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KURDISTAN REGION'S OIL EXPORTS ENTERING A YEAR-LONG HALT

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Executive Summary

The year-long cessation of oil exports from the Kurdistan Region has had a detrimental impact on the economy of the Region, given that oil serves as its primary source of revenue. The nascent oil empire of the Kurdistan Region, which debuted in 2009 with the export of its first batch of crude oil to the Turkish port of Ceyhan, has encountered several legal obstacles, including disputes over oil contracts with international oil companies, the 2007 passage of the oil and gas law by the Kurdistan Parliament, and the 2013-2014 decision of the Kurdistan Regional Government to pursue independent oil sales. The oil sector dispute between Baghdad and Erbil escalated in 2014, prompting legal proceedings from Baghdad that ultimately resulted in the cessation of KRI oil exports on March 25, 2023. The KRG is currently unable to fulfill its financial commitments due to the ongoing halt, which was precipitated by a recent ruling from the ICC. This highlights the complex and lengthy disputes that exist between Baghdad-Erbil regarding oil management and revenue distribution.

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Overview

Bleeding KRI white, the halt of oil exports continues to battle the economy of the Kurdistan Region of Iraq (KRI) Since its cessation on March 25, 2023. Oil accounts for the main source of revenue for the KRI, and by far Iraq, to meet the financial demands of the Region, especially the public sector payments which amounts to a monthly lot of $720 million. The KRI's nascent oil industry commenced in the mid-2000s, and most oil contracts were signed with International Oil Companies (IOCs) after 2005, when the Iraqi Constitution was adopted through an official referendum. Iraqi Kurdistan (KRI) initiated exploration of its oil potential and commenced offering Production-Sharing Contracts (PSCs) to international oil companies (IOCs) in order to facilitate the exploration of potential oilfields. Iraq was at the time pursuing Technical-Service Contracts (TSCs). As the dawn of oil industry became certain and oil production began in 2006, the KRI took a few steps to ensure it has the institutional backing to develop the oil industry, including:

- **2006:** Ministry of Natural Resources (MNR) was established
- **2007:** Oil and Gas Law was passed by the KRI Parliament

At the same time, Baghdad was seeking to attract investment and boost oil production. In the absence of a federal oil and gas law, Iraq made reservations against the KRI's 2007 Oil and Gas Law as well as the Production-Sharing Contracts (PSCs)-citing contradictions with the text of the Iraqi Constitution. Iraq's offer of technical service contracts (TSCs) changed the oil industry prospects significantly leading to signing up Shell, ExxonMobil, BP, CNPC, ENI, Petronas, CNOOC, Gazprom Neft, Total, Occidental, and several other major companies, which potentially deterred them from entering KRI. This is where disputes over the oil sector between Baghdad-Erbil began: Baghdad on the move to secure oil giant companies through TSCs with enormous volumes of promised investment and production versus KRI trying to get its politics right by offering PSCs to attract investors in hopes to build its economy, even though the legal standing of the contracts were challenged. At the same time, KRI's economic vitality was substantially tied to its share of Iraqi budget which mostly came from federal oil revenues, and thus a key incentive to remain within the federal system.[1] The fundamental legal disputes between the KRG and Baghdad revolved around disagreements regarding the KRI's oil industry. These issues escalated in 2013 when the KRI began oil exports without consulting Baghdad. Given that Iraq's economy is mostly dependent on oil revenues, it directly impacted the budget, which the KRI's share was set at 17% before Baghdad cut the share by 2014 in retaliation for KRI's independent oil sales.

In 2014, the Kurdistan Region of Iraq unilaterally pursued independent oil sales and Baghdad threatened to take legal actions against any party willing to trade or partake in Kurdish oil marketing. Separately, Iraq filed a complaint to the Paris-based International Chamber of Commerce's Court of Arbitration (ICC) against Türkiye for breach of the 1973 Iraqi-Turkish pipeline agreement for allowing the Kurdistan Region's oil exports without Baghdad's consent through the Turkish pipeline to the Ceyhan port. The arbitration court mandated Türkiye to compensate Baghdad for the unauthorized export of Kurdistan Region's oil without Baghdad's approval from 2014 to 2018, breaching the 1973 pipeline agreement.[2] Iraq's successful victory for winning an award of $1.5 billion[3] led to Türkiye's decision to halt all oil exports from Iraq in response. Since March 25, 2023, no oil from the Kurdish Region has been exported, effectively crippling the Kurdistan Regional Government (KRG) to dispense public sector salaries and pensions. This is because KRI's main source of revenue, similar to Iraq, depends on oil revenues. Oil, becoming the economic lifeline of KRI, brought an approximate monthly sum of $733 million to KRG coffers generating 80% of revenue for the Kurdistan Region.[4]

Box 1: Snapshot of Baghdad-Erbil Dispute

Key Question: whether the Kurdistan Region's pursuit of independent oil sales is constitutional.

Erbil's perspective: Iraq's 2005 constitution gives KRI the right to sign deals with oil companies and states without consulting the central government of Baghdad.

Baghdad's perspective: Erbil lacks the authority to enter into agreements and that any exports must pass through state-operated pipelines and be marketed by the State Organization for Marketing of Oil (SOMO).

ICC Arbitration Ruling (covering 2014-2018 KRI oil exports): decides in favor of Iraq, declaring the KRI oil sales to be illegal, citing the 1973 pipeline agreement between Iraq and Türkiye as basis for its ruling.

Iraqi Federal Supreme Court (FSC) ruling (2022): sales of oil and gas by the Kurdistan Regional Government (KRG), independently of the central government in Baghdad, is unconstitutional.

Result: halt of 450,000 bpd of oil exports, 440,000 bpd from the Kurdistan region and 75,000 bpd from northern Kirkuk.

Phases of Baghdad-Erbil Disputes

Baghdad and Erbil have had a contentious relationship for the past two decades, mostly over the oil sector. Considering the many factors involved, the Baghdad-Erbil dispute over oil can be categorized into four distinct phases. The in-depth review of all four phases will highlight the three primary roadblocks that Iraq and KRI have confronted since the birth of their formal relations after the fall of the Saddam Hussein regime in 2003:

1. National hydrocarbon law
2. Permanent Budget-sharing agreement
3. Establishing a clear Regional-Federal Arrangement

Phase I:Kurdistan Exports Oil Independently and Baghdad Cuts KRI Share of the Budget

Context: when the Kurdistan Regional Government (KRG) pursued independent oil sales in 2013, the then-incumbent Prime Minister of Iraq Nouri Al-Maliki warned the KRG authorities that only the central government has the authority to manage Iraq's energy resources according to the Iraqi Constitution. Baghdad sent warnings to Türkiye that their facilitation in transporting and marketing Kurdish oil is considered blatant interference in Iraq's sovereignty as well as breach of the 1973 agreement. Baghdad also argued that its state-owned marketed SOMO is the only party authorized to manage crude exports through Turkish port of Ceyhan. According to a previous agreement between Baghdad and Erbil in October 2012, the KRI agreed to export an average of 250,000 bpd in 2013 if Baghdad paid the operators in the region.[6] In return, KRI would receive 17% of the budget share.

Political Stalemate: PM Al-Maliki accused Erbil of not meeting their budgeted commitment to export the set volume of crude oil and warned that Baghdad might consider retaliating by reducing KRI share of the budget, a statement Al-Maliki soon denied publicly. However, the deal reached a stalemate over what they called a protracted unresolved budgetary matter. In lieu of pumping oil to Türkiye through the pipeline under Baghdad's control, the KRG exported smaller quantities via tankers through Türkiye and collected the revenue directly. Later, KRG started exporting crude through its oil pipeline to Fish-Khabur on the northern Iraqi border, where the oil enters Türkiye and is pumped to the Turkish port of Ceyhan on the Mediterranean coast.[7] According to multiple statement by the KRG authorities, KRI received $500 million in state budget allocations in January 2014 instead of $1.0 billion-$1.2 billion as agreed upon and then from February budget transfers were cut further and eventually stopped by March 2014.[8] Consequently, Baghdad, furious over the continued KRI's independent oil sales, reduced the KRI's budget share from 17% to zero to pressure KRG to stop independent oil sales.[9] To this day, the KRG authorities reference breach of budgetary agreements by Baghdad as the only reason behind the independent oil sales policy.

The 2013-2014 Baghdad-Erbil oil-driven dispute coincided with the outbreak of war with the Islamic State (ISIS), a massive displacement crisis, and the collapse of global oil prices, which coalesced to plunge the Kurdistan Region into financial crisis alongside Baghdad.[10] The stalemate continued until late 2018 where Baghdad under the leadership of Prime Minister Haider Al-Abadi initiated negotiations to strike another deal with Erbil to reinstate a portion of the KRG's budget in 2019.

Box 2: Kurdish Oil Sailing the Seas

The story of independent Kurdish oil sales began with high hopes on false premises. KRG authorities later found out that introducing Kurdish oil sales to the international market was harder than anticipated, as Baghdad sent threat waves all over the world threatening legal action against buyers if KRI oil is found on their shores. Despite the associated legal risks, the KRI authorities began cultivating dependence on Türkiye for oil sales through its oil pipeline. Whether Baghdad likes it or not, as Ashti Hawrami former KRI Minister of Natural Resources articulated in an interview, Kurdish oil is sailing the seas looking for potential buyers, all at the risk of Baghdad's watchful eyes.

To avoid detection, the oil was often funneled through Israel, transferred directly between ships off the coast of Malta, and decoy ships used to make it harder for Baghdad to track,[11] according to Hawrami. Reuters reported in 2015 that some buyers took tankers to Ashkelon, Israel, where it was loaded into storage facilities to be resold later to buyers in Europe. Kurdish oil was also sold offshore Malta via ship-to-ship transfers helping disguise the final buyers and thus protect them from threats from Iraqi state firm SOMO. According to Reuters, Kurdish oil was making its ways to Israel and Hungary by November 2015 generating a monthly sum of $800 million-$850 million. Nevertheless, Erbil's plan of independent oil sales was severely impacted by the decline in oil prices, and the generated revenue was inadequate to bridge the substantial financial deficit caused by the 17% budget reductions imposed by Baghdad. KRG unable to cover 70% of its employee salaries[12] started to cut salaries, a move that financial and budget experts deemed unconstitutional.

Phase II: Frozen Relations between Baghdad-Erbil Leads to KRI's Move for Independence in 2017

Marked by a series of miscalculations and misguided counselling by outside independent consultants, KRG staged a referendum on September 25, 2017. Despite regional and international rebuke, Kurds overwhelmingly cast "yes" votes, according to KRG sources. Kurdish authorities thought a decisive vote of the referendum would end the question of oil revenue-sharing and enable KRI to reclaim disputed territories, including oil-rich Kirkuk province.[13] On the contrary, the referendum further severed ties with Baghdad and key regional and international actors. Much to the chagrin of the KRG authorities, the results of the independence referendum were challenged by most states as well as the federal government in Baghdad since it took place without permission from the federal government. Overall, the UN did not support the results of the referendum either; given the absence of independent monitoring, there is no way of telling whether voting was free and fair, a question particularly pertinent in the disputed territories.[14]

Ramifications: According to Crisis Group, the US warned KRG that the decision to proceed with the referendum precipitates a serious crisis, and thus all sides hardened their positions in its aftermath, starting with retaking Kirkuk by Iraqi forces in early hours of October 16, 2017, which was under

Kurdish control since ISIS war in 2014 and later the loss of territories previously controlled by the Kurdish Peshmerga forces.[15] The KRG at the crossroads of a failed referendum and a collapsing political and economic condition was forced to return to the negotiating table with Baghdad. The KRG's budget share was significantly decreased by the end of 2018 and Baghdad's initial efforts to exert control over the KRI's oil sector was soon reinforced.

Box 3 : The Nature of KRI Oil Contracts

Recognizing the legal standing of KRI contracts enacted between the KRG and International oil Companies (IOCs) after the adoption of the Iraqi Constitution is critical. The main point that Baghdad, especially the FSC have brought up several times is that the KRI's PSCs directly contradicts the Iraqi Constitution, namely Article 111. Therefore, the entire structure of PSCs, which grants IOCs the right to a portion of Iraqi oil, directly violates the Constitution. The central government and Erbil differ on how to interpret the Constitution regarding oil management and revenue distribution which to this day remains the main point of contention. KRG cites Article 112 and Article 115 of the Iraqi Constitution to establish basis for its independent oil policy as well as licensing PSCs to IOCs.[16]

Phase III : Baghdad's Control Over Kurdistan Region's Oil Sector Strengthened

After consolidating its security footprint and taking advantage of the shifting balance of power in the aftermath of the independence referendum, Baghdad under the premiership of Prime Minister Haidar Al-Abadi reinstated the KRG share of the Iraqi budget with a significant cut of 4.4% officially at 12.67% in the 2018 negotiations. Baghdad also conditioned KRG to handover 250,000 bpd to Baghdad.[17] Reflective of the post-referendum tensions, Iraq's 2018 parliamentary elections altered the dynamics of relations between Baghdad and Erbil. A significant decision was made by Baghdad to send full salaries to the KRG, which lifted the financial burdens that the KRG had been carrying since 2014.

The formation of Iraqi government under the leadership of Adil Abdul-Mahdi (2018-2019) featured a more cautiously functioning Regional-Federal relationship. However, in the following years, Baghdad strengthened its posture under Mustafa Al-Kadhimi's leadership concerning issues that Baghdad deemed to be within the powers of the federal government, including the status of disputed territories, budget arrangements, management of natural resources, border control, and the status of the Peshmerga forces.[18] The terms imposed by Baghdad, such as overseeing oil exports and border control[19] ensured that the KRG's economic vitality will rely on its share of the federal budget. The implementation of the 2019 budget serves as an important turning point in the trajectory of Baghdad-Erbil relations in the years that follow, as the financial stability of the KRG would be intricately linked to Baghdad.[20] However, the 2019 deal did not lead to the financial guarantees that KRG was seeking. At the same time, the 2019 budget was an instrumental development in easing tensions between Baghdad-Erbil since Baghdad made payment of salaries for the Kurdish Peshmerga forces.[21]

In 2020, once again budget disputes led to widespread social unrest in KRI as Baghdad did not deliver the budget share for several months[22] preventing the KRG from paying public sector salaries. A renewed frontline of financial disputes with Baghdad added to the already fragile economic situation in KRI where the KRG failed to pay its civil servants in full and on time for five years since the war had begun with ISIS. Despite efforts to secure a 14% of the 2021 draft federal budget referencing the full size of KRI population as not being reflected in the 12.67%, Baghdad unable to pass a new budget bill, decided to stick with the 2019 draft budget law and secured 12.67% of the federal budget for the KRI. The 2021 federal budget brought about two important decisions regarding KRG's financial duties:[23]

- The Kurdistan Region is expected to generate at least 460,000 barrels of crude oil per day (bpd). Considering production, operational, and domestic consumption expenses, Baghdad would receive revenue from sales of 250,000 bpd at $45 per barrel.

- Additionally, 50% of the revenue generated by the KRG at border crossings will be transferred to the central government.

Phase IV :Regional-Federal Disputes between Oil, Budget, and Border Control

With the objective of delineating the regional-federal relations as defined in the Iraqi Constitution, Baghdad initiated a pressure campaign to clarify the obligations and responsibilities of regional authorities, specifically the KRI, as stipulated in the Iraqi Constitution. Red lines were drawn pertaining to oil, the KRI's budgetary share, and border control. A series of decisions by the Federal Supreme Court (FSC) in early 2023, and later the Paris-based International Chamber of Commerce (ICC) marked a new phase of relations between Baghdad-Erbil:

1. **Federal Supreme Court of Iraq (FSC) Rulings**

The Federal Supreme Court of Iraq has significantly contributed to the interpretation of provisions from the Iraqi Constitution. Under the verdict of FSC, the oil sector lies constitutionally within the rights of the Federal government to manage, control, and distribute, citing Article 112 of the Iraqi Constitution. Following this ruling, the FSC ruled in January 2023 that budget transfers previously delivered to the KRI are illegal given that the KRG did not honor its agreement to send the agreed-upon volume of oil to Baghdad.

- **February 2022:** FSC ruled the natural resource law passed by the Kurdistan Regional Government (KRG) in 2007 is unconstitutional and its oil exports and contracts illegal.
- **January 2023:** The FSC ruled that federal budget transfers to the Kurdistan region were illegal.

2. **ICC Ruling in Favor of Iraq**

Given the Iraq-Türkiye's 50-year-old pipeline agreement, Baghdad filed a complaint against Türkiye for blatant breach of the 1973 pipeline agreement to allow KRI oil sales without Iraq’s consent. On March 23, 2023, the International Chamber of Commerce ruled that Kurdish oil exports through Turkey's Ceyhan port was in breach of the 1973 pipeline transit agreement citing that Iraq's State Oil Marketing Organization (SOMO), was the only party that would manage exports through Ceyhan. The key outcomes caused by this decision are:

- Türkiye to pay $1.5 billion in damages to Iraq
- KRI to handover the oil industry in its entirety to Baghdad

Following its initial adherence to the court order to provide Iraq with $1.5 billion in compensation, Turkey subsequently voiced dissent and suspended all oil exports from the KRI and Iraq. Baghdad transports 75,000 bpd from Kirkuk to Ceyhan. Despite KRG not disclosing its production volume, industry analysts estimate it to be 440,000 bpd. The worldwide oil industry has been significantly disrupted by the sudden cessation of about 500,000 barrels of oil per day. This has caused a regional and even worldwide backlash and driven oil prices back toward $80 per barrel. The Iraq-Turkish Pipeline (ITP) accounts for 15% of Iraq's oil exports which is about 0.5% of global oil supply.[24]

Baghdad-Erbil 2024 State of Affairs

Erbil struggles to reach an agreement with Baghdad to resume oil sales and reimburse the KRI for expenses incurred throughout oil production. An oil deal in April 2023 was reached between Baghdad and Erbil to restart oil exports: the deal stipulates that 400,000 bpd of oil will be exported from the Kurdistan Region, which would be handled by the federal SOMO. The KRI for the first time will have its own representative in SOMO with the role of deputy head from the Ministry of Natural Resources to oversee the marketing of Kurdish oil until the 2023-2024 budget is approved in cooperation with representatives from the Oil Ministry. As per the provisions outlined in the agreement, oil revenues shall be deposited into an account at the central bank or an alternative financial institution. While overseen by Baghdad, the KRG shall retain control over the funds. It will be possible for Baghdad to audit the account.

Key Takeaways from the Dispute over the Oil Sector

- 12.67 percent of federal revenue- over $1 billion per month allocated to KRI
- Ongoing negotiations to change the KRI's PSC to TSC with international oil companies
- Cooperation mechanism: the Iraqi Ministry of Oil would help the KRG in the negotiations with four international companies with contracts to market Kurdistan Region's oil.
- KRG sources[25] state that Baghdad's unjust price for production costs, which are higher in Iraqi Kurdistan than in any other region of southern Iraq, is the primary factor delaying the resumption of oil exports.
- The extraction costs of oil are the primary source of disagreement between the Kurdistan Region and the central government. The cost of production in Iraq varies between 8,000 and 9,000 Iraqi Dinars [$5-6] per barrel, a substantial difference when compared to the cost of $20 observed in the Kurdistan Region.
- A transportation fee of $6 per barrel is levied by the Kurdistan Region, while Iraq charges $1.20 per barrel. This has created an untenable dispute over Iraq's national budget law.

Conclusion

Since oil exports are the main source of income for the KRI and play a significant role in its economy, the Region's economy continues to suffer from Baghdad and Erbil's ongoing disagreement over the oil industry and the resulting suspension of KRI's oil exports. After the ICC arbitration decision on March 23, 2023, the KRI has emerged as the main party with most of the damages. Baghdad's concerns about the KRI's oil sector are intended to assess the legitimacy of the KRI's independent oil sales. Baghdad has maintained this position ever since the KRI's oil industry began, and it stipulates that all oil exports must go through SOMO. The Kurdistan Region's and Iraq's overall political and economic stability will be greatly impacted by the settlement of this conflict.

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