Tipping Point of the Iraq-KRG Energy Dispute

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Articles & Testimony

Baghdad's legal wins won't mean much if it mishandles the political end, angers Turkey, and further damages the country's reputation as a reliable oil partner.

The Iraqi Federal Supreme Court's recent rulings and another imminent ruling by the International Court of Arbitration will surely bolster Baghdad's position to rein in Kurdistan's energy sector. The Iraqi federal government could relish such legal wins. However, they may complicate political, diplomatic, and industry logjams with Turkey and the Kurdistan Regional Government unless Baghdad gets the politics right.

One Country, Two Energy Policies

Since 2014, Iraq's energy policy and industry have been bifurcating across the federal government and the Kurdistan Regional Government (KRG). Although ambiguous, Iraq's constitution calls for shared responsibility between the federal government and the KRG over the oil and gas sector. However, the Iraqi parliament has yet to pass a national hydrocarbon law delineating those rights and responsibilities. In the **absence of such a law, (https://www.washingtoninstitute.org/policy-analysis/putting-iraq-krg-oil-relations-solid-legal-ground)** politics reigns supreme. While each side created facts based on their respective interpretation of the constitution, the country ended up with two sets of energy policies, contract models, international oil companies (IOCs), and buyers.

With might and influence, the Iraqi government sought to bring back KRG's energy sector under Baghdad's dominion. It deployed its political, legal, budgetary, and military prowess. In turn, the KRG resisted. Myopic power balance and political deal-making trumped more stable and mutually-beneficial legislative and economic tacks. The country suffered as a consequence. Iraq failed to maximize revenue from its oil sales or to speak with one voice with IOCs or OPEC. Total control upstages transparency and good governance. Contrary to its genesis, Iraq's oil federalism—decentralizing petroleum policy and revenue flows—is yet to be an antidote to the infamous oil curse.

Local Problems, International Ramifications

When a dispute between Kurdish and Iraqi parliamentarians blocked the passage of a national hydrocarbons bill in 2007, the KRG parliament passed its own law. The newly christened Ministry of Natural Resources began inking production-sharing contracts with IOCs. Short on capital and technology, the KRG contract model would pass off the risk of investment onto the companies but would reward them handsomely should they strike oil. Such partnerships with foreign firms sat well with the Kurdish government, whose existence and survival had been owed to Western support.

However, it was blasphemous for the Iraqi government, where oil nationalism lingers. In the absence of a new oil law, the Iraqi government continued to run its energy sector based on existing, Saddam-era laws. Then came the dispute over oil exports. As soon as its oilfields started gushing, the KRG looked for an outlet. It signed a long-term deal with Turkey and built a domestic pipeline linked to the Iraq-Turkey Pipeline. By May 2014, KRG oil flowed to international markets via the Ceyhan Terminal.

The Iraqi government immediately sued Ankara at the International Court of Arbitration over allowing Kurdish oil to flow without Baghdad's consent. After repeated delays due to the pandemic, the death of arbitrators, and requests by the Turkish and KRG governments that Baghdad halt the proceedings, the arbitrators passed a ruling in early 2023. Although the details of the ruling are not yet finalized or made public, it is expected to favor Iraq, which had demanded US$36 billion in damages. Although Turkey is a defendant in the suit and not the KRG, the latter is slated to lose the most.

The arbitral ruling is the latest instance in Baghdad's pressure campaign against the KRG. When KRG oil exports became imminent, the federal government cut its share of the national budget, causing a financial crisis from which the KRG never fully recovered. Numerous budget deals have been made and broken ever since, depending on oil prices and the Erbil-Baghdad power balance. For instance, having blocked ISIS, Kurdish Peshmerga forces took over Kirkuk and its oilfields in 2014, and the Iraqi government relied on the KRG's pipeline to export Kirkuk's oil. However, Baghdad's pressures resumed soon after the Iraqi forces regained control over Kirkuk after the 2017 KRG independence referendum.

Besides political and budgetary pressures, two Iraqi Federal Supreme Court (FSC) rulings squeezed the KRG further. In February 2022, **the FSC decreed that the KRG's 2007 natural resource law was unconstitutional (https://www.washingtoninstitute.org/policy-analysis/death-oil-federalism-implications-new-iraqi-court-ruling)** and its oil exports and contracts illegal. Adding salt to the KRG's financial injuries, the FSC ruled in January 2023 that the federal budget transfers to the Kurdistan region were illegal.

In effect, the FSC has tied the hands of the new Iraqi Prime Minister, Mohammed Shia al-Sudani, and his reconciliation efforts with Erbil. KRG officials pointed to Iran's fingerprints on the FSC's jolt of activism, especially since they coincided with Iranian direct and indirect attacks on the KRG's energy infrastructure. **Iran rained missiles at the villa of a (https://english.alarabiya.net/News/middle-east/2022/03/19/Iraqi-Kurdish-oil-tycoon-s-home-in-ruins-after-Iran-strike-in-Irbil)** Kurdish oil executive, **and militia rockets fell on the KRG's main gas fields. (https://www.reuters.com/business/energy/exclusive-attacks-major-iraqi-gasfield-drive-out-us-contractors-2022-08-30/)**

Own Goals and the Race to the Bottom

The decade-old Baghdad-Erbil dispute amounted to little more than a lose-lose dynamic. Baghdad's arm twists and Erbil's evasion tactics undercut the potential to connect their respective energy industries and maximize revenue for their public coffers. Early on, Baghdad decided to black-list any company operating in Kurdistan, which bisected

Iraq's energy market.

On the other hand, Erbil has been selling its oil at steep political discounts, averaging US$15-18 below Brent in 2022. Losing revenue but not yielding to Baghdad, the KRG conceded to Turkey, IOCs, and oil traders, burdening its finances with billions in debt. Hence, the KRG's finances are unsustainable even at high oil prices; in 2022, 60 percent of gross oil revenues serviced the KRG's debts. The KRG's bloated public sector eats up US$800 million a month. Such legal disputes and spiteful politics compound existing corruption and militia infiltration and repel investors.

Despite Iraq's promise, Exxon and Shell have developed cold feet about their investment prospects. Iraq continues to purchase overpriced Iranian gas and power to make up for a third of its demands while it burns half of the natural gas it produces.

Despite its nascent energy sector, the KRG's goals have been no less ruinous. As Baghdad got more rigid on the KRG, Kurdish parties divested from Iraqi politics and deepened their ties with Ankara and Western oil traders, where Kurdish influence is significantly thinner. With Turkey's backing, the KRG managed to delay a ruling by the International Arbitration Court. However, the KRG fell short of using the time it bought to push for a favorable national hydrocarbon law in Baghdad.

Missed opportunities included the leverage the Kurdish parties enjoyed after the elections and government formation processes since 2014. Such leverage was wasted instead over turf wars and top government jobs. Despite questioning its constitutionality and impartiality, the KRG parties voted for the creation and have representatives at the Iraqi Federal Supreme Court.

Although rolling back KRG's energy industry has been among the few consistent Iraqi policies across government cabinets, Baghdad has been pushing against an increasingly ajar door. Internal cohesion has been at an all-time low since the Kurdish civil war in the 1990s. The rift between the Kurdistan Democratic Party (KDP) and the Patriotic Union of Kurdistan (PUK) has been deepening over managing the KRG energy sector and its revenue flow.

The power balance has shifted in KDP's favor since PUK leader Jalal Talabani died. Nechirvan Barzani, prime minister from 1999 until he became president in 2019, is the architect of the KRG's oil and gas sector. To safeguard the energy industry from fracturing across partisan lines a la the Kurdish Peshmerga, he remained conciliatory toward a weaker PUK.

However, his cousin, Prime Minister Masrour Barzani, seems bent on coercing the PUK into the junior partner he sees it as. The PUK is weaker but remains a capable disrupter. When PM Barzani pitched Kurdish gas prospects to energy-strapped Europeans in mid-2022, investors did not bite. The bulk of natural gas in Kurdistan lies in PUK-controlled areas, for which Masrour cannot speak.

Since October 2022, the PUK team has boycotted KRG cabinet meetings. As pressure on the KRG mounts, the PUK may defect from a henceforth unified KRG energy policy and go at it alone. Chronically, delayed payments and personal snubs have also soured Masrour's relationship with IOCs at a time when the KRG needs them the most, the latest of which caused the exit of Trafigura, an oil trader.

Let Not the Crisis Go to Waste

A unified KRG would be the building block for moving toward an Iraqi energy sector that stands on solid legal grounds and contributes to Iraq's energy security and independence. However, Baghdad would welcome the opportunity to deal separately with KDP and PUK rather than with a unified KRG. That would further delay passing the much-needed legislation regulating the national energy sector.

Without KRG unity, the Iraqi parliament could pass a hydrocarbon law that disregards the KRG's input. Both sides have in the past opted for short-term provisions in the annual budget law, only to break apart for lack of trust. Populism has also been damaging.

Resolving the KRG-Iraq dispute is not short on ideas and proposals. Numerous negotiations have taken place over contractual and export rights, plus advice offered by international agencies. What is thin is trust and political will. Since the rule of law ensures accountability, creating a **proper Federal Supreme Court (https://www.washingtoninstitute.org/policy-analysis/iraqs-constitutional-moment)** as per the constitutional requirements should be the first order of business.

Without an agreement between the KRG and the federal government, Iraq would likely turn its legal win at the Court of Arbitration into a political loss. Populists in Baghdad itch for an international victory. However, wiser actors know better. Turkey will not hand over billions of dollars in damages to Iraq, nor will it abandon its lucrative deal with the KRG. Even if Turkey budged, it would offload its losses onto the KRG and demand a more favorable deal on KRG gas.

The devastating **earthquake has wounded Turkey (https://epcenter.ae/3Ia5Nj2)** , and its politics is preoccupied with a crucial election in May. Pressuring a nervous Turkish president could backfire on Iraq diplomatically. Turkish exports to Iraq stood at US$13.7 billion in 2022, and Prime Minister Sudani sees Turkey as Iraq's gateway to Europe.

Empowered further by the necessary FSC and hydrocarbon legislations, Iraq could reach a grand bargain with Turkey on water flows, border security, and energy exports. Moreover, Iraq's Arab neighbors would be observing Baghdad's actions, especially as they seek to further connect their economies with Iraq's, as in the case of linking up with Iraq's power grid. Iraq is reportedly stepping closer to linking its power grid to the Gulf Grid, called the GCC Interconnected Authority. Another instance of Gulf investment is the Saudi Sovereign Wealth Fund earmarking some US$10 billion to invest in Iraq.

The impact of the internal disputes between the ruling Kurdish parties and between the KRG and the Iraqi government extends to Iraq's relations with Iran. Iran would be loath to see Iraq's power and gas sectors unshackled. Iraqi militias with close ties to Iran have targeted IOCs operating in Iraq and Kurdistan, such as oilfields in Basra and Khor Mor's gas field in Kurdistan.

The United States is also watching this space. Washington has been extending successive waivers that allow Iraq to import Iranian gas conditioned on the promise that Baghdad takes steps toward energy independence. However, Iraq's addiction to Iranian gas and power persists.

Given the energy shortage in Europe brought about by Russia's war in Ukraine, the US has been nudging Iraq and the KRG to ramp up gas production and aim at exporting it. The KRG has a contract with Russia's Rosneft to build a gas exporting pipeline. However, a more significant Russian role in the KRG energy sector is doubtful in the near term.

The dispute calls for someone mediating between KRG and Baghdad. However, the US has not played a mediating role since 2008, while the KRG and Baghdad reverted to blame games instead of conflict resolution. Although neither side is asking Washington to mediate, the US Department of Energy commissioned a **special report (https://www.qamarenergy.com/sites/default/files/Qamar%20Energy%20-%20The%20Natural%20Gas%20Sector%20in%20the%20Iraq%20Kurdistan%20Region%20-%20September%202021.pdf)** about the promise of Kurdish gas to help rationalize such negotiations. On the flip side, oil markets could quickly lose the 400,000 barrels of oil that the KRG currently exports if the crisis is not handled wisely.

Bilal Wahab is the Wagner Fellow at The Washington Institute. This article was originally published on the Emirates Policy Center website ***(https://epc.ae/en/details/brief/tipping-point-of-the-iraq-krg-energy-dispute-)*** *.* ❖

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