TURKEY AND THE KURDISTAN REGION OF IRAQ: STRAINED ENERGY RELATIONS

Since the Kurdistan Regional Government's (KRG) referendum on independence in 2017, relations between Erbil and Ankara have soured; this poses a challenge to the Kurdistan Region of Iraq (KRI) which remains extremely dependent on oil and gas exports to Turkey. The aftermath of the referendum caused a major collapse of both KRI oil exports and revenues, and, although there has been some recovery since then, output remains far short of the KRG's pre-referendum aspirations. Meanwhile, the role of Turkish investment in the KRI is diminishing as Russia's Rosneft assumes an increasingly important role, not least in terms of developing a major new gas pipeline to Turkey. At the same time, the power of the federal government in Baghdad has grown. This was demonstrated by the government wresting control of major oil-producing areas in Kirkuk from the KRG in 2017 and this will no doubt play a significant role in whether Baghdad might seek to use KRI infrastructure for its own resumption of exports from Kirkuk to Ceyhan.

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Turkey has a complex set of energy relations with Iraq. It plays a crucial role in the development of both oil and gas in the autonomous Kurdistan Region of Iraq (KRI) and traditionally it has played an important role in the transit of oil from federal Iraq. Likewise, while Turkish companies are constantly seeking major commercial opportunities in federal Iraq, Turkish investors are already playing a major role in the development of hydrocarbon resources in the KRI. This role, however, remains circumscribed by the policies of the Turkish government, particularly since the independence referendum in the KRI on 25 September 2017, and by the potentially dominant role that Russia's Rosneft oil company looks set to play in the export of hydrocarbons from northern Iraq.

A Complex Triangular Relationship: Turkey-Federal Iraq-KRI

The importance of the energy relationship between Turkey and the KRI cannot be underestimated, but neither can the political complexities of triangular relations among Ankara, the KRI authorities in Erbil, and the federal Iraqi government in Baghdad. All of this has to be set against the background of fierce regional conflicts and tension. The conflicts include the ongoing strife in Syria and fighting—defined by some Turkish officers as war—between Turkey's security forces and the Kurdish militants of the PKK, which are considered terrorists by Turkey and its NATO allies. The tension particularly reflects the crisis initiated by the Kurdistan Regional Government in Erbil when it held its independence referendum last year in the face of widespread opposition from Turkey and other leading governments, notably the US, who were prepared to assist Kurdish autonomy but had major concerns regarding outright independence.

In terms of Turkey's relationship with the KRI, the most important consequence of the referendum is that it has almost completely sidelined the groundbreaking set of agreements concluded between the KRG and the government of Turkey in November 2013.

These agreements included:
- Turkish support for KRI oil exports via the Kirkuk-Ceyhan pipeline, with payments for oil delivered at Ceyhan to be made into an escrow account in Turkey until Erbil and Baghdad reached agreement on revenue sharing;
- Participation by a state-backed enterprise, the Turkish Energy Company, in 13 exploration blocks in the KRI;
- Construction of a new pipeline to enable the KRI to export as much as one million b/d, since there would otherwise be problems in conveying heavy crude oil from the Shaikan field to Ceyhan;

- Developing the necessary gas pipeline infrastructure to enable the KRI to export as much as 20 bcm/y, with deliveries expected to start in 2017.

In a global geopolitical context, the most important energy issue concerns oil transit through Turkey from both federal Iraq and the KRI. For Turkey itself, however, development of gas within the KRI is at least equally important.

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The oil issue concerns oil exports from both federal Iraq and the KRI via the main Kirkuk-Ceyhan pipeline and a feeder line into that system from fields in the KRI. This pipeline was developed in the 1970s to handle Iraqi shipments to destinations in Europe and North America. More recently, particularly as the KRI developed an effective government in the late 2000s and early 2010s, it became an outlet both for oil produced within the KRI and for limited volumes of oil produced within federal Iraq, primarily from those portions of the giant Kirkuk field under federal control.

However, as a result of persistent damage to the Iraqi section of the line in the turbulent years since Saddam Hussein was overthrown in 2003—and particularly as a consequence of the war with ISIS—federal Iraq ceased to use the line. During these years, the KRG, aided by the construction of a feeder system within the KRI to a junction with the Kirkuk-Ceyhan line at the Turkish border point of Fish Habur, became the line's sole user.

Now that Baghdad, which currently exports almost all of its oil via marine terminals in southern Iraq, has eliminated insurgent threats to the Iraqi section of the Kirkuk-Ceyhan line, it is prepared to consider resuming Kirkuk area exports via Ceyhan. Indeed, one of the first reported comments of Iraq's new oil minister, Thamir Ghadhban, who took up his position on 24 October 2018, was that Baghdad planned to start oil export talks with the Kurdish authorities.[1] But consideration and implementation are quite different matters, as was demonstrated in a statement on 5 November 2018 by Baghdad's Oil Ministry spokesman, Aasim al-Jihad, when he said:

[1] Nayla Razzouk and Abbas Al Lawait, "Iraq's Kurds Add Pipeline Capacity to Export Kirkuk Oil," *Bloomberg,* 4 November 2018, https://www.bloomberg.com/news/articles/2018-11-04/iraq-s-kurds-add-capacity-to-oil-pipeline-to-export-kirkuk-crude

> So far no final decision with regards to increasing the production rates of Kirkuk's oil has been made, and no agreement for the mechanism of exporting Kirkuk's oil through using the pipeline network for export of Kurdistan Region's (oil) to the Ceyhan port or dealing with the matter in another form has been reached.[2]

In principle, a resumption of federal exports through Ceyhan could be accomplished through rehabilitation of the existing Iraqi section of the line, or a replacement pipe within federal Iraq, or use of the pipeline system within the KRI – or a combination of these. In technical terms, the simplest would probably be to use the KRI system. Indeed, on 4 November 2018 the KRG announced that it had expanded the capacity of its own line from the Shaikan field to the Turkish border from 700,000 b/d to 1,000,000 b/d, saying: "This extra capacity will accommodate future production growth from KRG producing fields, and can also be used by the federal government to export the currently stranded oil in Kirkuk and surrounding areas."[3]

But major obstacles must first be overcome. For more than a decade, Baghdad and Erbil have failed to resolve their dispute over federal Iraqi payments to Erbil—overwhelmingly derived from oil exports—and the handling of income derived from the sale at Ceyhan of oil produced in the KRI. The result is that Baghdad does not wish to pursue a major resumption of oil exports via Ceyhan until it is clear that payments for such sales will be paid to the State Oil Company for Marketing of Oil (SOMO). This is because Baghdad wants to ensure that revenues secured from oil exports at Ceyhan will not be seized or legally frozen by the KRI as a consequence of continuing disputes over the central governments revenue-sharing with the KRG within the national budget.

Fallouts of the Iraqi Kurdistan Referendum

Then, there is the question of Kirkuk and the referendum on 25 September 2017. The Kirkuk oil field has three domes, which are geological formations that effectively constitute distinct producing areas. One of these domes, Khurmala, falls clearly within the KRI and its output constitutes a major element of current KRI oil production. But in June 2014, when the Iraqi army abandoned the Kirkuk area in the wake of the fall of Mosul to ISIS, the Kurdish Peshmerga forces secured full control of Kirkuk, a city the KRG regards as an integral part of Iraqi Kurdistan, along with the other two domes, Avana and Baba.

[2] "Iraq halts Kirkuk oil to Iran for domestic reasons, won't use KRG pipeline," *Rudaw,* 4 November 2018, http://www.rudaw.net/english/business/041120181. For federal Iraq, the situation is modestly exacerbated by the fact that, as a result of the reinstitution of US Sanctions against Iran in November 2018, Baghdad has decided to halt the trucking of some 30,000 b/d of oil from Kirkuk to Iran.

[3] Ministry of Natural Resources, Kurdistan Regional Government, "KRG Update on Oil Production and Operations," http://mnr.krg.org/index.php/en/press-releases/605-krg-update-on-oil-production-and-operations

This effectively doubled KRG output, which reached its peak in September 2017 when deliveries from the KRI through the Kirkuk-Ceyhan line reached 609,000 b/d. But September was also the month in which the KRG held a referendum to ask the Kurds of northern Iraq whether they wished to move from autonomy to outright independence.

For the KRG, holding the referendum—which resulted in a 93 percent vote for independence—was a chance to prove that the Kurds of northern Iraq really did want independence from Baghdad. It was held despite strong warnings from both Baghdad and Ankara, and against the advice of governments in the West and elsewhere, whose companies are deeply involved in developing KRI oil and gas resources. Following the referendum, Baghdad immediately dispatched troops to the north and the KRI rapidly lost much of the Kirkuk region as well as most of the Kirkuk oil field to Baghdad.

"For more than a decade, Baghdad and Erbil have failed to resolve their dispute over federal Iraqi payments to Erbil."

These developments resulted in a massive contraction of KRI exports and revenues. In November 2017, exports via Ceyhan fell to a nadir of just 246,000 b/d. The latest firm figures showed exports via Ceyhan running at 316,000 b/d for the first quarter of 2018. Matters appear to have improved since then, with the KRG's Ministry of Natural Resources declaring on 4 November 2018: "The KRG currently exports over 400,000 b/d of crude oil."[4]

Nonetheless, such levels mean that current production (since exports account for well over 80 percent of total KRI output) is still running at less than half the one-million-barrel-a-day rate—an aspiration that the KRG viewed prior to the referendum as the basis of securing the economic foundation of an independent Kurdish state.

In terms of revenues generated from oil sales—the backbone of KRG finances—the impact has been massive. In the first half of 2017, KRG net revenues from oil exports (a figure that allows for payments to companies, including settlement of previous debts) amounted to 3,328.2 million dollars. In the second half of 2017, thanks to particularly high third-quarter sales, the comparable figure was 1,999.2 million dollars. But in the first half of 2018, it was down to just 648.6 million dollars.

[4] Ministry of Natural Resources, Kurdistan Regional Government.

Nor can the KRG necessarily rely on major supply increases from other fields in the KRI to improve the situation. At Taq Taq, where Turkey's Genel Energy was producing 75,500 b/d in 2012, when in 2013 it was anticipating eventual production of perhaps as much as 200,000 b/d, major downgrades of recoverable reserves have been accompanied by a fall in actual production to just 12,800 b/d in the first half of 2018. This is now said to be a stable production level that Genel Energy says "provides a solid base from which to ramp up activity at the field." Likewise, Gulf Keystone Petroleum Company (GKP) has failed to live up to its 2014 goals of producing 66,000 b/d in 2016 from its heavy oil field at Shaikan and then rising, at some unspecified date, to 100,000 b/d. In practice, output at Shaikan climbed promisingly from 16,000 b/d in 2014 to 35,500 b/d in 2015, but has since stalled and was running at just under 32,000 b/d in the first half of 2018. Moreover, the KRI's dependence on the Turkish route remains near absolute, since the only alternatives are small scale (and often smuggled) deliveries by tanker trucks to Iran or to federal Iraq.

These volumes have been just enough to ensure that oil producers such as Genel Energy at Taq Taq, GKP at Shaikan, and the Norwegian-Emirati DNO oil company at Tawke and Peshkebir receive their due payments on a regular basis. However, these payments remain dependent on Turkish transit, and both the companies and the KRG in Erbil remain well aware of Turkey's ability, if it so chooses, to turn off this tap. On 26 September 2017, the day after the referendum, President Erdoğan visited the Habur border to witness joint military exercises with federal Iraqi troops. He warned that if the Kurds declared independence then they "will be left in the lurch when we start imposing our sanctions." He added: "It will be over when we close the oil taps, all (their) revenues will vanish, and they will not be able to find food when our trucks stop going to northern Iraq."[5]

In essence, the President was making the point that Turkey cannot tolerate an independent Kurdish State because of the implications for his own fight against Kurdish separatists in Turkey and their associates in Syria. For the time being, at least, this means that stability for foreign investors in the KRI hinges on the KRG continuing its current policy: favoring independence in the long-term but avoiding any further moves towards independence in the short-term. At present, and almost certainly for quite some time to come, the Turkish government will focus far more on dealing with Baghdad in energy matters than in dealing with Erbil. This represents a radical transformation from the situation in 2013 when the then Prime Minister Recep Tayyip Erdoğan and KRI President Masoud Barzani presided over the November energy accords.

[5] "Barzani's decision to hold referendum 'betrayal to Turkey,' Erdoğan says," *Hürriyet Daily News,* 26 Septmeber 2017, http://www.hurriyetdailynews.com/barzanis-decision-to-hold-referendum-betrayal-to-turkey-erdogan-says-118415

"The KRG incurred major losses as a result of the independence referendum—including losing much of the Kirkuk region as well as most of the Kirkuk oil field to Baghdad."

The transformation is particularly relevant with regard to gas, since gas development in the KRI, as demonstrated by the 2013 accords, is largely predicated on accessing the Turkish market or markets reached via Turkey.

Turkey's Genel Energy is the foremost current investor in gas development in the KRI, although this may well change with the entry of Russia's Rosneft into this sector. Genel Energy has two significant gas fields in the KRI: Miran and Bina Bawi. But it has run into trouble developing them.

In November 2015, KRG Minister of Natural Resources Ashti Hawrami and Genel Chairman Tony Hayward jointly declared the KRI should be able to start delivering up to 10 bcm/y to Turkey in approximately 2018 or 2019 and double that amount in the early 2020s. At first, it looked as if progress might be made quite quickly. Botaş, Turkey's state-owned gas pipeline company, organized a tender for the construction of a key component of the necessary export infrastructure, a 20 bcm/y capacity pipeline from Şırnak on the Iraqi-Turkish border to a connection with the Turkish grid at Mardin. However, when initial bids were evaluated in February 2016, the lowest bid came in at 4.8 million dollars above the 25 million dollar target level, so Botaş re-tendered the 185-km project.

At this point, the situation gets a little murky. Market reports indicate that Botaş accepted an offer from a Turkish company, Vemak, on 26 April 2016 and that Vemak began work on the project on 4 August 2016. Yet, there is little indication as to what actual progress has been made since then. Furthermore, sources involved in facilitating improved KRG-Turkish energy relations in the wake of the referendum say they fear that there has been no real development of this project in the last year or so.[6]

Equally important, Genel Energy's development of the gas fields that were originally expected to fill much of this line, Miran and Bina Bawi, slowed down as Genel experienced severe financial problems. Particularly in the wake of the referendum, Genel became increasingly inclined to look to other areas beyond Turkey for possible oil and gas production projects.

[6] Telephone interview with source, 26 October 2018.

When Hawrami and Hayward were voicing their optimism concerning large-scale KRI gas exports to Turkey, Genel was trying to develop a 5.4 billion dollar project in which it would be responsible for upstream development at Miran and Bina Bawi in the KRI. These fields have around 320 bcm of gas in place (technically, gross mean raw gas) and should be able to yield around 240 bcm of gas for actual sale (technically, gross mean sales gas). The fields also contain around 80 million barrels of liquid hydrocarbons. Output would be sold to the KRG, which would then pipe the gas to a midstream company for processing. While upstream development would initially only cost around one billion dollars, with a further 1.9 billion dollars required over the life of the fields, the midstream company's work would require some 2.5 billion dollars in investment.

As recently as February 2017, Genel was optimistic that it could speed up field development at Miran and Bina Bawi with the signing of fresh agreements covering the original Production Sharing Agreement (PSA). and the terms under which output from Miran and Bina Bawi would be "lifted"—in other words, supplied—to the KRG.

Genel stated: "With the production sharing contract and gas lifting agreement (GLA) terms formally confirmed, Genel will now be able to progress the project. The company remains committed to developing these large scale, low-cost, onshore gas fields, which will form the cornerstone of gas exports to Turkey under the 2013 KRG-Turkey gas sales agreement."[7] In practice, however, progress was limited and in January 2018, Genel secured a 12-month extension, so that it currently has until 9 February 2019 to fulfill the terms of the GLA.

The problem Genel faces is that the GLA provides for the execution of final agreements on both the midstream gas processing facilities and pipeline transportation. While the role of Rosneft in developing pipeline infrastructure is now well-established, the question is whether the Russian giant will take a stake in the vital midstream company, since, at present, there appear to be no other prospective investors.

The Role of Rosneft

The decline in Genel's fortunes stemming from its setbacks at Taq Taq means it is no longer the most important player in KRI gas development. In practice, that role has been assumed by Rosneft. Indeed, it is reasonable to argue that Rosneft is now the most important single player in both Kurdish oil and gas development.

[7] "Genel to Begin Developing Miran and Bina Bawi Gas Fields," *Alliance News*, 13 February 2017.

In February 2017, Rosneft and the KRG signed a cooperation agreement covering upstream investment, infrastructure, logistics, and trading. This was expanded in June when they agreed "on monetization of the export oil pipeline in Iraqi Kurdistan" and agreed in principle on a number of PSAs. On 18 September 2017, the two sides amended their agreements to include, as the KRG announced, "the construction of a natural gas pipeline to supply power plants and factories in the Kurdistan Region and provide significant volumes of natural gas for export to international markets such as Turkey and the European Union."[8] *Reuters* reported that the line was expected to cost more than one billion dollars and that it would have a 30 bcm/y capacity, meaning that it would be built on the same scale as such major regional infrastructure projects such as the Southern Gas Corridor from Azerbaijan to Italy or Russia's TurkStream pipeline to Turkey and beyond.[9]

> *"Stability for foreign investors in the KRI hinges on the avoiding any further moves towards independence in the short-term."*

All of these developments preceded the fateful referendum on 25 September 2017. What really matters is what happened after the referendum. On 18 October 2017, Rosneft first signed the documents required to give force to its five PSAs, in which it will have an 80 percent stake and for which it would pay around 400 million dollars. Then on 19 October 2017, it took a 60 percent stake in the oil pipeline that carries exports from fields in the KRI to a junction on the Turkish border with the Kirkuk-Ceyhan line. According to subsequent reports, by the end of 2017, Rosneft had transferred no less than 2.1 billion dollars to the KRG, effectively valuing its contracts in the KRI at well over 3 billion dollars.

In practice, Rosneft's transfers more than covered revenue losses incurred in the last quarter of 2017 as a result of the recapture of Kirkuk by Iraqi federal forces. However, while this infusion was no doubt both welcome and necessary, the underlying question remains: Will Rosneft will be able to help the KRG find alternative ways of securing long-term hydrocarbon revenues?

[8] Ministry of Natural Resources of the Kurdistan Regional Government, "KRG and Rosneft Deal on Construction of Natural Gas Pipeline, Exports Expected in 2020," 18 September 2017, http://mnr.krg.org/index.php/en/press-releases/596-krg-and-rosneft-deal-on-construction-of-natural-gas-pipeline,-exports-expected-in-2020

[9] Dimitry Zhdannikov, "Russia's Rosneft clinches gas pipeline deal with Iraq's Kurdistan," *Reuters,* 18 September 2017, https://uk.reuters.com/article/uk-kurdistan-rosneft/russias-rosneft-clinches-gas-pipeline-deal-with-iraqs-kurdistan-idUKKCN1BT1G8

On 25 May 2018, Rosneft and the KRG took a major step towards achieving this objective when they signed an agreement to undertake a detailed analysis of potential gas cooperation options which, Rosneft stated, "will elaborate an integral plan to progress the gas business within the Kurdish Region of Iraq."[10] Rosneft added:

> One step in this plan is the conduct of a pre-FEED (Front-End, Engineering and Design) of Iraqi Kurdistan's gas pipeline construction and operation. This is a key project to the monetization of the exploration and production opportunities Rosneft has been evaluating since signing a Gas Cooperation Agreement with the Kurdistan Regional Government of Iraq at the 10th Eurasian Economic Forum in Verona on 19 October 2017.[11]

Turkey's attitude is likely to prove crucial in determining the outcome of this initiative. In commercial terms, the logical markets for KRI gas are neighboring regions of Iraq, notably the areas around the devastated city of Mosul which could make good use of Kurdish gas for power generation, and regional markets in southeast and southern Turkey. But so long as Erbil remains at odds with Baghdad over a vast range of issues, and so long as Baghdad's finances prove sufficient to provide fuel and power to Iraq's war-stricken regions, it can prevent KRI gas heading for Mosul. Turkey, however, still constitutes a big opportunity, both as a market in itself and, if KRI gas were really to take off, as a transit route for gas to access export markets further afield by means of the Southern Gas Corridor.

Rosneft acknowledged that the path might not necessarily be easy when it concluded its own announcement of the agreement with these cautionary words: "Following the outcomes of the integral development plan in terms of the attractiveness and efficiency of the options, Rosneft will decide on how to participate in the regional gas business."[12]

As politicians and businessmen come to terms with the post-referendum reality of reduced revenues for the KRI, and as the KRG confronts the chilly post-referendum winds blowing from Ankara, the KRI's leaders are compelled to rely on a combination of old and new forms of energy diplomacy. The old form essentially consists of what is left of the personal rapport between KRG President Barzani and the cross-border commercial interests of prominent Turkish and Iraqi Kurdish businessmen and politicians. The new form essentially consists of reliance on fresh intermediaries, most notably Rosneft, both to bridge the immediate gulf between

[10] "Rosneft and The Kurdistan Regional Government of Iraq signed Gas Business Development Agreement for Kurdish Region of Iraq," *Oil and Gas Daily,* 25 May 2018.

[11] Oil and Gas Daily (2018).

[12] Oil and Gas Daily (2018).

Erbil and Ankara, and possibly even the gulf between Erbil and Baghdad, and to provide hard cash to keep the KRI economy afloat.

It has been a tough task in the past. Now, federal Iraq is growing in strength and therefore, as it demonstrated with its takeover of Kirkuk in 2017, it is increasingly able to impose its own will on controversial issues. The KRG faces an even tougher task these days in balancing its aspirations to become both a leading oil and gas exporter and to transform the KRI into a fully independent nation.