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DEPENDENT ASPIRATIONS: THE OIL POLICIES  
OF THE KURDISTAN REGIONAL GOVERNMENT

THOMAS STROUSE

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# DEPENDENT ASPIRATIONS: THE OIL POLICIES OF THE KURDISTAN REGIONAL GOVERNMENT

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## Table of Contents

<a href="#">INTRODUCTION.....</a>	<a href="#">3</a>
<a href="#">KURDISTAN'S FLEDGLING OIL SECTOR.....</a>	<a href="#">4</a>
<a href="#">ERBIL MOVES QUICKLY; BAGHDAD LAGS BEHIND.....</a>	<a href="#">5</a>
<a href="#">KURDISH EXPORTS AND REVENUE SHARING.....</a>	<a href="#">7</a>
<a href="#">KRG DEPENDENCIES AND LEVERAGE.....</a>	<a href="#">9</a>
<a href="#">ASSESSING THE TWO ARGUMENTS.....</a>	<a href="#">14</a>
<a href="#">THE ROLE OF THE KURDS IN IRAQI POLITICS.....</a>	<a href="#">16</a>
<a href="#">TURKEY'S SHIFTING RED LINES ON THE KRG.....</a>	<a href="#">19</a>
<a href="#">CONCLUSION: 2010 AND BEYOND.....</a>	<a href="#">22</a>

## **Introduction**

The Kurdistan Region of Iraq is years ahead of the rest of the country in terms of economic and institutional development. Beginning to develop its oil and gas sector following the U.S.-led invasion of Iraq in 2003, the Kurdistan Regional Government (KRG) has been part of an ongoing struggle with Iraq's central government over oil policies since that time. Underlying the major differences between Baghdad and Erbil are deep political and identity issues that have made compromise difficult.

Despite its desire for an independent and decentralized oil policy, the KRG is forced to rely on Iraq's central government because it controls the national pipeline that transports oil from northern Iraq to markets through Turkey. For its part, Turkey insists on dealing with Iraq's central government on oil exports as well as other official state matters. Ankara's relationship with Erbil is deeply influenced by Turkey's own Kurdish minority, which it fears could use the KRG as a model of enhanced autonomy inside Turkey. Consequently, the KRG must maintain difficult relationships with both Baghdad and Ankara as it exploits the energy resources that sustain its autonomy and promote its development.

Relations between Baghdad and Erbil have occasionally been tense since 2003, with issues relating to oil at the center of many of their disputes. The Kurdish region was much quicker than the central government to exploit its oil assets, signing deals with foreign oil companies in the absence of an oil law and without permission from Baghdad. The KRG signed its first contract with DNO, a Norwegian oil company, in June 2004. It has since signed contracts with more than 30 additional foreign oil companies. When the Iraqi parliament was unable to come to an agreement on a federal hydrocarbons law, the Kurds drafted and approved their own

regional oil and gas law in August 2007. The Kurds decided that they could no longer be inhibited by the instability in the rest of Iraq and that the KRG must carve out its own path if it hopes to successfully develop its oil and gas sector, which is crucial to the Kurdistan Region's long-term sustainability.

## **Kurdistan's Fledgling Oil Sector**

Prior to 2003, Iraqi Kurdistan was undeveloped, underexplored, and its oil potential was for the most part unknown. Despite the lack of exploration, the region is positioned in the vicinity of some of Iraq's major oil fields, specifically Kirkuk, which has been producing oil for decades. There have always been expectations that oil existed in the region, but for political and economic reasons, the Kurds found themselves powerless to exploit their potential resource endowment.

It was official state policy during the days of Saddam to not carry out oil exploration in the Kurdish region.<sup>1</sup> After gaining semi-autonomy following the first Gulf War in 1991, the Kurds were still unable to exploit their oil resources. They essentially had to deal with a double embargo—one imposed by the UN on Iraq and the other imposed by the Iraqi government on the Kurdish region.<sup>2</sup> In the early 1990s, the Kurds set up a special projects commission in order to build a refinery at the site of four wells that were drilled in the late 1970s, but capped following the breakout of the Iran-Iraq War in 1980. However, the Kurdistan Region was unable to import necessary parts because of the UN embargo imposed on Iraq following its invasion of Kuwait in 1990. Since the Kurds were unable to build a refinery and produce oil from the field, the local population began collecting oil that bubbled up from the surface and took it to surrounding

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<sup>1</sup> Interview, former executive at the Iraq National Oil Company, Erbil, 15 March 2010. \*Due to the level of sensitivity of issues relevant to this paper, many sources in Erbil requested that information be provided "on background."

<sup>2</sup> "The Kurdish Policy Imperative," Gareth Stansfield, Robert Lowe, and Hashem Ahmadzadeh, Chatham House Briefing Paper, December 2007. p. 4.

villages in order to refine. This occurred in an area known as Taq Taq, which is one of two medium-sized fields where the KRG is producing oil today.<sup>3</sup>

The UN embargo imposed on Iraq turned the major border crossing with Turkey, Ibrahim Khalil, into a lucrative smuggling route. Significant profits were made by some Kurdish factions, earning money on transit fees from oil smuggled out of Iraq, as well as taxes on the consumer goods being smuggled into Iraq. Revenues from oil smuggling were a major point of disagreement between the two main Kurdish political parties, the Kurdistan Democratic Party (KDP), the dominant party in the Kurdish provinces of Dohuk and Erbil, and the Patriotic Union of Kurdistan (PUK), the dominant party in Sulaymaniyah province. The competition over control of the smuggling revenues contributed to the periodic violence between the two sides in the 1990s.<sup>4</sup>

### **Erbil Moves Quickly; Baghdad Lags Behind**

Despite a number of factors inhibiting the ability of the Kurds to exploit their oil resources in the past, they quickly began trying to attract foreign companies to invest in their oil sector following the American invasion of Iraq in March 2003. In fact, the first public calls by the Kurdish leadership for foreign investment occurred only weeks after the war began. At the time, many companies remained hesitant because there was not even a government in Baghdad, let alone laws detailing ownership and control of Iraq's oil resources in a postwar environment.

The PUK, which formerly controlled Sulaymaniyah as part of the interim regional government, had actually begun seeking investment from foreign oil companies as early as July 2002, quietly offering sample production sharing agreements (PSA) to Western companies in the summer and fall of that year. The sample PSA was for the Taq Taq area, northeast of Kirkuk,

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<sup>3</sup> "Kurds Powerless to Tap Into Oil Wealth," *Agence France-Presse*, 21 June 1995.

<sup>4</sup> "A Shaky De Facto Kurdistan," David Aquila Lawrence, *Middle East Report*, No. 215, Summer 2000, p. 25.

which had already been producing small amounts of oil for local consumption. No company accepted the PUK proposal in 2002 and foreign firms held out for the remainder of 2003, despite an obvious attraction to what the untapped region might have to offer. Among other reasons, companies did not want to jeopardize the opportunity to reach future deals with Baghdad if they got involved in questionable legal deals with the Kurds early on in the war.<sup>5</sup>

The KRG signed its first exploration and development contract in June 2004, marking the first oil deal signed with a foreign company in a post-Saddam Iraq. The operating company, DNO, began drilling in November 2005 and discovered the Tawke field one month later. The company's experience in Kurdistan is a useful vehicle to examine Baghdad-Erbil relations in the context of oil policies, with DNO's fate often moving with the ebb and flow in relations between the KRG and Iraq's central government.

DNO and other foreign companies took an enormous amount of risk by signing oil deals with the KRG. First, the companies could not be certain that the contracts would be honored in the face of Baghdad's disapproval. Second, there was no guarantee that they would discover oil in their respective areas of exploration. Prior to the signing of the contracts, oil companies had many questions about the reserve potential in the region. Seismic work had not previously been completed and the only evidence to rely on was the existence of promising surface structures, with which geologists are able to make educated guesses about reserve potential. Ultimately, one does not know how much oil or gas is under the ground until drilling begins.<sup>6</sup> Despite the risks, there were enough small- and medium-sized companies that were willing to enter the promising market in northern Iraq.

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<sup>5</sup> "Iraqi Kurds Offering Upstream Oil Deals to Foreign Firms," *The Oil Daily*, 14 May 2003.

<sup>6</sup> Interview, Tarik Chalabi, DNO's Iraq General Manager, Erbil, 15 March 2010.

The KRG announced the signing of its second major oil deal in May 2006 for the Taq Taq field. This contract was signed with Turkey's Genel Enerji and Canada's Addax Petroleum (later acquired by China's Sinopec). The same month, the KRG established a Ministry of Natural Resources and named Ashti Hawrami as its first minister. Hawrami is an experienced oilman, who prior to his appointment as Minister of Natural Resources, was Chairman and CEO of a successful UK-based oil consulting firm called ECL. In August 2007, the Kurdistan Regional Assembly approved a regional oil and gas law, granting the KRG the authority to sign oil contracts and manage its own oil sector. Six contracts were signed prior to its passage, with more than 25 additional contracts signed on the basis of the Oil and Gas Law of the Kurdistan Region – Iraq over the subsequent several months.<sup>7</sup>

These quick, gradual steps helped lay the foundation to Kurdistan's fledgling oil sector. Although the KRG got off to a quick start, Baghdad seemed to lag behind. This enabled the Kurds to negotiate with Iraq's central government from a position of relative strength, as Baghdad struggled to bring in foreign companies because of the unstable political and security situation. Despite massive amounts of state funding intended to revitalize Iraq's oil sector, overall Iraqi production has yet to reach pre-war levels of around 3 million barrels per day (b/d).

### **Kurdish Exports and Revenue Sharing**

As the KRG signed numerous contracts with foreign firms against the wishes of Baghdad in 2007 and 2008, the Tawke and Taq Taq oil fields began operating at moderately low levels of production. While negotiations over future Kurdish exports stalled, the work on the fields continued. Production from the fields reached levels high enough for export in 2008, with export infrastructure completed in the early part of 2009.<sup>8</sup>

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<sup>7</sup> "Iraq's Oil Politics: Where Agreement Might Be Found," Sean Kane, United States Institute of Peace, Peaceworks No. 64, January 2010. p. 15.

<sup>8</sup> Interview, international energy expert, Erbil, 15 March 2010.

After receiving permission from Baghdad to begin oil exports through the Kirkuk-Ceyhan pipeline, which is controlled by the central government, the Kurdish region began exports on June 1, 2009, marking the first time that Kurdish oil had been exported from Iraq. Although this was a major victory for the Kurds, there were a number of issues that had not been resolved between Baghdad, Erbil, and the operating companies. Despite giving the KRG permission to begin oil exports, a payment mechanism for the operating companies had not been agreed upon. The KRG wants the central government to at least pay the companies the capital costs that they have incurred, but Baghdad believes that the KRG should pay the companies from the revenues that it receives from the federal government. Baghdad maintains the position that the Kurdish contracts are illegal, but that exports are a separate matter. As stipulated by Iraq's latest budget law, the Kurdistan Region is entitled to 17 percent of Iraq's federal revenues, after deductions from "sovereign expenses." Although there are a number of glitches in the revenue sharing process, generally speaking, the KRG does not dispute its allocation percentage.<sup>9</sup>

Despite reaching a high-point in June 2009, Kurdish exports were halted near the end of September.<sup>10</sup> With a payment mechanism never established, operating companies decided to halt exports after not receiving payment for their work. While exports were flowing, the KRG appeared to be under the impression that Baghdad would eventually give in and pay the companies. This never happened. Among other reasons, Baghdad argues that without even seeing the contracts, it is not willing to pay the companies for their work.<sup>11</sup> From the perspective

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<sup>9</sup> Iraqi oil export revenues, including from any Kurdish exports, go to the federal government, rather than to an independent escrow account that would then automatically distribute revenues to the Kurdistan Region and to the central government, which is the preferred method of the KRG. "Iraq's Oil Politics: Where Agreement Might Be Found," Sean Kane, United States Institute of Peace, Peaceworks No. 64, January 2010. p. 20.

<sup>10</sup> Exports from Tawke were tied in with the Kirkuk-Ceyhan pipeline, but output from Taq Taq had to be trucked to a gathering station near Kirkuk where it was then exported to markets via the same pipeline. A plan exists to eventually construct a pipeline to tie the Taq Taq field into the main export route. Kurdish crude oil exports, as well as all other Iraqi exports, are marketed by Iraq's State Oil Marketing Organization (SOMO).

<sup>11</sup> In a conciliatory gesture, the KRG published its contracts with DNO and Genel Enerji on January 17, 2010 "to facilitate discussions and to show the transparent nature of these contracts and their economic benefits for everyone in Iraq." <http://www.krg.org/articles/detail.asp?nr=223&lngnr=12&smap=02010100&anr=33405>

of the Kurds, not only is the amount it receives from the federal government not enough to pay the companies, but additionally, the revenue payments to the KRG are not paid in a timely fashion and are generally used by Baghdad as a way to pressure the Kurds.<sup>12</sup>

Going forward, it makes little economic sense for Baghdad to continue to resist the KRG's desire to increase oil exports, thus depriving the central government of much needed revenues. The Kurds are not demanding 100 percent of their oil export revenue. Instead, they hope to increase Iraq's total exports, which would in turn increase revenues for the Kurdistan Region. As it stands now, with no Kurdish exports flowing, Iraq's central government is receiving exactly 83 percent of zero from KRG export potential.

It is clear that the central government's position is purely motivated by politics. From the perspective of Baghdad, the political ramifications of allowing the Kurds to control their own oil sector may be too much to bear, viewing the KRG's goal of an independent oil sector as an existential threat to the Iraqi state. Iraq's central government is skeptical of the "real intentions" of the Kurds, believing that their actual goal is an independent Kurdistan.

### **KRG Dependencies and Leverage**

Despite a number of problems with the revenue sharing mechanism between the federal government and the KRG, the relatively sizable revenues from Baghdad have enabled Kurdish officials to govern and develop their region autonomously. The Kurdistan Region has made significant advances since 2003, but it also remains highly dependent upon Baghdad, both economically and politically. Unlike the period throughout the 1990s when the Kurdistan Region's budget was based on humanitarian aid and customs revenues, today more than 90

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<sup>12</sup> Interview, Minister Falah Mustafa Bakir, Head of the KRG's Department of Foreign Relations, Erbil, 16 March 2010.

percent of its budget comes from Iraq's central government.<sup>13</sup> The KRG's 2010 budget is set at around \$10 billion.<sup>14</sup> Politically, while the KRG has informal relations with a number of foreign governments, including representation in more than 10 countries, with nearly 20 represented in the Kurdistan Region, there are a number of issues on which foreign governments insist on dealing with Iraq's central government.

If the Kurds hope to further develop their oil sector, they have few options for getting the oil that they produce to world markets. At the moment, a 600-mile pipeline transports Iraqi crude oil, including any Kurdish exports, from Kirkuk to the Turkish port of Yumurtalik, near Ceyhan on the Mediterranean, where it is then exported to world markets.<sup>15</sup> The KRG is unable to use the northern pipeline for exports without permission from Baghdad. Additionally, a new pipeline through Turkey is unlikely in the near-term, despite Kurdish desires to build one. While relations have improved considerably between Turkey and the KRG over the past few years, Ankara does not want to anger Iraq's central government, nor does it want to provide Iraqi Kurds with a self-sufficient economic base with which the KRG can effectively use to move toward establishing an independent state.

The stable security situation and positive economic outlook in the Kurdish region has enabled the Kurds to strengthen their clout as a regional force within the Iraqi state, despite also remaining dependent on the central government. By developing its oil and gas sector, the Kurdistan Region hopes to increase its political and economic leverage vis-à-vis the central government. Natali argues that asymmetric regional economic growth has the potential to "influence centre-periphery relations by strengthening the Kurdistan region's power in relation to

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<sup>13</sup> "The Spoils of Peace in Iraqi Kurdistan," Denise Natali, *Third World Quarterly*, Vol. 28, Issue 6, September 2007, p. 1124.

<sup>14</sup> "Kurdistan's 2010 Budget Approved," *The Kurdish Globe*, 17 April 2010.

<sup>15</sup> The Kirkuk-Ceyhan pipeline is one of two export outlets for Iraqi crude, the other being Iraq's southern ports near Basra, which accounts for nearly 80 percent of all Iraqi oil exports.

the state and increasing leverage on the central government to accommodate Kurdish demands.”<sup>16</sup>

Zedalis suggests that in some respects, the KRG’s adoption of its own oil and gas law was “an assertion of autonomy and self-governance” and in other respects, it was “an expression of frustration with the inability of the central government in Baghdad to nurture the kind of political compromise and ethnic sectarian reconciliation necessary to ensure the adoption of the federal oil and gas framework law.”<sup>17</sup> By passing a regional oil and gas law and signing numerous deals with foreign oil companies, the Kurds were essentially creating a *fait accompli*, hoping to force the central government to eventually accept the contracts and the position of the KRG as an oil producer. By developing significant production and export capacity in Kurdistan with the help of foreign investment, the KRG also hopes that various international interests will eventually compel Baghdad, as well as Ankara, to make concessions to the Kurds on oil exports. It is also important to note that the exploration and development contracts signed would not be able to generate substantial production for a few years. The KRG has been in effect giving itself a head start.

The KRG’s strategy for some time has been to use Baghdad’s initial failures in securing foreign investment in Iraq’s oil sector as a way to justify its own successful efforts. However, in December 2009, Iraq’s central government signed a number of contracts with large foreign oil companies which could dramatically increase production over the next several years. Baghdad took a longer time to secure oil deals than the KRG, largely because of the poor security situation and political gridlock in Baghdad, for which the Kurdish bloc is partially responsible. The Iraqi government has also had to deal with rampant resource nationalism in the parliament. Despite

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<sup>16</sup> “The Spoils of Peace in Iraqi Kurdistan,” Denise Natali, *Third World Quarterly*, Vol. 28, Issue 6, September 2007. p. 1112.

<sup>17</sup> Zedalis, Rex. 2009. *The Legal Dimensions of Oil and Gas in Iraq: Current Reality and Future Prospects*, Cambridge University Press: New York, NY. p. 79.

the central government's initial setbacks, it appears that signing its own contracts provided it with a renewed sense of confidence in its ability to increase oil exports and not have to rely on the Kurds for their export potential. Nevertheless, it remains unclear how quickly the central government and the operating companies will actually begin to increase production.

Leverage and timing have played a significant role in which side has the upper hand in oil negotiations. "When Baghdad is weak, the Iraqi government agrees to Kurdish demands," Anderson and Stansfield argue. "When Baghdad is strong, an effort is made to reassert pre-eminence over the Kurds."<sup>18</sup> For example, when Kurdish exports began in June 2009, lower oil prices and Iraq's budget problems may have played a role in the central government welcoming the additional revenue it would earn from increased oil exports. On the other hand, when oil prices reached a record high in 2008, it was easier for Baghdad to ignore the benefit of higher export volumes.<sup>19</sup> As a result of the rising price of oil from 2006 to 2008, Iraq's revenues from oil exports increased by around 30 percent per year, despite limited increases in output. During this period, Iraq's central government felt little economic pressure to increase production, whether from its own fields or from the KRG.<sup>20</sup>

With a budget set at around \$72 billion for 2010, the central government faces a budget deficit of more than \$19 billion.<sup>21</sup> Iraq has had problems financing projects with foreign firms, currently finding itself unable to fund its 51 percent share in a proposed joint venture with Shell. The project would collect and market significant amounts of gas being flared off as waste at some of Iraq's main southern oil fields. The deal has also met strong opposition in the

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<sup>18</sup> "Kurds in Iraq: The Struggle Between Baghdad and Erbil," Gareth Stansfield and Liam Anderson, *Middle East Policy*, Vol. 16, Issue 1, Spring 2009.

<sup>19</sup> "Kurdish Oil Export Plan Confirmed," *Foreign Reports*, 11 May 2009.

<sup>20</sup> "Iraq's Oil Politics: Where Agreement Might Be Found," Sean Kane, United States Institute of Peace, *Peaceworks* No. 64, January 2010. p. 15.

<sup>21</sup> "Al-Maliki Gambles on the Deficit," *Niqash*, 23 February 2010.

parliament.<sup>22</sup> Only time will tell if Baghdad's latest oil deals will face similar challenges.

Although a government in Baghdad strapped for cash should be more inclined to accept Kurdish willingness to increase exports, this catalyst for an oil deal remains to be seen.

Kurdish exports reached a peak of around 100,000 b/d in 2009. According to operating companies, this higher level of production comes at little extra cost since the production facilities are operating anyway. Without the ability to export, the companies are left to produce small amounts of oil for local consumption. DNO is currently producing around 6,000 b/d, which is marketed by the KRG's Ministry of Natural Resources and consumed locally.<sup>23</sup> It is not clear whether this is an effective cost-recovery method for the operating companies.

DNO's Iraq General Manager says that it could produce 50,000 b/d tomorrow and that it is only politics that is stopping the company from doing so.<sup>24</sup> The KRG's Minister of Natural Resources Ashti Hawrami asserts that with Tawke and Taq Taq at full capacity, the Kurdish region could produce 100,000 b/d in a matter of days if the issue over oil exports is resolved. Hawrami expects export potential to reach 250,000 b/d after one year; 450,000 b/d after two years; and 1 million b/d after four years. This four-year target would mark a nearly 50 percent increase from Iraq's current output level.<sup>25</sup> At current price levels, 100,000 b/d of extra production would provide Iraq with \$3 billion of additional annual revenue—1 million b/d would provide it with an additional \$30 billion. In February 2010, Iraq exported around 2.1 million b/d, with approximately 450,000 b/d flowing from Kirkuk. After reaching record post-war export levels in February, total exports dropped to 1.8 million b/d the following month, marking the

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<sup>22</sup> "Iraq's Kurdish Region Aims to Resume Oil Exports," *The National*, 12 April 2010.

<sup>23</sup> Interview, Tarik Chalabi, DNO's Iraq General Manager, Erbil, 15 March 2010.

<sup>24</sup> Ibid.

<sup>25</sup> Text of speech given by KRG Minister of Natural Resources Ashti Hawrami, "Commencement of Oil Export Ceremony," Erbil, 1 June 2009.

lowest level since April 2009.<sup>26</sup> This is fairly indicative of the challenges that remain for Iraq's oil sector in general.

### **Assessing the Two Arguments**

By arguing that the KRG's oil contracts are illegal, Iraq's central government is asserting that only it has the authority to sign and validate contracts with foreign oil companies.

Ultimately, this issue comes down to control. Iraq's central government believes that Kurdish oil policies should come under the authority of the federal government. This view appears to be prevalent in Baghdad and it is not unique to the current Iraqi government. There are deep suspicions of foreign oil companies and their motives throughout Iraq, which is likely a legacy of the colonial period. This is especially the case in the Oil Ministry, which is also highly suspicious of anything resembling a production sharing agreement (PSA) with foreign firms.<sup>27</sup>

The KRG's contracts take the form of a PSA, which grant foreign companies equity shares in the oil produced as compensation for their work, investment, and political risks that they undertake. This type of contract is generally more favorable to companies, especially when exploration and development are involved. Likely a consequence of a strong sense of Iraqi nationalism, Iraq's central government fears that such contracts will be perceived as selling out Iraq's oil to Western oil companies and other foreign interests. Baghdad's contracts come in the form of a technical service agreement (TSA), where the companies get paid a fee for their services, rather than receive an equity stake in the oil that they produce.<sup>28</sup>

Hawrami and Iraq's Oil Minister Hussein Shahrstani have clashed repeatedly over oil policy since being appointed to their respective positions in 2006. They have both aggressively—

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<sup>26</sup> "Iraq Crude Oil Output and Exports Fall Sharply in March: Ministry," *Platts Commodity News*, 22 April 2010.

<sup>27</sup> Interview, Senior Kurdish official, Washington D.C., 19 April 2010.

<sup>28</sup> "Oil for Soil: Toward a Grand Bargain on Iraq and the Kurds," International Crisis Group, Middle East Report, 28 October 2008. p. 24.

and publicly—criticized the approach of the other and are far from being cordial with one another. Although not a total game-stopper on oil issues, the personal rivalry between Hawrami and Shahrستاني (as well as between other senior Arab and Kurdish officials) has been very unproductive for Baghdad-Erbil relations.<sup>29</sup> Although personal rivalries exacerbate the major disagreements between the two sides, the problem is essentially structural, and not merely personal.

Hawrami's defiant posture has put him at odds with the central government, but it has also enabled the Kurdish region to quickly attract a number of small- and medium-sized foreign oil companies to help the Kurds exploit their sizeable reserves. For his part, Shahrستاني has never wavered on his position first announced in April 2007 that the contracts signed by the KRG are illegal. His own influence and popularity were strengthened in late 2009 as a result of his handling of the oil deals that Baghdad signed with foreign companies, repeatedly emphasizing the tough terms that he negotiated with the companies. By comparison, Hawrami's reputation suffered during the same time period as a result of a stock scandal involving DNO. Furthermore, the KRG's decision in September 2009 to halt Kurdish exports accomplished little in forcing Baghdad to compromise. The level of exports had not yet achieved maximum potential, and thus, revenues were not perceived as being exceedingly crucial for Iraq's national budget.<sup>30</sup>

An additional complaint from Baghdad is that the KRG oil deals were not issued under a transparent bidding and selection process. Kurdish officials argue that it was necessary to move quickly and efficiently to attract foreign companies. Contrary to the process under which KRG contracts were offered and signed, Iraq's central government was exceptionally thorough and

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<sup>29</sup> Interview, international energy expert, Erbil, 15 March 2010.

<sup>30</sup> "KRG in Conditional Offer," *Upstream*, 22 January 2010.

transparent during the bidding and selection process, which was played live on Iraqi television. By demonstrating the government's level of transparency when dealing with foreign oil companies, Shahrstani and Iraqi Prime Minister Nouri al-Maliki made an attempt to stem the possible tide of resource nationalism among the general populace and in the parliament.

## **The Role of the Kurds in Iraqi Politics**

The Kurds use the Iraqi Constitution adopted in October 2005 as the primary basis for their right to set an oil policy independent from the central government, most often citing Articles 112 and 115. Article 112 First states: "The federal government, with the producing governorates and regional governments, shall undertake the management of oil and gas extracted from present fields."<sup>31</sup> The KRG uses this intentionally ambiguous part of the Constitution to express its right to develop any undeveloped or future fields, as opposed to "present fields." Article 115 states: "All powers not stipulated in the exclusive powers of the federal government belong to the authorities of the regions and governorates that are not organized in a region."<sup>32</sup> The KRG uses this section of the Constitution to capitalize on the document's silence regarding the management of its own oil sector and developing any undeveloped or future oil fields inside the Kurdish region.

The Kurds sit in a unique position within the framework of the current Iraqi state. After facing years of repression under authoritarian Iraqi governments, the Kurds have been blessed with a disproportionate level of influence in Iraq since 2003. The 2005 Iraqi Constitution provides the Kurds with the legal rights to administer their region, despite a number of ambiguities on issues related to oil policies. With a sizable bloc in the Iraqi parliament and high-level positions in the central government, Kurdish representation in Baghdad has helped the

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<sup>31</sup> Iraq's Constitution: [http://www.uniraq.org/documents/iraqi\\_constitution.pdf](http://www.uniraq.org/documents/iraqi_constitution.pdf)

<sup>32</sup> Ibid.

Kurds increase their ability to negotiate on behalf of their interests. The Kurds have benefited from their level of autonomy, but they also benefit from their participation in Iraq's federal system. For example, with Iraqi President Jalal Talabani, a Kurd, in Baghdad, Iraqi Kurds have repeatedly been able to protect their 17 percent share of federal revenues by Talabani threatening to veto budget laws if the Kurdish share of the budget is reduced.<sup>33</sup>

As a political and ethnic faction in Iraq, the goal of the Kurds is not to capture the levers of power of the Iraqi state, but rather, they seek to: (1) strengthen and enhance Kurdish regional autonomy; (2) extend the separation between the Kurds and the rest of Iraq; (3) prevent a strong Iraqi central government from using its military against the Kurdish population; and (4) maximize the chances for an independent Kurdistan in the future.<sup>34</sup>

Iraqi Arabs fear the nationalist aspirations of the Kurds. Equally so, Iraqi Kurds fear the hegemonic ambitions of the Arabs to their south. Past atrocities suffered at the hands of Saddam's regime are engrained into the Kurdish psyche, contributing to a sense of mistrust of Arabs in general. Kurdish officials, as well as others in Iraq, have summarized the fundamental problem with respect to the three major ethnic and religious groups in Iraq as the following: "The Shi'a are afraid of the past, the Sunnis are afraid of the future, and the Kurds are afraid of both the past and the future."<sup>35</sup>

There are a variety of deep political, emotional, and identity issues that have led to the current impasse between Baghdad and Erbil on oil policies and other matters. The perception of "national rights" which Iraqi Kurds believe they should be guaranteed is not easily reconciled with the Iraqi Arab view that the Kurds in northern Iraq are a minority group which should be satisfied with "minority rights." This difference in perception is a fundamental component to the

<sup>33</sup> The Iraqi President will no longer have a veto power in the next government.

<sup>34</sup> "To Protect or to Project? Iraqi Kurds and Their Future," Joost Hiltermann, *Middle East Report*, No. 247, Summer 2008.

<sup>35</sup> Interview, Senior Kurdish official, Washington D.C., 26 February 2010.

current dispute between Baghdad and Erbil in particular, and between Iraqi Arabs and Iraqi Kurds in general.

Kurdish journalist Azad Amin recently wrote in *The Kurdish Globe*:

*“The relation between Erbil and Baghdad is defined by the opposing perception of the status of the Kurds and Arabs. On one hand, the Kurds perceive themselves as a nation thus entitled to their national rights including the right to possess their territory and natural resources of that territory. On the other hand, the Arabs perceive the Kurds as a minority group to be satisfied with minority rights. It is because of these opposing perceptions that the Kurdish claims on Kirkuk and KRG’s signing oil exploration contracts with international oil firms without Baghdad approval seem excessive demands while the Kurds perceive these as their natural rights.”*<sup>36</sup>

The status of Kirkuk, the disputed, oil-rich city in northern Iraq, is also a central element to the dispute between Iraqi Arabs and Iraqi Kurds. Hiltermann suggests that “the Kurds see Kirkuk as vital in providing, at a minimum, enhanced economic leverage vis-à-vis the central government and, more ambitiously, an economic base supporting their bid for statehood.”<sup>37</sup> Kurdish officials argue that the dispute over Kirkuk should be separated from the issue of KRG oil policies. The Kurds do not dispute the fact that Baghdad has the right to manage the Kirkuk field, which was already producing oil by the time the Constitution was approved in 2005.<sup>38</sup> However, it has been pointed out that if the “geology of the province had contained water aquifers instead of oil fields,” it is unlikely that the fight over Kirkuk would be so problematic.<sup>39</sup> Iraqi Arabs fear that if the Kurds control Kirkuk, the region’s oil resources could provide an economic base for an independent Kurdistan. Turkey shares this same fear.

Leading up to the U.S. invasion of Iraq in 2003, Turkey repeatedly warned against any Kurdish advance on Kirkuk or other major Iraqi oil fields. Ankara has threatened to send troops

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<sup>36</sup> “Kingmakers or History Makers,” *The Kurdish Globe*, Azad Amin, 3 April 2010.

<sup>37</sup> “To Protect or to Project? Iraqi Kurds and Their Future,” Joost Hiltermann, *Middle East Report*, No. 247, Summer 2008.

<sup>38</sup> Interview, Senior Kurdish official, Washington D.C., 19 April 2010.

<sup>39</sup> Anderson, Liam and Stansfield, Gareth. 2009. *Crisis in Kirkuk: The Ethnopolitics of Conflict and Compromise*, University of Pennsylvania Press: Philadelphia, PA. p. 23.

across the Iraqi border, in an attempt to block a possible move by the Kurds to establish an independent state. Turkey worries that a Kurdish takeover of Kirkuk and its surrounding oil fields could provide the Kurds with the opportunity to move toward the establishment of an independent Kurdistan.<sup>40</sup>

## **Turkey's Shifting Red Lines on the KRG**

Turkey's relationship with the Kurds of Iraq has historically been driven by the anxiety created by its own Kurdish minority in southeastern Turkey. Ankara fears that a strong, self-governing Kurdistan Region in northern Iraq could further incite the nationalist aspirations of its own Kurdish population. Turkey is also concerned by the presence of Kurdistan Workers Party (PKK) rebels within KRG-controlled territory. PKK rebels use northern Iraq as a safe haven to launch cross-border attacks against Turkey. Although it has engaged in limited military action targeting the rebels in northern Iraq, Turkey has also helped initiate a high level of security and intelligence cooperation with the KRG in order to avoid any broad escalation of conflict in the region.

Turkey's "red lines" with regard to Iraqi Kurdistan have proven to be flexible, shifting as economic ties have expanded over the past few years. Indicative of these shifting red lines is the opening of Turkey's first ever consulate in the Kurdistan Region of Iraq in March. The new Turkish Consul General, Aydin Selcen, arrived quietly in Erbil on March 11, following up on a promise made by Turkish Foreign Minister Ahmet Davutoglu during a trip to Erbil in October 2009.<sup>41</sup> This is a significant development and it is symbolic of how far KRG-Turkish relations

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<sup>40</sup> "Rebuilding Iraqi Oil Sector Must Navigate Feuds Old and New," Maureen Lorenzetti and Bob Williams, *The Oil & Gas Journal*, 21 April 2003.

<sup>41</sup> The consulate, which will officially open in June, also played host to the Turkish Foreign Ministry Undersecretary Feridun Sinirlioglu when he visited the region in late April to meet with Kurdistan Region Prime Minister Barham Salih and Kurdistan Region President Massoud Barzani, extending an invitation to the latter to visit Ankara.

have improved in a short period of time. Not long ago, the idea of a Turkish consulate in Erbil would have been unthinkable.

There are a number of factors that have led to the improved relationship between Turkey and the KRG. The Turkish Consul General in Erbil says that political, economic, and security cooperation between the two sides has enabled the opening of the consulate. The economic relationship has been especially important. The Kurdish region is among the top ten trading partners of Turkey and Turkey is Kurdistan's largest trading partner. Several hundred Turkish companies operate in Kurdistan, accounting for more than half of the foreign companies registered in the KRG.<sup>42</sup> More than 80 percent of all foreign investment in Kurdistan comes from Turkey.<sup>43</sup>

The expanding economic ties between the two sides have the ability to help ease any tension in the political or security relationship. Turkish Foreign Minister Ahmet Davutoglu recently expressed Turkey's desire to pursue a level of economic interdependency between Turkey and its neighbors. "If you have an economic interdependency, this is the best way to prevent any crisis," Davutoglu said.<sup>44</sup> Oil experts and advisors to the KRG express their concern that the Kurdish region might be overselling to Turkey, essentially giving away too much dependence to a neighboring state that may not be looking out for the best interest of the Kurds in Iraq.<sup>45</sup> Moreover, Turkey has the ability to use its trade and investment as leverage in order to prevent Kurdish moves toward increased autonomy. One analyst asserts that "Turkey's strategy toward Iraq's Kurds has largely been predicated on a policy of golden handcuffs to temper nationalist inclinations: Annual trade with the region now totals over \$5 billion, and the KRG's

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<sup>42</sup> With a consulate in Erbil, Turkish citizens will no longer have to travel to the Turkish Embassy in Baghdad or to the Turkish consulate in Mosul. Interview, Aydin Selcen, Turkish Consul General in Erbil, Erbil, 15 March 2010.

<sup>43</sup> "Stability in Iraqi Kurdistan: Reality or Mirage?" Lydia Khalil, Brookings Institution, Working Paper Number 2, June 2009. p. 33.

<sup>44</sup> Turkey Hopes to Grow Economic Ties and Influence Within Middle East," *The Washington Post*, 8 April 2010.

<sup>45</sup> Interviews, oil experts and advisors to the KRG, Erbil, March 2010.

reliance on Turkey as its primary outlet to the outside world has created a degree of effectively coercive economic dependence.”<sup>46</sup>

The Turkish government has been consistently expanding its influence with both Baghdad and Erbil since 2003, implementing a hedging strategy between all parties in Iraq. As one former Western diplomat now working in Erbil explains, if the rest of Iraq begins to disintegrate into another round of civil war, Turkey would have the option of moving closer to the KRG. Turkey could also position itself as a mediator between Baghdad and Erbil if Arab-Kurd tensions increase in the future.<sup>47</sup>

Turkey’s primary source of leverage over the KRG comes from its ability to control the export outlet for Kurdish crude oil. The Turkish Consul General in Erbil says that Turkey is not threatened or concerned by the development of the Kurdistan Region’s oil and gas sector. To the contrary, he says that Turkey wants to help the KRG utilize its energy resources and will continue to encourage Turkish investment in the region’s oil sector. To demonstrate this point, he emphasized that one of the first foreign oil companies to sign an oil deal with the KRG was a Turkish company, Genel Enerji.<sup>48</sup>

The Kurdish region, which is believed to have significant untapped natural gas reserves, also has ambitions to become a major gas producer in the long-term. It signed its only gas contract with the UAE’s Crescent Petroleum and its affiliate Dana Gas in 2007. Together, they operate the Khor Mor and Chemchemal gas fields. Austria’s OMV and Hungary’s MOL joined the project in May 2009 and the venture is now called Pearl.<sup>49</sup> However, some initial payment problems have given rise to doubts about the prospect that Iraq, and the Kurdish region, will be a

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<sup>46</sup> “Uneven Tracks for Iraq’s Regional Reintegration,” *World Politics Review*, Michael Wahid Hanna, 23 February 2010.

<sup>47</sup> Interview, former Western diplomat, Erbil, 15 March 2010.

<sup>48</sup> Interview, Aydin Selcen, Turkish Consul General in Erbil, Erbil, 15 March 2010.

<sup>49</sup> Interview, Manager of Crescent Petroleum gas project in Kurdistan, Erbil, 17 March 2010.

reliable gas producer in the near future, especially with regard to the Nabucco pipeline project.<sup>50</sup>

“Opportunities presented by the future Nabucco natural gas pipeline could help breathe life into the Kurdistan Region, and Iraq in general,” the Turkish Consul General said in an interview.

“Turkey wants to help with this.”<sup>51</sup>

## **Conclusion: 2010 and Beyond**

The oil and gas potential in northern Iraq provides the Kurdish region with significant opportunities for the future. The KRG’s sizeable reserve potential has brought foreign investment into its growing oil sector, and it also provides investors with a general sense of security. Foreign investors, Western and otherwise, are aware that regardless of the current political situation, oil will remain in Kurdistan, providing security for foreign investment.<sup>52</sup>

The foreign oil companies operating in the Kurdish region, who remain unhappy about not being paid by either Baghdad or Erbil, say that they are committed to a long-term presence and that their interests align fully with the Kurdistan Regional Government. Oil company executives based in Kurdistan all agree with one assertion—it is solely politics that is currently holding back the region’s oil sector from reaching maximum potential. It is unlikely that the companies will be able to stick around forever if politics continue to inhibit production and exports. The companies took a significant amount of risk and have invested heavily in their respective projects. They are not preparing to leave at the moment, but if political gridlock remains, it may leave some of them with few other options in the future. The companies want to see an amicable resolution to the dispute as that is the only way that they are guaranteed to be

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<sup>50</sup> The Nabucco gas pipeline project is an international consortium that plans to build a pipeline which would transport gas from the Caspian region to central Europe. Iraq has been mentioned as one of the first sources of gas supply for the planned 31 billion cubic meters of gas per year pipeline which would flow through Austria and Turkey.

<sup>51</sup> Interview, Aydin Selcen, Turkish Consul General in Erbil, Erbil, 15 March 2010.

<sup>52</sup> Interview, Western attorney from an Iraq-based law firm, Erbil, 14 March 2010.

paid. Since the companies signed contracts with the KRG, and not with Baghdad, ultimately it is the responsibility of the KRG to uphold the contracts.

The post-election horse-trading following Iraq's recent parliamentary election provides the Kurds with a window of opportunity to exact concessions from the next government in Baghdad. The fate of KRG exports could be part of a bargain following the formation of the next government. Senior Kurdish officials in Erbil suggest that the possibility of a new Oil Minister in Baghdad presents the Kurds with a significant opening to make progress on the oil front.<sup>53</sup> Prior to joining any coalition government, the Kurds want more concrete assurances than they received from the previous government, regardless of the next Prime Minister. During his tenure, Prime Minister Maliki broke a number of promises he previously made to the Kurds and the Kurdish leadership does not want to have another four years of political gridlock between Baghdad and Erbil. In the words of Kurdistan Regional President Massoud Barzani, "whether Maliki or another person takes over, this time everything should be written, documented, and signed. We will not be satisfied with promises and good intentions."<sup>54</sup>

Since 2003, the Kurds have benefited greatly from their ability to remain largely united as a political and ethnic faction in Iraq, oftentimes capitalizing on Arab disunity and relishing in their role as one of the most important kingmakers in Iraqi politics. Much has been made about the rise of the Kurdish opposition party, Gorran, and the possibility of a fragmentation in Kurdish politics that could weaken the position of the Kurds in Baghdad. However, the divisions between Gorran and the two main Kurdish political parties, the KDP and the PUK, are largely over domestic political issues of the Kurdistan Region, including corruption and the decades-long patronage system associated with the two dominant parties. By all accounts, all Kurdish

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<sup>53</sup> Interview, Senior Kurdish official, Erbil, 16 March 2010.

<sup>54</sup> Interview with Massoud Barzani, *Al-Arabiya Television*, 1 April 2010.

political parties will continue to speak with one voice in Baghdad. As one Kurdish official aligned with the KDP put it, “no Kurdish political party wants to be the one that loses Kirkuk.”<sup>55</sup>

The Kurds have high aspirations for the Kurdish region and for their oil and gas sector in particular. Despite having the ambition and the resources, their go-it-alone approach to oil policies must eventually acknowledge the stark reality of their various budgetary and structural dependencies, their precarious situation in a region with many rooting against them, and the KRG will also need to learn how to most effectively use its leverage within Iraq and the region. Only through a compromise with Baghdad will the KRG be able to reach its true potential as an important and reliable oil and gas producer in its own right. If neither side is willing to soften its position and accept compromise, politics will continue to hold back not only the Kurdistan Region, but also the entire country.

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<sup>55</sup> Interview, Kurdish official, Erbil. 16 March 2010.