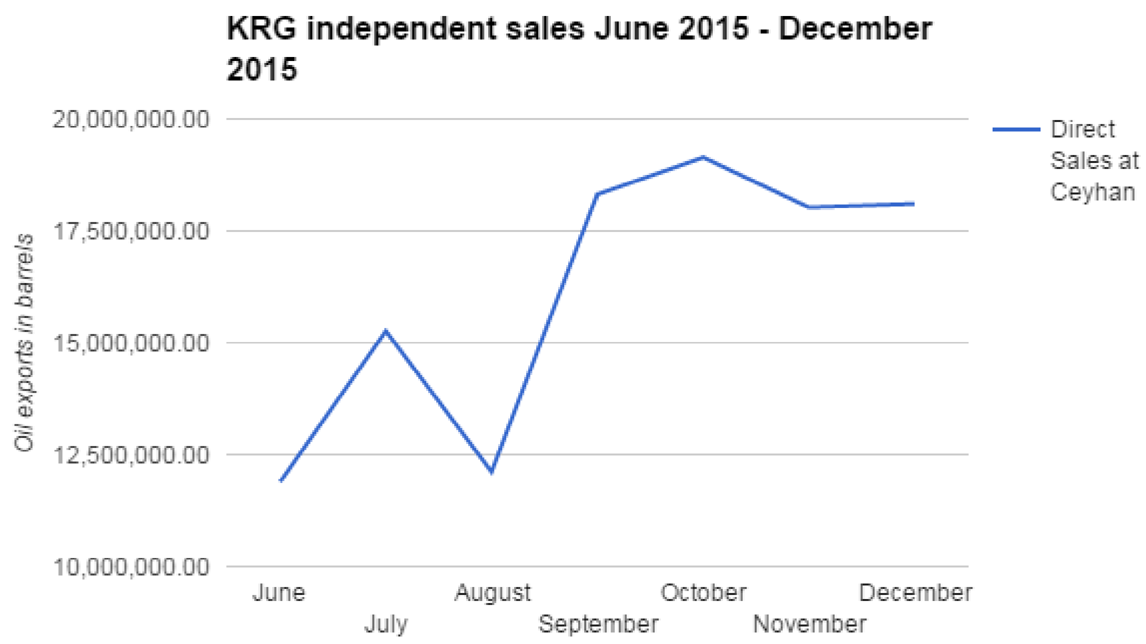
KRG Pipeline to Ceyhan/ Source: U.S. Energy Information Administration (EIA)



Map of oil pipelines in KRG territory/ Source: KRG

Post-June 2015 Fully Independent Kurdish Exports

Since June 2015, the KRG has been independently exporting oil without an agreement with the GOI. From June 2015 to November 2015, Kurdish oil exports generated an average of $682 million in monthly revenue. Erbil contends that the threat of the Islamic State to the KRG, coupled with "budgetary non-compliance by the Iraqi federal government," led to a severe economic crisis and thus necessitated a policy of direct oil exports. The 1.8 million internally displaced persons (IDP) fleeing the IS have sought safe haven in the KRG, costing the KRG an estimated $1 billion in 2015. The World Bank estimates the KRG needs $1.4 billion, beyond the allotted KRG budget, to stabilize its economy.



Data from KRG Ministry of Natural Resources

Direct oil sales have given the KRG a vital source of revenue. Still, the drastic fall in oil prices has curtailed potential profits. According to some, cutting financial ties with Baghdad in favor of an independent oil program was a risky gamble as the KRG prioritized independence over its share of the Iraqi budget, estimated at approximately $1 billion per month. The KRG had assumed oil exports would garner a price of $55 per barrel, generating around $850 million in monthly revenue. Thus, from June 2015 to October 2015, the KRG had an estimated 25 percent revenue gap and struggled to pay salaries and provide basic services. This revenue gap has likely grown since

October 2015. To cope with the shortfall in revenue, the KRG is instituting budget cuts, beginning in January 2016, which include a 50 percent pay cut to senior officials.

Attracting International Oil Companies (IOC)

IOCs have brought billions of dollars to the KRG, built its oil infrastructure, and explored the region for undiscovered oil reserves. Without IOC investment, the Kurdish oil industry is unlikely to have reached its current capabilities. Baghdad has tried to halt any KRG dealings with IOCs. In 2007, Iraq's oil minister Hussein Sharistani declared all KRG contracts with IOCs "illegal." Baghdad also threatened to blacklist IOCs that defy the national government and sign contracts with the KRG, denying those companies access to Iraq's lucrative southern oil fields. Nevertheless, 47 IOCs from 17 countries are operating in the KRG. In order to circumvent the GOI and attract IOCs, the KRG offered investor-friendly legal contracts that offset Baghdad's legal threats.

The KRG's use of "product sharing contracts" (PSC) as opposed to the Iraqi federal government's use of "service contracts" provided a substantial incentive for IOCs to side with Erbil over Baghdad. The PSC grants the IOC a percentage in the production or profit of oil, if commercial sales are established. On the other hand, a service contract pays the IOC a service fee for the cost of development and exploration and a fixed return from the sale of oil produced, however the IOC is not granted any rights to the energy resources. The PSC model gives investors a higher potential for return on investment and allows companies to claim an oil field's reserves on their books, which may increase IOCs' book value.

Ignoring Baghdad's threats, small oil companies like Gulf Keystone, DNO, and Genel quickly established a presence in the KRG. These companies were lured by the combination of high oil prices and attractive KRG contracts. By 2010, the KRG had succeeded in attracting 40 IOCs, generating $10 billion worth of foreign investment in its oil sector.

In November 2011, Exxon Mobil was the first "supermajor" oil company to defy Baghdad by signing six contracts covering 840,000 acres to develop Iraqi Kurdistan.

The KRG's ability to get Exxon to commit to Erbil was a major achievement for the KRG. Exxon's involvement brought legitimacy to the KRG's earlier contracts and opened the door to other major IOCs, including Chevron, Total, and Gazprom who were previously too wary to enter.

At the peak of KRG oil exploration and development between 2010 and 2013, Erbil was commonly referred to as a "boomtown." Yet, this boom was based on high oil prices that surged to over $100 per barrel. With oil prices now hovering in the low $30s, the IOCs' interests have shifted elsewhere. Erbil can no longer count on a flood of foreign investment to develop their oil sector. Moreover, the once amicable relationship between the KRG and the IOCs is now characterized by dependence and debt. The KRG owes DNO, Genel, and Gulf Keystone a combined $1.7 billion from past crude oil exports. These IOCs could refuse to increase production if they do not receive payment from Erbil.

Aligned interests of Turkey, Israel, and the KRG

The landlocked KRG's ability to export oil independently would have been impossible without Turkey. Turkey has always supported a unified Iraq; nevertheless, Ankara has enabled a Kurdish pipeline independent of Iraq and allowed its port of Ceyhan to be used as a transit route for KRG oil. Currently, all reported KRG oil exports are shipped through Turkey.

One reason for the enhanced Erbil-Ankara relationship is that a thriving Kurdish economy pays economic dividends for Turkish trade. The KRG is Turkey's third largest trading partner, behind Germany and the United Kingdom. Further, there are 1,500 Turkish companies doing business in the KRG (out of 2,500 foreign companies), and they operate throughout key sectors of the economy. Moreover, the KRG allows Turkey to diversify its sources of energy. As Turkey's relations with Russia and Iran grow uncertain, Ankara is looking to KRG energy supplies to reduce its dependency on Russian and Iranian energy.

Politically, Turkey's assistance to the KRG, and more specifically to the Barzani led KDP party, give the Turks an important foothold in Iraq, a pro-Turkish ally along Turkey's Iraqi border, and an avenue to counter Iranian domination of the Shiʿi-led

Iraqi government. Ankara has also used the KRG as a broker or mediator with Turkey's domestic Kurdish nationalist movement, the PKK (Kurdistan Workers' Party). For example, on December 9, 2015, KRG President Masoud Barzani visited Ankara in the midst of an ongoing round of Turkey-PKK violence and called on the PKK to stop conducting attacks in eastern Turkey.

The Israeli-Kurdish relationship is not new. In the 1960s and 1970s, Israel provided covert assistance to the Iraqi Kurds in their fight against Saddam Hussein's government. Yet, Turkish animosity towards the Kurds was always a hindrance to the Israel-Kurd relationship. With Turkey's modified attitude towards the Iraqi Kurds, there is a potential for KRG oil exports to form the backbone of a blossoming triangular alliance.

As a major customer for Kurdish oil, Israel has become a key factor in enabling the Kurdish oil industry to bypass Iraqi lawsuits. According to a *Financial Times* report, from early May 2015 to August 11, 2015, 19 million barrels of oil were sold or transferred to Israel for re-export. Erbil independently exported roughly 36 million barrels during that period, thus, a conservative estimate indicates that 53 percent of Kurdish oil was sent to Israel.

Israel, which does not have diplomatic relations with Iraq, is in a unique position to purchase Kurdish oil and facilitate its re-export, as Baghdad is unable to bring lawsuits in Israeli courts. Iraq has blocked Kurdish exports to other states with lawsuits; in one case, an oil tanker bound for the United States was forced to turn back and take its cargo to Israel's Ashkelon port.

It is unclear how KRG oil exports, which are sent through Turkey and into the hands of third party shipping companies, are directed to Israeli ports. The first reported shipment of Kurdish oil arrived in Israel on June 20, 2014 with periodic shipments reported throughout 2014. On November 17, 2015, KRG Minister of Natural Resources Ashti Hawrami acknowledged that KRG oil has been sent to Israel. However, Erbil played no visible role in shipping its oil exports to buyers and it appears that third-party oil traders were responsible for directing Kurdish oil to Israeli ports.

Israel has been one of the few countries that are publicly supporting Kurdish nationalism in Iraq. In June 2014, Israeli Prime Minister Benjamin Netanyahu called for the international community to “support the Kurds’ aspirations for independence.” For Israel, Kurdish autonomy or independence would be part of an “axis of regional cooperation” that would counter Sunni extremism led by the IS and *al-Qaʿida* and Shiʿi extremism led by Iran. By importing Kurdish oil, Israel may be attempting to provide indirect financial support to the cash-strapped KRG and bolster Kurdish stability and autonomy.

Erbil undercutting the competition

Data on KRG export totals and revenue indicates that Erbil has been selling oil below market prices, at a discount. Selling oil below market prices compensates buyers for risking the threat of a Baghdad lawsuit. According to data released by the KRG Ministry of Natural Resources, Erbil sold 76.7 million barrels of oil between June 2015 and October 2015, generating approximately $3.2 billion in revenue, which amounts to an average of $41.35 per barrel of crude oil. Yet, a weighted average of ICE Brent crude oil prices, corresponding to KRG exports per month, in this period is $51.57 per barrel, indicating that Kurdish exports were selling oil at a 19.8 percent discount. In addition to Israel, the *Financial Times* reported that France, Greece, and Italy have also purchased KRG oil.

Middle East Economic Survey (MEES) calculates that the KRG lost $70 million in revenue due to discounted oil in December 2015. Thus, Baghdad has forced Erbil to lower the price of its oil and take a substantial loss in revenue. Nevertheless, Erbil has provided enough incentive to buyers to undermine Iraq’s legal campaign against its independent exports.

KRG’s successful push for independent exports is tempered by low oil prices, dependence, and debt

The drop in oil prices, coupled with the war against the IS and influx of IDPs, has crippled the once thriving Kurdish oil industry and the economy. Moreover, the KRG’s strategy of discounting its oil exacerbates the already low oil prices. Thus, Erbil’s oil revenue is far below what it had hoped and insufficient to cover both government salaries and over $16 billion in accumulated debt. Plans are underway to increase revenue by increasing the KRG's oil export capacity; however, it is unclear if the KRG has the ability to pay for improvements to its oil infrastructure.

Furthermore, the KRG has replaced its dependence on Baghdad with a dependence on Ankara. Without diversified access to export markets, Erbil is completely reliant on KRG-Ceyhan pipeline, controlled by Turkey. In addition, Erbil has taken two $500 million loans, in 2014 and 2015, from Ankara. It remains to be seen if the KRG can function without Turkey's support. Further, the KRG remains indebted to IOCs, which could refuse to increase production. Consequently, if the Kurds are seeking a truly independent oil industry they must diversify their access to the international oil market and reduce their debt to the IOCs.

The past decade has proven successful for the Kurdish oil industry. Though landlocked, situated in a hostile environment, and lacking clear legal backing to export oil, the Kurds of Iraq have managed to sidestep the Iraqi government and construct a quasi-independent oil industry. They have attracted major IOCs, including Exxon, by offering competitive contracts, and obtained critical support from Turkey. They have also found buyers by selling oil at a discount. Oil revenues have allowed the KRG economy to stay afloat during a severe economic crisis. However, these KRG strategies were premised on high oil prices and the relative political stability of the KRG. Thus, the future of the KRG's oil industry is complicated by the economic and political crises that have emerged during the past two years.

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