

Corruption Remains the Second Insurgency of Iraq

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An in-depth conversation on why corruption, political squabbles, inadequate legislation, and other problems continue to hinder the Iraqi/KRG energy sector, and what the international community can do about it.

The following is the edited text of a conversation between Dana Taib Menmy of the Mediterranean Institute for Regional Studies (MIRS) and Bilal Wahab of The Washington Institute.

MIRS: What is the future of energy pipelines across the Middle East—particularly Iraqi ones with Iran—in light of ongoing conflicts in the area?

Wahab: Iran exerts a sizable influence on Iraq and its politics. However, the energy sector is where the two countries remain competitors for market share, export quotas within OPEC, and international investment. Iran has been trying to make inroads into the Iraqi energy sector but to little avail so far. Iraq needs capital and technical capacity, for both of which there are more competitive international alternatives than Iranian firms. However, Iraq could benefit from diversifying its export routes, including pipeline extensions to Iran.

Technical assessments have been created for a pipeline that allows Iraq to import natural gas from Iran to feed power generators in Baghdad. Such a pipeline would be 300 km long whose construction could cost \$600 million according to a study by Bayan Center, a Baghdad-based think tank. Iraq's Ministry of Oil also signalled, with scant details, that it is considering building a new pipeline to Turkey to replace the inoperable part of the Iraq-Turkey Pipeline (ITP) that Iraq controls.

Separately, in summer of 2016, officials from Iran and the Kurdistan Regional Government (KRG) reached agreements on technical details of an oil-exporting pipeline that would allow the KRG to open a second outlet for its oil in addition to its line to Ceyhan. The proposed oil pipeline could carry anywhere between 250,000 to 400,000 bpd that would facilitate an oil swap deal with Iran. Accordingly, the KRG would feed Iranian refineries close to the Iraqi border with crude oil, and Iran would deliver equivalents to buyers of KRG oil at Iranian ports. In 2017, Iran seems to

have entered similar negotiations, this time with the Iraqi oil ministry. Since the KRG lost control of Kirkuk oilfields to Iraqi authorities, the Iraqi government has been trucking some of Kirkuk's oil to Iran.

Technical and financial considerations aside, Iran's track record and reputation as a partner in oil pipelines call for caution. Iran has a history of renegeing on deals it shakes hands to. Even a signed deal or MOU with Iran may not amount to much. For example, as a study by the Oxford Institute for Energy Studies notes, in the past decade Iran has signed numerous memoranda of understanding and/or contracts with Bahrain, Kuwait, Oman, and Syria, the UAE, and India. None of these have been implemented.

Since Iraq's liberation from Saddam, however, single party rule has been replaced with decentralized but competitive centers of power, thriving in an environment of chaos exacerbated by gutted and weak state institutions.

MIRS: What are the problems and perils of the Iraqi oil and gas sector? Why haven't oil revenues brought peace and prosperity to the Iraqi people?

Wahab: It has become quite the cliché, although quite rightly, to say that Iraq suffers the resource curse. Indeed, while the flow of oil revenues afforded the country a well-armed military and saved its people from starvation, subsequent governments have failed to invest oil revenues in a fashion that translates into a sustainable, modern economy. Corruption is rampant.

Iraq has no choice but to reform its oil-based economic system in a fashion that fosters the role of productive private sector. Rule of law, transparency and curbing corruption are a must.

Under the rule of Saddam Hussein, oil revenues funded his regime's wars, brutal suppression of local dissent, and the cooptation of the masses into tolerating dictatorship. Since Iraq's liberation from Saddam, however, single party rule has been replaced with decentralized but competitive centers of power, thriving in an environment of chaos exacerbated by gutted and weak state institutions. Elections encouraged identity politics, which in turn encouraged myopic practices of patronage politics rather than long-term, strategic policies. As a result, civil wars, terrorism, corruption, and mismanagement have squandered Iraq's record high revenues from oil sales.

But the only way out is through; that is, Iraq has no choice but to reform its oil-based economic system in a fashion that fosters the role of a productive private sector. Rule of law, transparency, and curbing corruption are a must. Iraq is getting help from the World Bank and IMF to reform its economy. The country has the ingredients to become a developed and prosperous country. Its politics stands in the way.

MIRS: Why doesn't Iraq have its own oil and gas law? Wouldn't such a law resolve disputes between Baghdad and Erbil on sharing oil revenues?

Wahab: As mentioned above, politics has trumped policy in Iraq. The Iraqi parliament did initial reading for a national hydrocarbons law in 2007. The draft law did a fine job codifying constitutional articles about Iraq's petroleum resources such as oil federalism and revenue sharing. However, disputes over delineating rights and responsibilities between the federal government in Baghdad and the KRG in Erbil undercut passage of the law. Although the KRG passed its own regional natural resources law, Iraq still lacks a national oil law and relies on old laws and regulations.

Since the parliament failed to pass the law in 2007, Iraqi and KRG oil policies and industries have been diverging. Disputes over rights and revenues continue to linger. In effect, the balance of power between the KRG and Baghdad superseded rule of law. Indeed many of their conflicts over oil, gas, and the budget stem from the absence of such a law.

Politics trumps economics. That is, Baghdad's reluctance to accept oil federalism and the KRG's attempts to take federalism to extremes resulted in economic losses for both sides. For example, the Iraqi government currently

shuts out much of Kirkuk's oil because it refuses to use the KRG's pipeline. The KRG, on the other hand, has been selling oil at significant discounts to oil traders to avoid cooperating with Iraq.

I think the next parliament elected in May 2018 needs to prioritize the passage of an oil and gas law so the KRG can bail out its debt-stricken economy, allow Iraq's energy sector to reach its full potential, and maximize the economic gains from its breadwinning industry.

MIRS: What are the main issues surrounding contracts with international oil companies (IOCs)? What are best types of contracts for Iraq and the KRG?

Wahab: By now, we realize that Iraq and the KRG have adopted the contracts that better fit their particular industries. In other words, technical service contracts (TSCs) are rather appropriate for Iraq while production-sharing contracts (PSCs) fit the profile of the KRG's nascent energy sector. Nonetheless, both sides are in need of revisions in a low oil price environment.

For the Iraqi government, contract renegotiations and revisions to the contract model are setting goals to better streamline the interests of the state and the oil firms. The fiscal structure of Iraq's TSCs was beneficial to Iraq when oil prices were record high. Not anymore. Indeed, the Iraqi Oil Ministry is slated to roll out a new TSC model by the end of February and adopt it for a new round of licensing later this year.

The KRG, on the other hand, suffers from accrued debts to IOCs and oil traders because of its uncontrolled public spending. The war against ISIS, post-referendum loss of Kirkuk fields, and continued geological challenges have exacerbated an already difficult situation.

MIRS: Do you expect oil prices to rise further after producers recently extended an agreement for curbing production and export?

Wahab: Oil producers value market stability, even if low, over price volatility. In the near term, oil prices are expected to rise but not to extremes. The OPEC deal holds thanks to the adherence of its members and the cooperation of Russia. Moreover, OPEC is wary of high oil prices, which will encourage shale oil to rebound and flood the market, and in effect push prices down again as we saw in the last price cycle. OPEC seems to have found a price sweet spot whereby they can satisfy their budgets without triggering a disruptive boom in shale oil production.

MIRS: What are the prospects of an agreement between the Iraqi federal government and the KRG on suspended oil issues?

Wahab: I would argue that the prospects are rather promising. The aftermath of the botched KRG referendum would force it to abandon using its oil for the goal of secession from Iraq. Economic goals are easier to achieve with oil than political ones. Moreover, Kurdish opposition parties who have been unable to hold the KRG energy sector to account may welcome oversight from Baghdad.

Baghdad, on the other hand, cannot simply discard the inroads that the KRG has made. In particular, the fastest route to export Kirkuk's oil is through the KRG pipeline rather than building a new line to Turkey.

If left to technical experts, an economically win-win compromise is quite feasible to reach, including one that addresses export of northern fields and revenue sharing. We already see signs of common sense and goodwill in an agreement between the North Oil Company and KRI's KAR Group, whereby crude is refined at Kalak facilities in the KRI. One could imagine such cooperation to extend to Khurmala dome, which is geologically linked to Kirkuk but is run by KAR.

Again, it's Iraq's complicated politics that stands in the way. The national elections and subsequent government formation would create opportunities for creating some goodwill between Baghdad and Erbil.

MIRS: What are the real data on Iraq and the KRG's proven oil and gas assets?

Wahab: We are expecting refreshed and updated data from both the Iraqi and Kurdish governments. Iraq's production has been rising, which means that reserves have been depleting. Iraq's oil ministry said that the country's reserves stand at 153 billion barrels. OPEC, however, estimates Iraq crude reserves at 148 billion.

The KRG's once-touted 45 billion barrels in reserves proved to be a highly optimistic number. As exploration and production continued, geological challenges proved such numbers wrong. For example, in 2016 Genel Energy announced that it was cutting by half its reserves figures for Taq Taq from an original 683 million barrels. By now, more than half of Taq Taq's reserves have been already produced. More drastically, in 2015 MOL downgraded reserves at Akri Bijeel from 800 million barrels to 4 million, a 95% decline. Such figures could continue to change should the KRG energy sector recover so that explorations in green fields continue.

The governments in Baghdad and Erbil suffer from diminished legitimacy. While Iraq, afraid of an angry public, is bracing for elections in May, the KRG has tried to replenish its credibility by asking Deloitte to audit its oil and gas sector.

MIRS: How could international and local think tanks influence authorities in bringing transparency into the energy sector?

Wahab: International actors do have an influence on governance in Iraq. There is also a realization among Iraq's political elite that business as usual would perpetuate instability. ISIS had its roots in the failure of inclusive governance. Corruption remains the "second insurgency" of Iraq. High unemployment among Iraq's youth creates fertile grounds for insurgencies, terrorist groups, and militias to easily recruit fighters, feeding in turn into the vicious cycle of violence and instability.

In addition to Iraqi buy-in, external pressure and help are mounting as well. The IMF and the World Bank are engaging Iraq's economic institutions with loans and technical assistance. Reforms in tariff and subsidies will help Iraq's finances (electricity subsidies alone cost Iraq's budget \$11 billion 2017). With their help, moreover, Iraq's neighbours and partners are meeting in Kuwait to raise funds for Iraq's reconstruction.

MIRS: What is the extent of the KRG's total debts, including to IOCs and lenders? Can the KRG pay those debts back, and if not, what will happen? What is the Iraqi federal government's role in resolving this issue?

Wahab: According to KRG sources, it owes about \$20 billion to creditors that include KRI citizens and firms, Turkey, oil firms, and oil traders. A rough calculation shows that in 2016 only 67% of oil revenues on average flowed into KRG coffers, with the remainder earmarked for repaying IOCs and oil traders.

In addition to these debts, the KRG is months behind on dispensing public payroll salaries, which are not paid in full either. With the loss of revenues from Kirkuk fields since mid-October 2017, which halved KRG exports, the KRG's financial crisis has deepened. Despite violent protest by citizens, the KRG seems to prioritize paying IOCs to keep them onboard over public wages—it paid \$100 million in December 2017.

As mentioned above, there are technical avenues for Iraq and the KRG to cooperate. The Iraqi energy industry is recovering—December 2017 witnessed record exports of 3.5 million barrels per day. The end of the ISIS caliphate would pave the way for more IOCs entering the Iraqi oil sector.

The KRG maintains some leverage, especially the pipeline to Ceyhan. By refusing to use it, the Iraqi government is losing revenue by shutting in Kirkuk production. Its gas project with Genel at Bina Bawi and Miran would help greatly with increasing power generation. Before it sits to negotiate in earnest, the Iraqi government expects further concessions from the KRG, including surrendering all oil exports to SOMO. By so doing, the KRG would lose control over its independent oil exports but could generate greater revenues compared to selling to traders. It could ask the

Iraqi government to assume the KRG's debts, which, as sovereign, Iraq is better tooled to handle. Such deals would be more likely in a post-election context. ❖

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