Iraq's Energy Future Lies to the North

by James Jeffrey, Michael Knights

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Brief Analysis

U.S. support for Iraqi oil export projects involving Turkey, the Gulf, and Europe can help keep undue Iranian influence at bay.

Despite a fifteen-year security crisis that would have sunk most societies, Iraq has registered year-on-year oil production increases that make its energy sector a global success story. Going forward, Iraqi hydrocarbons will either be exploited by Iran and its allies or used for Iraq's own benefit, transforming the country into an energy export hub between the Gulf states, Turkey, and Europe. The United States has a strong strategic interest in promoting the latter outcome.

A FAST-GROWING SECTOR

At the CWC Group's "Iraq Petroleum" conference in Berlin late last month, officials, business reps, and analysts were told that Iraq has become a strong number two in OPEC oil production, coming close to 5 million barrels per day (bpd) last year, with almost 4 million exported. Moreover, Baghdad is planning a major seawater injection program with the aim of further expanding production, first to 7 million bpd and eventually to 9 million. The latter target would put it in the same league as Saudi Arabia, the United States, and Russia.

Iraq's potential gas production is also enormous—it wastes an extraordinary 16 billion cubic meters (bcm) annually in flaring alone, or 0.5 percent of global production. A joint project between Shell, Mitsubishi, and the Iraqi government will be the largest flaring capture effort in the world, providing 2 bcm annually for much-needed electricity generation. Iraq's ambitious plan is to capture and use all of its gas production with zero flaring by 2021. The initial objective is to replace more expensive, less efficient, and dirtier oil products, but if Iraq reaches its capture goal, it could become not only a gas exporter, but also a gas transit hub linking Turkey, Iran, Syria, Jordan, Saudi Arabia, and other key economies.

KURDISTAN AND KIRKUK OIL

The most pressing obstacle to these plans is Baghdad's ongoing tussle with the Kurdistan Regional Government (KRG) over oil from northern Iraq. The Kirkuk fields are especially thorny, generating a dispute that has drawn in Turkey and Iran, with Washington as an occasional mediator.

The problem began when the 2005 constitution gave the KRG a significant role in developing "new" fields, which it did with a vengeance by courting international oil companies and signing production sharing contracts. Yet the constitution also required the federal government—via the State Oil Marketing Organization (SOMO)—to market production from everywhere in the country, including the KRG. In return, the federal budget set aside some 17 percent of oil revenues for the KRG (closer to 12 percent when certain national expenditures were taken out, though the associated figures and definitions have long been fuzzy). The KRG usually did not allow SOMO to market its oil, however, so the federal revenue payments often went unpaid. Today, the latest Iraqi budget nets the Kurds only about 12.5 percent of anticipated oil income. The two sides have repeatedly sought to paper over their differences with American help, only to break their agreements and renew the dispute.

When the Islamic State invaded the north in 2014, Kirkuk city and its oil fields were defended not by the Iraqi army, but by Kurdish Peshmerga, who seized the fields and began exporting Kirkuk oil through the KRG pipeline to the Turkish border and then on to the port of Ceyhan. For the most part, they marketed the oil itself rather than byproducts. Baghdad did not like this deal but had no choice at the time.

With the Islamic State's defeat, however, the central government saw its chance, particularly after the KRG's strategic mistake of holding an independence referendum last September. Amid heavy regional pressure on the Kurds, Baghdad quashed their independence bid and took back Kirkuk.

The dispute now centers on how to export and market Kirkuk's oil, and who will market the KRG oil still flowing to Ceyhan. In the meantime, Kirkuk's estimated 300,000 bpd are shut in.

IRAQ'S ENERGY PARTNERS

When major international players look at Iraq, they see not only future energy supplies and a rich market for their exports, but also potential geostrategic gains. These players are particularly interested in Kirkuk's stranded oil.

Russia. Rosneft, Moscow's main state oil company, has invested some $3 billion in the KRG hydrocarbon sector. This includes partial ownership of the pipeline from Kirkuk via the KRG to the Turkish border, which links to the Ceyhan line (portions of Iraq's original Kirkuk-Ceyhan pipeline running through non-Kurdish territory to the Turkish border were destroyed by the Islamic State).

Turkey. Ankara still allows the KRG to market its own oil (roughly 300,000 bpd) at Ceyhan, claiming it cannot turn this flow over to SOMO unless Baghdad assumes the KRG's oil-related debts to Turkey. Ankara has clear strategic and trade interests in preserving a friendly, autonomous Kurdish region in northern Iraq. Turkey also hopes for significant gas exports from the KRG, which would be provided at below-market prices and without destination restrictions.

At the same time, Ankara wants Baghdad to drop its arbitration against Turkey for allowing KRG oil exports through the jointly owned Iraqi-Turkish pipeline. Ankara covets trade opportunities in Iraq's broader imported goods and services market as well. Indeed, Turkey led international donors with a $5 billion pledge at last month's Iraq reconstruction conference in Kuwait.

Iran. The Islamic Republic already exports overpriced electricity and gas to Iraq, and it seeks to strengthen this stranglehold on the country's power generation market. It also hopes to establish a pipeline from Kirkuk to Iran in order to draw northern Iraqi oil away from its traditional Turkish export route, ultimately delivering Iranian crude through Gulf ports instead of refining Iraqi crude. While locked in disputes with the KRG, Baghdad has attempted to export some oil to Iran via truck, though this effort has been stymied by marauding Islamic State remnants in the area. Iraqi authorities have also threatened to divert much of Kirkuk's oil by building a new pipeline to Iran.

The larger geostrategic stakes are significant as well. If Baghdad's Shia-majority government decides to favor an export route through Shia Iran instead of through Kurdish or Sunni Arab areas of Iraq, then it would put itself firmly in the camp of the regional pariahs in Tehran and essentially write off 40 percent of its population as untrustworthy, second-class subjects. Likewise, choosing Iran over Turkey would be a major blow to Ankara's prestige given its economic strength and commitment to Iraqi reconstruction—not to mention the damage this would do to Iraq's chances of full recovery.

IMPLICATIONS FOR U.S. POLICY

Under these circumstances, U.S.-led international mediation is necessary to avoid yet another win for Iran. Iraqi prime minister Haider al-Abadi recently backtracked on the Iran option for Kirkuk oil, suggesting that local production could be shipped via the KRG pipeline. He has not followed through, however, probably because such a compromise would weaken him before the May national elections.

While the United States and its coalition partners may need to wait till after those elections to formalize a deal, they should still prioritize efforts to hammer out the details of an export and revenue-sharing agreement between Baghdad and the KRG in the meantime. Iran is trying to make Iraq dependent on its overpriced gas, and it will likely seek to drive this gas over to Syria in the near future. Greater energy interconnection between Iran and Iraq—including oil swaps and the use of sanctioned Iranian construction firms in Iraqi pipeline projects—will only loosen Baghdad's connection to free markets and international capital.

To prevent that outcome, the United States should put its weight behind a north-south energy corridor in which Iraq serves as an energy hub between ever-friendlier Gulf states and Turkey, ultimately forming an export bridge to Europe. Washington should also support the Basra-Haditha-Aqaba pipeline project to bring Iraqi oil and gas to Jordan. This project—along with reconditioning of the reversible north-south strategic pipeline linking hydrocarbon-rich southern Iraq to Turkey—would reduce Baghdad's over-dependence on exporting oil through the Persian Gulf, where Iran can hold Iraqi terminals and the Strait of Hormuz hostage. Finally, Baghdad could play a profitable role as a gas transit hub between the Gulf, Europe, and the Levant.

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