State and Substate Oil Trade: The Turkey-KRG Deal

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After the U.S. withdrawal from Iraq, there has been increasing tension between the central government in Baghdad and the Erbil-based Kurdistan Regional Government (KRG) in northern part of the country. Although KRG President Masoud Barzani supported Iraqi Prime Minister Nouri al-Maliki in the federal elections of 2010, the two sides have been in open conflict over energy projects within the semi-autonomous Kurdish region. The KRG is a substate actor in regional relations whose international legal status has not yet been determined. It is important to note that any future determination will undoubtedly hinge on oil and gas resources. Maliki's administration has consistently argued that the Federal Oil Ministry has primary authority over Iraq's oil sector. The KRG has claimed independent authority over energy resources in the region, including the right to sign oil-field exploration and production contracts within its territory, govern oil fields, and export oil and natural gas. The federal constitution of Iraq regulates the oil revenue-sharing mechanism and other features related to energy exploration and production. Following from this, all petroleum exported from Iraq should be marketed through the country's State Oil Marketing Organization (SOMO), with the KRG receiving 17 percent of the resulting revenues. However, the regulation of the energy sector in the KRG is unclear.[1] In light of this situation, Deputy Prime Minister Hussain al-Shahristani has expressed concern regarding violations of the fundamental principle embodied in the statute, asserting that KRG authorities should follow the constitutional order and not make oil-extraction deals with third countries without Baghdad's approval.[2] Until recently, Baghdad appeared to have the upper-hand in the conflict, as the export pipelines have been under control of the central government. However, the commissioning of an oil pipeline linking Erbil to Turkey is changing the status quo by physically allowing the KRG to export oil to regional and international markets.

The changing status quo builds on previous overland exports by tanker truck. Instances of oil-revenue generation through domestic sales and road-based exports have been commonplace for some time though not accounted for by the Iraqi treasury. This export of oil to Turkey has been going on with little opposition from the central government in Baghdad. Nevertheless, it is the oil pipeline between the KRG and Turkey that creates new tensions between Baghdad and Erbil. The landlocked KRG has occasionally been able to strike temporary political agreements with Baghdad to feed oil into the existing Iraq-Turkey Pipeline (ITP), but such deals have lost momentum. In the absence of an agreement between the two sides, and despite the setbacks posed by the tensions, the Kurdish oil sector has begun to flourish independently over recent years. This goes hand-in-hand with the culmination of the KRG's independent energy policy, which reached its peak at the end of 2013, when the KRG started to pump oil to Turkey through the ITP.

IRAQ'S SHARE IN GLOBAL ENERGY

Energy geopolitics and mercantilism are the two main frameworks shaping energy-policy debates today. Energy markets and institutions responsible for their supervision challenge this statist framework.[3]

Oil is traded in a global market underpinned by international institutions representing the supply (producers) and demand (consumers) side of the value chain. With the establishment of the Organization of Petroleum Exporting Countries and the International Energy Agency in the aftermath of crises in the 1960s and 1970s, the oil trade has witnessed significant changes over the last three decades. The economic influence of the so-called rising powers, epitomized by the BRIC[4] countries, has put pressure on the institutions of global energy governance as demand has grown at an unprecedented speed.

The increasing demand on the global oil market has highlighted the key energy-consuming regions that prioritize "energy security" in their policies. While the agency of national oil companies (NOCs) is often used to ensure energy security, international oil companies (IOCs) have also determined the fundamentals of the global oil market. Through the overlap of global and regional dynamics, the process of energy globalization has produced new dimensions of energy security. The globalization of the trade in oil and natural gas is a naturally occurring phenomenon that stems from the basic logic of supply and demand. Security of supply and security of demand are mutually supportive concepts that go hand in hand, regardless of the circumstances.[5]

At the end of 2013, Iraq's share of world oil reserves[6] stood at 150 billion barrels of oil (bbo), or 8.9 percent, making it the fifth-largest holder of global reserves (Table 1). Within the Middle East, Iraq ranks third, after Saudi Arabia (265.9 bbo, or 15.8 percent of the global share) and Iran (157 bbo, or 9.3 percent). With the increasing importance of the reserves-to-production (r/p) ratio in global oil security — a natural-resource life-span indicator — Iraq accounted for the largest addition to global crude oil in 2011-13 with an r/p of more than 100 years.[7] Iraq's oil production witnessed remarkable growth over the last half of the decade; as of 2013, it stood at over 3 million barrels per day (3.7 percent of global output).

Iraq sits on the world's twelfth-largest natural-gas reserves (Table 2). Proven reserves within the state have been growing, and stood at 3.6 trillion cubic meters (tcm) in 2013, equal to 1.9 percent of the global total.[8] However, it has proven to be

TABLE 1. Proven Oil Reserves for Top 25 Countries at End of 2013

Country	Thousand Million Tonnes	Thousand Million Barrels	Share Of Total	Reserves / Production Ratio (Years)
Venezuela	46.6	298.3	17.7%	> 100
Saudi Arabia	36.5	265.9	15.8%	63.2
Canada	28.1	174.3	10.3%	> 100
Iran	21.6	157.0	9.3%	> 100
Iraq	**20.2**	**150.0**	**8.9%**	**> 100**
Kuwait	14	101.5	6.0%	89.0
United Arab Emirates	13	97.8	5.8%	73.5
Russian Federation	12.7	93.0	5.5%	23.6
Libya	6.3	48.5	2.9%	> 100
United States	5.4	44.2	2.6%	12.1
Nigeria	5	37.1	2.2%	43.8
Kazakhstan	3.9	30.0	1.8%	46.0
Qatar	2.6	25.1	1.5%	34.4
China	2.5	18.1	1.1%	11.9
Brazil	2.3	15.6	0.9%	20.2
Angola	1.7	12.7	0.8%	19.3
Algeria	1.5	12.2	0.7%	21.2
Mexico	1.5	11.1	0.7%	10.6
Norway	1	8.7	0.5%	12.9
Azerbaijan	1	7.0	0.4%	20.6
India	0.8	5.7	0.3%	17.5
Oman	0.7	5.5	0.3%	16.0
Vietnam	0.6	4.4	0.3%	34.5
Australia	0.4	4.0	0.2%	26.1
Egypt	0.5	3.9	0.2%	15.0
Sum of Top 25 Countries	**230.4**	**1631.6**	**96.7%**	
Rest of the World	**7.8**	**56.3**	**3.3%**	
Total World	**238.2**	**1687.9**	**100.0%**	**53.3**

Source: BP (2014) with modifications by the authors

TABLE 2. Proven Natural Gas Reserves for Top 25 Countries Ranked at End of 2013

Country	Trillion Cubic Feet	Trillion Cubic Metres	Share of Total	Reserves / Production Ratio (Years)
Iran	1192.9	33.8	18.2%	> 100
Russian Federation	1103.6	31.3	16.8%	51.7
Qatar	871.5	24.7	13.3%	> 100
Turkmenistan	617.3	17.5	9.4%	> 100
United States	330.0	9.3	5.0%	13.6
Saudi Arabia	290.8	8.2	4.4%	79.9
United Arab Emirates	215.1	6.1	3.3%	> 100
Venezuela	196.8	5.6	3.0%	> 100
Nigeria	179.4	5.1	2.7%	> 100
Algeria	159.1	4.5	2.4%	57.3
Australia	129.9	3.7	2.0%	85.8
Iraq	**126.7**	**3.6**	**1.9%**	**> 100**
China	115.6	3.3	1.8%	28.0
Indonesia	103.3	2.9	1.6%	41.6
Norway	72.4	2.0	1.1%	18.8
Egypt	65.2	1.8	1.0%	32.9
Canada	71.4	2.0	1.1%	13.1
Kuwait	63.0	1.8	1.0%	> 100
Libya	54.7	1.5	0.8%	> 100
Kazakhstan	53.9	1.5	0.8%	82.5
Malaysia	38.5	1.1	0.6%	15.8
Uzbekistan	38.3	1.1	0.6%	19.7
Oman	33.5	0.9	0.5%	30.7
Azerbaijan	31.0	0.9	0.5%	54.3
Netherlands	30.1	0.9	0.5%	12.4
Sum of Top 25 Countries	**6184.0**	**175.1**	**94.3%**	
Rest of the World	**373.8**	**10.6**	**5.7%**	
World Total	**6557.8**	**185.7**	**100.0%**	**55.1**

Source: BP (2014) with modifications by the authors difficult to catch up to the pre-war levels of production. From 1.9 billion cubic meters (bcm) in 2008, natural-gas production shrank to 0.9 bcm in 2012, the lowest level in a decade.[9]

POTENTIAL VS. REGIONAL INSECURITY

Due to security problems, Iraqi oil production is badly constrained in some parts of the country. Recent insecurity in the northeast posed by insurgents from the Islamic State of Iraq and the Levant (ISIS) is likely to challenge oil and gas investments and development within the country. The threat posed by ISIS has changed security dynamics overnight. The federal government's request to Kurdish peshmerga forces to help secure oil facilities in the north constitutes a new dynamic, transforming the KRG within the federal structure of Iraq as Erbil gains greater control of the oil resources at Kirkuk. However, as the threat from ISIS spreads across the region and starts to jeopardize assets of Western energy companies, the Kurds are gaining more support from the international community. Led by the United States, an anti-ISIS coalition began to bomb targets in September 2014. After ISIS released its hostages, Turkey finally joined the coalition, easing pressures between the state and the KRG. Tensions were high, as Turkey was hesitating to lend support to the KRG, when ISIS militants attacked the government and reached the outskirts of Erbil in the summer of 2014.

As one of Iraq's oil-producing regions, the KRG's industry is still in an early stage of development. The KRG's output was approximately 180,000 bpd, of which 30,000 can be exported to Turkey by tanker trucks. The remainder was destined for refining locally prior to the signing of the Turkey-KRG oil-pipeline deal.[10] Oil contractors operating in the territory under the KRG assess the proven oil reserves at more than 2 billion barrels, recoverable on P1 and P2 bases, and total resources of more than 17.7 billion barrels. KRG officials similarly claim regional oil wealth to be as high as 45 billion barrels. As for natural-gas resources, the region is said to be even more promising: more than 350 bcm of recoverable gas has been discovered on P1 or P2 bases, while the total resource base is estimated at nearly 1.2 trillion cubic meters.[11] These amounts make the extent of the region's resource base comparable to those of the Shah Deniz natural-gas field in the Caspian Basin. With necessary arrangements in place, regional production could reach export levels of 1 million bpd by 2016, and 2 million bpd for oil and 20 billion cubic meters (bcm) for gas by 2020.[12] Nevertheless, the incremental growth of oil production is dependent on investments by oil companies, as capital is necessary to support development. Over 50 oil companies, including industry majors such as ExxonMobil, Chevron, Sinopec, Total, Genel Energy and Gazprom Neft, have been attracted to the region, thanks to contractual production-sharing agreements (PSA) with high profit margins, offered by the KRG's Ministry of Natural Resources.[13] In a world of ever more costly oil extraction, fields in the KRG offer cost savings thanks to their geology, thus making it easy to attract the attention of the oil industry.

LEGAL AND SECURITY CHALLENGES

Politically ambiguous regions require oil companies to consider final investment options in order to tap into the region's resources. Even companies that have already signed contracts in the KRG are still waiting to decide on when to move from the exploration phase to the production phase of field development. With the Iraqi government considering unilateral exports of oil from Kurdistan as smuggling, and threatening legal action against the buyers,[14] uncertainty over export-oriented producers is growing. On the other hand, Turkey and the KRG have been defending the oil trade from Erbil to the Mediterranean terminal at Ceyhan, ignoring the legality of arbitration proceedings by the Federal Ministry of Oil in Baghdad.[15] As the Baghdad-Erbil dispute is heating up, the issue of oil-transport security is looming in the background. It is enormously risky to invest billions of dollars to develop the fields, considering the fact that the region lacks secure infrastructure to deliver the crude to world markets. To ensure the exploration and production activities of the major oil companies, whilst upholding their investment plans, the KRG needs to prove that oil companies can reliably export and be paid for their products. Owing to the land-locked geography of the KRG, the only solution is through pipelines. While relations remain problematic with Baghdad, unpredictable with Iran and unclear with Syria, Turkey remains the only viable option for exports to international markets via pipeline. Nevertheless, energy cooperation with Turkey is poised to further enhance the KRG's financial standing and, while the disagreement with Baghdad continues, to improve the viability of a Kurdistan that is independent of the federal government of Iraq. In the face of the ISIS threat to the unity of Iraq, the economic facts on the ground created by the Turkey-KRG agreement are the only promising security arrangement for the KRG. As much as the oil trade could be a positive force, some critics argue that the cementing of these exports might also threaten the future of Turkey-Iraq relations.[16]

TURKEY'S ENERGY DEMAND

With remarkable economic growth over the last decade, Turkey has become one of the world's rapidly emerging energy markets. The state has been experiencing a surge in demand in every sector of the industry, which may be difficult to sustain at current levels of supply. Its primary energy consumption, which has increased sharply in recent years, is expected to double in the next decade.[17] Against the backdrop of a rising need for energy, Turkey is clearly in a situation of energy insecurity. Only around one-fourth of its total energy demand is being met by domestic resources, while the rest is being satisfied mainly through imports of oil and natural gas from Iran and Russia. It is no surprise that Turkish energy policy aims to diversify its sources of imports to gain reduced prices.[18] Compatible with its energy policy, Turkey has also started to encourage investments and acquisitions of oil and gas fields outside the country with Turkish energy companies playing an active role. Since Middle Eastern energy reserves constitute its nearest option geographically, the country is uneasy about aligning its foreign policy and energy strategy to this region.[19] Not surprisingly, the Kurdistan region of Iraq, located at the doorstep of the Turkish energy market, is seen as a strategic gateway for meeting future energy demands and driving the country's energy policy.[20]

Furthermore, energy cooperation with the KRG has the potential to offer Turkey an opportunity to decrease its energy-import deficit, around $60 billion annually in 2013.[21] In light of this, a significant reversal in Turkish foreign policy towards the

KRG has been observed over the past few years, helping to open up the geographically landlocked region as a new source of oil and natural-gas supply. While the region is officially part of federal Iraq, a century-long Kurdish quest for independence has increased in the post-Saddam period. As the ties between Baghdad and Erbil weaken, the latter is poised to bind itself to its northern neighbor, Turkey, to pursue further economic integration and political stability by offering it a suitable investment environment. Nevertheless, the issue is complicated by Ankara's problems with its own 30-year Kurdish insurgency. While the main Kurdish opposition to Baghdad has been the Kurdistan Democratic Party led by Barzani, Ankara has been struggling against Kurdistan Workers' Party (PKK) terrorism since 1984. Nevertheless, the PKK and the Turkish government started a peace process in 2013 that ended in summer of 2015.

TURKEY AND THE KRG

Turkey has become the number-one investor in the region, incurring significant financial costs to upgrade relations between Ankara and Erbil to a strategic level. Annual trade has exceeded $8 billion and, thanks to rapprochement between the state and substate actors, Iraq has become the second-largest market for Turkish exports after Germany.[22] As Turkey's energy demand grows, production capacity in Northern Iraq for future economic partnership is very high.[23] This has caused the lessening of political tensions between Ankara and Erbil, running high at one time. The Turkish Army was threatening to invade the KRG region to counter the terrorism threat posed by the PKK.[24] In addition, the current good relations, unimagined six years ago, are about to be elevated to a new level with the start of oil and gas flows from the region to Turkey. The first consignment of KRG oil was transported through the Turkish port of Ceyhan on the Mediterranean Sea on May 22, 2014; Israel was the first buyer of KRG crude delivered by tanker to the port of Ashkelon.[25] Further oil shipments are expected to continue through Ceyhan later this year.[26] With the Turkey-Iraq border becoming more porous, oil and gas deals between Ankara and Erbil have directly challenged Baghdad's claims to exclusive control of Iraq's natural resources, with Turkish and Kurdish leaders engaging in trade rather than conflict.[27]

Although the fundamentals of energy cooperation between Turkey and the KRG were defined in 2012, it was only on March 25, 2013, that the deal was finalized in the form of a framework agreement between the parties. In order to commercially realize the project, the Turkish government decided to establish a new oil company that only deals with this project and does not engage in energy development in other parts of Iraq. Since the state-owned Turkish Petroleum Corporation (TPAO) has a series of operations in the southern part of Iraq, a subsidiary, Turkish Petroleum International Company (TPIC), was established and transferred to another state-owned company, the Turkish Pipeline Corporation (BOTAS). Within the TPIC, the Turkish Energy Corporation (TEC) was created specifically to handle energy development in the KRG on behalf of Turkey.[28]

PIPELINE CONNECTIONS

In conjunction with the framework agreement signed in March, a series of energy deals between Turkey and the KRG came to an end after long negotiations in November 2013. The parties wrote up agreements to govern export pipelines, the sale of gas, the oil trade, the acquisition of oil fields by the TEC, and the revenue mechanism.[29] For the pipeline dimension, long-term logistical preparations have been guaranteed. The KRG has nearly completed a crude pipeline to the Turkish border. The first section begins at the Taq Taq fields and runs to Khurmala, near Kirkuk. The second section goes up to the border city of Feyshkabour, staying within KRG territory. On the Turkish side of the border, crude will flow into the existing ITP pipeline, which is actually composed of two parallel lines: the 46-inch line is currently being used to transport federally controlled Iraqi oil from Kirkuk to the Ceyhan port. The second line, 40 inches in diameter, has been dormant due to poor maintenance and lack of crude supply. The new KRG pipeline is connected into the latent 40-inch line just before the Turkish border. After completing the testing phase, crude from Kurdistan will enter the ITP and flow through Turkish infrastructure to facilities at Ceyhan. About 400,000 bpd were pumped into the export pipelines by the end of 2014 and a second new pipeline will be constructed for heavier crude.[30] In effect, Erbil and Ankara would be appropriating half of the ITP for KRG exports, despite stark objections from Baghdad. Meanwhile, Turkey has already begun preparing for gas imports from the region by extending its gas pipeline network toward the KRG border. BOTAS has already begun construction of a 42-inch pipeline to handle 20 bcm of gas imports annually. On the Kurdish side, construction of a parallel gas export pipeline has commenced.[31]

UPSTREAM DEVELOPMENTS

Upstream, TEC and the KRG have finalized terms for production-sharing agreements in some of its exploration blocs. As a result, for the first time since its foundation, BOTAS has become an upstream player through its recently founded subsidiary, TEC. According to the agreement signed by the parties on November 27, 2013, the TEC has become the major stakeholder in seven blocs in the KRG: Pulkhana, Jabal Kand, Arbat, Choman, Hindren, Khurmala and Khalakan. In addition, the TEC will buy minority stakes in all of ExxonMobil's exploration blocs: Baeshiqa, Pirmam, Betwata, Qara Hanjeer, Arbat-East and Al Qush.[32]

The parties concluded an oil-trade agreement that would enable Turkey to import oil from Kurdistan at a discounted rate. In addition, BOTAS will be paid 1 percent for all oil transmitted through the pipelines as the transit fee for Turkey. However, on a logistical level, it remains to be seen what will happen at the Turkish port of Ceyhan, until now reserved for federal Iraqi oil sales. It is likely that Turkey may need to separate crude from the KRG into storage tanks and ensure it is not blended with oil controlled by SOMO. The 2010 agreement that regulates the functioning of the ITP appears to give SOMO exclusive rights to the facility. Accordingly, the Iraqi side accuses Turkey and the KRG of oil smuggling, stating that purchasers would be banned from buying any other Iraqi crude or fuel sold or purchased by SOMO.[33]

Another important pillar of the deal is the gas purchase-sales agreement. The KRG is potentially to supply up to 20 bcm annually to Turkey mainly from the Miran natural-gas field; the Anglo-Turkish oil company Genel Energy is likely to be the first company to export the resource.[34] Turkey's desire to reach KRG gas fields emerged almost a decade ago and Ankara is now showing an interest in satisfying international needs through the re-exportation of gas from the KRG to Europe.[35] The price significantly undercuts other major suppliers such as Russia and Iran. Although Turkey could use the cheap gas it gets from the deal to negotiate better conditions from its traditional suppliers, it seems to be missing this opportunity. Turkish BOTAS has opted for the oil-indexed gas-pricing mechanism, a formula traditionally dominating the trade in natural gas. This is similar to that used in the Eurasian gas trade, rather than a market-based scheme. Hub-based gas-to-gas trading has increased in importance in European markets and serves the interests of the gas importers vis-à-vis the producers.[36] BOTAS could use the opportunity not only to delink gas prices from oil products as a bargaining tool against Gazprom and the National Iranian Gas Company, but also to establish a domestic gas hub for determining the price for a broader region.

FINANCIAL ASPECTS

Another crucial aspect of the deal that remains to be solved is related to revenue sharing. After the first Gulf war, federal Iraqi oil revenues had been subjected to a UN-mandated mechanism that pays reparations associated with the former regime, mostly to Kuwait. From there it flows to the Federal Reserve Bank of New York, where an American executive order protects it from creditors. On the other hand, according to a framework agreement, the KRG agreed to open an account in the Turkish state bank, Halkbank, for future revenues generated by oil and gas transactions.[37] Baghdad insists on a bank account to be opened in the United States, while Turkey and the KRG have opted for a Turkey-based account. Trilateral negotiations are being held among Ankara, Baghdad and Erbil to determine the location of the bank account and a revenue-sharing mechanism between Iraq and the KRG.

CONCLUSION

The politics of Iraqi oil continue with a new set of actors. Unprecedented developments in Turkish energy policy vis-à-vis a substate actor, the Kurdistan Regional Government of Iraq, are rooted in an economic, political and strategic calculus. Due to the extent of reserves under the KRG's control, the oil and gas from the KRG are likely to change the energy security dynamics in the region and beyond. The extent of Iraqi oil and gas reserves, including the production and r/p for oil at over 100 years of current production, is set to change the future of the KRG. Together with calls to provide security for the north of Iraq in the face of an ISIS insurgency, Turkish energy demand is transforming the regional energy-security landscape. Access to new sources of oil and gas supplies at reasonable prices is the key prerogative of Ankara's energy policy vis-à-vis the KRG. The energy demand is further exacerbated by Turkey's goal of turning the country into one of the world's top economies by 2023. Turkey's longing for energy security has wider implications for trade in natural gas with Russia and Iran. Future imports of KRG gas are likely to increase Ankara's ability to demand price arbitrage with Russia and, possibly, Iran while increasing the market liquidity needed for hub-based energy trade, if circumstances allow. As for the KRG, Erbil hopes to strengthen its political standing through oil revenues and, in the absence of a deal with Bagdad, Syria and Iran, the Turkish energy corridor is viewed as the most feasible option. Implications of the regional energy deal between Ankara and Erbil are likely to invite other sources of energy via Turkey to Europe. Finally, the uneasy energy-trade relationship emerging between Ankara and Erbil furthers fragmentation of the Iraqi state while elevating the Kurdish path to independence should the trade between the two parties continue in the absence of a regional conflict. Equally, the very energy deal between Ankara and Erbil poses a political problem for Turkey's future resolution of the status of its own Kurds and could pose a long-term threat to the territorial integrity of Turkey itself. The same goes for Ankara's energy-security objectives. As future exploration and development of oil and gas in the KRG increase production capacity, allowing Turkey to diversify away from traditional suppliers, the challenges of the official stance by Bagdad remain to be resolved.

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