

Iraq Can't Commit to OPEC's Oil Output Deal

by [Bilal Wahab \(/experts/bilal-wahab\)](/experts/bilal-wahab)

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ABOUT THE AUTHORS



[Bilal Wahab \(/experts/bilal-wahab\)](/experts/bilal-wahab)

Bilal Wahab is the Nathan and Esther K. Wagner fellow at The Washington Institute.



Brief Analysis

Despite pressure from OPEC to cap its oil production, the Iraqi government can neither afford a cut nor enforce it upon the Kurdistan Regional Government.

Under tremendous fiscal pressure, OPEC members may cut a deal in Vienna this week that would cap oil production in order to raise global prices. The deal is being **championed by the cartel's largest producer** (<http://www.washingtoninstitute.org/policy-analysis/view/opec-meeting-is-more-about-regional-rivalry-than-production-cuts>), Saudi Arabia, but the second largest producer, Iraq, has resisted a cap. Although low oil prices threaten Iraq's stability, Baghdad cannot afford to cut itself off from potential revenue -- its already massive public spending has been aggravated by the ongoing war against the Islamic State (IS) and the looming reconstruction effort. Even if it were willing to risk the lost revenue, it could not implement any such commitment because the country's energy policy and industry remain divided between the central government and the Kurdistan Regional Government. Accordingly, the KRG should consider how it could benefit from helping Baghdad secure an exemption from OPEC's output quota.

OPEC'S EXPECTATIONS VS. IRAQ'S CHALLENGES

One of OPEC's central missions is to manipulate global oil prices by limiting global oil supplies, which it does by negotiating output quotas for its members. As in any cartel, however, OPEC deals are marred by cheating. Due to wars and sanctions, Iraq has not seriously committed to such a deal since the inception of the quota regime in 1986, and it has been exempt since 1991. It wishes to remain so, similar to Iran, Libya, and Nigeria. But as a much larger producer than those states, Iraq is under renewed pressure to commit to the imminent production ceiling.

Facing a financial crunch and shrinking cash reserves due to low oil prices, OPEC members have sought to address the global oil glut in recent months, but Baghdad has been quick to push back. Iraq's production level reached 4.7 million barrels per day (bpd) in September, according to Oil Minister Jabbar al-Luaibi, and its output could increase

further due to maturing investment projects, revamped infrastructure, and successful efforts to eject IS from oilfields such as al-Qayyara and Hamrin. Yet while Luaibi is adamantly opposed to a cut, he signaled that Iraq may be amenable to a production freeze at September levels.

This view is likely rooted in the steep global price drop of late 2014, which crippled Iraq's economy. Oil sales account for 60% of the country's GDP and 90% of government revenues. Hence, the government dominates the economy and the labor market, resulting in an inefficient and bloated public sector. For example, IMF data indicates that Baghdad spent more than 11% of its 2011 GDP on electricity subsidies, the second highest rate in the Middle East. And the Iraqi and Kurdish governments employ an estimated 40% and 50% of the labor force, respectively -- a huge political patronage machine lubricated by previously record-high oil prices.

Today, however, the KRG is months behind on paying salaries, and its ratio of public spending to GDP is over 50%. These problems are compounded by the campaign against IS, which along with the Syria war has resulted in a mass wave of refugees and internally displaced persons. Of Iraq's total 5.5 million IDPs and refugees, the KRG hosts 1.8 million, or about 28% of its total population. This takes a toll on the local economy and public services, since many of the new arrivals live in urban areas instead of refugee camps. The KRG has also accumulated debilitating debts -- estimated at \$20 billion -- to a mass of creditors, including international oil companies (IOCs). This year, for example, only 67% of oil revenue flowed into KRG coffers on average; the rest had to be used for repaying IOCs and oil traders.

Against such financial needs, the KRG cannot afford to limit its oil production and sales, despite sharing Iraq's OPEC quota. In fact, the KRG plans to increase its oil exports in 2017, even as Baghdad considers a production freeze.

A FRACTURED ENERGY POLICY

When Iraq last agreed to an OPEC quota, its energy policy was nationalized and centrally managed from Baghdad. Today, IOCs dominate the country's energy sector, and management is divided between federal officials in Baghdad and KRG officials in Erbil. Production cuts would be costly to both governments given their contractual obligations to IOCs, who produce 100% and 80% of KRG and Iraqi oil, respectively. Such cuts would put IOCs at a disadvantage since their payments in Baghdad's service contracts and the KRG's production sharing contracts are directly associated with oil output. Yet OPEC still regards Iraq as a unitary country and counts KRG output toward Baghdad's quota, even though the Kurds maintain their energy industry and policy independently.

At present, the KRG contains several significant oil fields and controls the northern pipelines to Turkey's Ceyhan port, from which it has exported about half a million bpd this year. The fields in question were developed through a string of KRG contracts with IOCs. Moreover, around 245,000 bpd is pumped from the Avaneh and Bai Hassan fields in Kirkuk, which came under KRG control in June 2014 when IS began its large-scale offensives in northern Iraq. The 4.7 million bpd figure touted by the Iraqi Oil Ministry in September may therefore be artificially inflated by as much as 190,000 barrels -- apparently, Baghdad double-counted Kirkuk's production, once as part of KRG output and again under the portfolio of the North Oil Company, the federal ministry branch that managed Kirkuk's fields before the IS assault. Such discrepancies weaken Baghdad's position vis-a-vis its fellow OPEC members, who estimated Iraq's output at 4.159 million bpd in January.

Given their persistent institutional disagreements and the ongoing war with IS, Baghdad and the KRG have resorted to dealmaking in order to alleviate disputes over management of the country's petroleum resources. Yet these deals are inherently unstable due to changes in government, economic dynamics, or the national balance of power. Prime Minister Haider al-Abadi has been more conciliatory than his predecessor, Nouri al-Maliki, who cut the KRG's share of the federal budget in 2014 when the Kurds refused to turn their oil exports over to the central government. After the IS incursion, the KRG pipeline to Turkey became the sole export route for Kirkuk's oil, which Iraq sells via

Ceyhan. Still, given the political risk conjured by Baghdad's looming claim on Kurdish oil, the KRG has had to sell its exports at a discount of around \$10 per barrel -- a significant loss of revenue.

OPPORTUNITIES FOR COOPERATION

If Baghdad is to commit to an OPEC production freeze, it will need to reach a new, mutually beneficial agreement (however episodic) with the KRG. The time is right -- there is increasing goodwill between the two parties, as manifested by military cooperation in Mosul and visits by Abadi and KRG president Masoud Barzani to their respective capitals. The KRG already cooperates with Baghdad on technical matters, such as handing half of Kirkuk's oil output to Iraqi authorities at Ceyhan.

Because Iraq can neither afford a production cut nor enforce it upon the KRG, Erbil and Baghdad have a common interest in an OPEC deal that exempts Iraq from a quota and yet raises oil prices. Instead of embarrassing federal authorities, the KRG should bolster Baghdad's position at OPEC toward either an exemption or a freeze at a projected quota. Doing so would not dilute the KRG's hard-won political autonomy. In turn, the central government could ease the legal restrictions on Kurdish oil sales that have resulted in the aforementioned risk discount. Likewise, Baghdad and the KRG's IOC partners have a strong interest in the stability and predictability of Iraq's large energy sector, which they can facilitate in part by encouraging each side to adopt a unified stance at OPEC.

Finally, OPEC pressure provides an opportunity to increase the transparency of Iraq's oil output and sales. Both Baghdad and the KRG have voiced commitments toward this end. The Kurds recently contracted with the firms Deloitte and Ernst & Young to audit their oil and gas value chain, and greater transparency would bring both sides closer to comprehensive data sharing. Baghdad should also include a KRG official in its delegations to OPEC, similar to how it approached the annual IMF meeting in October. Maintaining open channels for cooperation and dealmaking would help defuse conflicts that threaten to further disrupt their energy industries and economies.

Bilal Wahab is a Soref Fellow at The Washington Institute. ❖

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