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MEMORANDUM September 10, 2014

To: Senate Energy and Natural Resources Committee
Attention: Tristan Abbey

From: Robert Pirog, Specialist in Energy Economics,

Subject: **Kurdish Oil Exports and U.S. Policy**

This memorandum is written in response to your request for information and analysis of the issue of Iraqi-Kurdish oil exports and the policy position of the United States. In your request, you posed four separate questions which will be answered in the following sections of this memorandum. The questions to be addressed include, what prevents the Kurds from exporting more oil, what is the U.S. policy on Kurdish oil restrictions, what are the potential gains and losses with respect to changing U.S. policy, and what is the current status of Kurdish oil exports?

Background[1]

Iraq is a major producer and exporter of crude oil, with proved reserves estimated to be the world's fifth largest at 115 billion barrels as of January 2013. However, Iraq's oil resources are unequally spread over demographic-sectarian lines. Most of Iraq's oil reserves, 60 percent, are concentrated in five super-giant fields in the south, while 17 percent of reserves are in the north of Iraq. The southern area of Iraq is under Shiite control, while the northern area falls largely, although not entirely, under Kurdish control. The Sunni minority, concentrated in the center of Iraq, have few oil resources under their control. Sectarian lines have tended to define recent Iraqi political debate and dialogue, with the control and manipulation of oil policy frequently serving as the means to transmit political disagreement. Since the spring of 2014, a new element, the Islamic State (IS), has disrupted Iraqi political calculations, as well as northern Iraqi oil production.

The Iraqi Ministry of Oil oversees oil and natural gas production and development through operating companies. The North Oil Company (NOC) operates in the northern regions, in some proximity to the Kurdish areas which are controlled by the Kurdistan Regional Government (KRG). Other Iraqi operating companies operate in the southern and central regions of Iraq.

The KRG has been involved in conflicts with the national government (NG) concerning oil sovereignty issues. The KRG passed its own hydrocarbons law in 2007 after years of attempting to pass a national hydrocarbons law apparently failed. Both sides have objected to new and past agreements signed with

[1] For more detailed information on Iraqi oil issues, see Energy Information Administration, Iraq Country Analysis Brief, available at http://www.eia.doe.gov. This section of the memorandum is based on material contained in that Brief.

major international oil companies for development and production which have a direct effect on how oil revenues are divided. Direct oil exports by the KRG are another area of conflict and the focus of this memorandum.

The oil sovereignty and export issue became critical to the KRG in February 2014 when the NG cut off funding of the KRG budget. Prime Minister Barzani of the KRG announced in an interview published on April 28, 2014 that Kurdish pipeline oil would be available for direct sale on May 2, 2014.[2] The first cargo of KRG oil was loaded for export on May 22, 2014, although subsequent legal action brought by the NG has challenged these exports.

Kurdish Oil Exports

Potential growth of Kurdish oil exports depends upon three factors; technical issues, mostly concerned with pipelines, legal issues with the NG concerning the ownership of oil from the KRG, and security issues, both military and political. While it appears that the situation regarding technical issues is improving, there is little sign that outstanding legal issues are near resolution, and the military-political security situation is uncertain.

Technical Issues

Assessing the capabilities of the northern Iraq pipeline capacity from Kirkuk to Ceyhan (Iraq-Turkey Pipeline) in 2012, the EIA described a system within Iraq that had physically deteriorated and had also been subject to repeated disruptions. As a result, the EIA reported that the capacity of the line was less than one half of its design capacity of 1.6 million barrels per day (b/d), and might be as low as 300,000 b/d.[3] The KRG has recently completed upgrades on a separate pipeline within Kurdish territory, linking to the Iraq-Turkey pipeline at the Turkish border. While KRG oil must still transit the Iraq-Turkey pipeline within Turkey, and hence remain under the observation of the NG, this new, enhanced line allows Kurdish oil to avoid the frequently disrupted Iraq-Turkey line within northern Iraq.

It has been reported that the recent improvements in the KRG pipeline to the Turkish border would raise the flow of oil from about 100,000 b/d to as much as 250,000 b/d this year. Kurdish oil production, according to the KRG will average 400,000 b/d in 2014 and increase to about 1,000,000 b/d in 2015 and double that amount in 2019.[4] The volume of KRG oil shipped into Turkey for export by pipeline has been supplemented by truck shipments. While the NG has not, in practice, tried to disrupt truck shipments, they have challenged the legality of pipeline exports.

The KRG must find export markets for its crude oil if production is to continue. The storage capacity at Ceyhan dedicated to Kurdish oil is said to have a capacity limit of 2,500,000 barrels. It was reported that the tanks were at full capacity at the end of July, 2014, with the result that the pipeline to Turkey was being shut down for approximately one week.[5] The KRG must also find export markets for its crude oil to finance the government and continue the ongoing military action against the forces of the Islamic State (IS).

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[2] International Oil Daily, "KRG Prime Minister Pledges Direct Kurdish Sales This Week," April 29, 2014.

[3] Energy Information Administration, Iraq Country Analysis Brief, available at www.eia.doe.gov.

[4] Ali Berat Meric, Selcam Hacaoglu, "Iraqi Kurds, Turkey to Double Oil Export Pipeline Capacity," Bloomberg, August 20, 2014, available at www.bloomberg.com.

[5] Iraq Business News,"Kurdish Oil Tanks Full in Turkey," July 31, 2014, available at www.iraq-businessnews.com.

Legal Challenges

On May 23, 2014, one day after the first tanker was loaded in Ceyhan with KRG oil, the NG opened arbitration proceedings against the Turkish government and the state-owned pipeline operator, Botas, in an attempt to prevent KRG oil exports. The NG's contention was that the loading violated the Iraq-Turkey Pipeline Agreement, specifically article 2.4, which states that oil capacity on the pipeline, "shall be exclusively assigned to load the crude oil coming from (federal) Iraq".[6]

The next day, May 24, 2014, the NG threatened legal and commercial action against port inspectors at Ceyhan following the first export of KRG pipeline delivered crude oil.[7] The KRG claimed the NG action was inconsistent with NG policy which had allowed truck borne exports of crude oil.

The next NG legal action, on July 28, 2014, against the KRG regarding oil exports, was in the U.S. courts in Texas. The issue was the concern that a shipment of Kurdish oil might be brought into U.S. territorial waters and unloaded. The NG contended that the oil was contraband, or stolen oil, and should be seized. The court's decision ordered seizure of the cargo should it enter U.S. waters. The following week the KRG filed a motion to vacate the court order issued by the Texas U.S. court. This stage of the legal proceedings is documented in the memorandum by the Law Library of Congress, Global Legal Research Center, which you provided to me for my use.

On September 8, 2014, it was reported that the NG is suing a shipping firm, Marine Management Services, for its activities related to "the illegal export of Iraqi crude by the KRG." The NG is suing for $318 million, and possibly significantly more, according to the Iraqi Oil Ministry.[8] Marine Management Services, based in Greece, is the owner of the *United Leadership*, the first tanker to load a cargo of KRG crude oil.

These legal actions taken together suggest that the NG is challenging the export of KRG oil at various links in the supply chain. These include the pipeline, the port, the shippers, and ultimately the final purchasers if these can be identified. It is likely that the NG strategy is to force any party associated with the export of KRG oil into long, expensive legal proceedings that might result in large penalties and damages being assessed. In a world oil market in which alternative supplies are readily available, this legal strategy is likely to have some success.

Security Issues

The military situation in northern Iraq has been difficult since the spring 2014 offensive by the IS. The NG has been unable to export any crude oil through the Iraq-Turkey pipeline due to disruptions to production and damage to the pipeline itself. While direct damage to KRG oil production and transportation facilities appears to be limited, uncertainty has prevailed as international oil companies have evacuated some employees and it is likely that development plans have been put on hold or slowed until the political situation is more stable.

[6] International Oil Daily, "Baghdad Launches Legal Counterattack Against Ankara," May 27, 2014.

[7] International Oil Daily, "Baghdad Warns Port Inspectors Over Kurdish Sales," May 28, 2014.

[8] International Oil Daily, "Baghdad Widens Legal Offensive Against Kurdish Oil Exports," September 8, 2014.

U.S. Policy Concerns

On August 26, 2014 it was reported that U.S. State Department spokesperson Jen Psaki, in a daily briefing, reiterated that U.S. policy on Kurdish oil exports and sales had not changed. According to Ms. Psaki, the United States has urged the KRG and the NG to find a common mechanism to solve oil disputes. Media reports suggest that the United States has applied pressure to foreign governments to reject shipments of KRG oil without the permission of the NG.[9]

U.S. policy on this issue could develop in three directions, it could remain the same, it could be more open to KRG exports, or it could increase the pressure on countries around the world to exclude KRG oil shipments. Since the policy decision affects conflicting U.S. interests, trade-offs among various policy objectives are likely.

Several policy concerns are likely to be affected by the U.S. position on KRG oil exports. The desire for greater autonomy, or even separation by the Kurds from Iraq would likely be enhanced if the KRG had a large, independent source of revenue. If oil exports approached the levels projected by the KRG, 1 million b/d, at current oil prices those exports could yield gross revenues of about $100 million per day. Revenues of that magnitude could make the KRG fiscally independent of the NG. The further separation of the KRG from the NG would likely be encouraged by a U.S. policy more favorable to Kurdish oil exports, however, a U.S. policy position less favorable to Kurdish oil exports might also increase the tensions between the KRG and the NG. The most favorable outcome for the United States would appear to be a fair Iraqi oil law, agreed upon by all factions in Iraq, as recognized by Ms. Psaki in the cited State Department briefing. If the Kurds were to successfully break away from the NG it might make it more likely that the further disintegration of Iraq might result. The Shiites in southern Iraq might choose to keep their own oil revenues and separate from the Sunnis leaving Iraq fractured.

If the KRG received adequate revenues, either directly from oil exports, or through the NG, it might become a more effective fighting force against the IS. Kurdish forces have had some success against IS fighters when supported by U.S. airstrikes. The KRG's ability to buy weapons with monies derived from oil sales, as well as the pesh merga's morale, might be increased if the KRG could be assured of adequate revenues to meet government employee payrolls. However, if greater oil export earnings for the KRG also resulted in the breakdown of Iraq as a nation, this might reduce the aggregate ability of all the Iraqi factions taken together to resist the IS.

If a change in U.S. policy on KRG oil exports is viewed within Iraq as the United States picking sides within the larger sectarian struggle, the result might be an over-all reduction in U.S. influence and co-operation within Iraq. The ability of the United States and Iraqis to resist the IS might be negatively affected. This factor might suggest that the stated policy of the United States on KRG oil exports might not change.

The effect of KRG oil exports on world oil markets is likely to be important, especially if volumes were to approach 1 million b/d.[10] On balance, even though political and military disruptions threaten supply in several areas of the world, the increasing oil supplies available from North America, coupled with relatively weak demand growth have led to some moderation in the world oil price. An additional source of new supply on the world market could lead to declining oil and petroleum product prices. Reduced prices for gasoline and other petroleum products could stimulate overall demand in the United States and

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[9] See transcript at, http://www.state.gov/r/pa/prs/dpb/2014/08/230911.html#SYRIA.

[10] For perspective 1 million b/d is about 5.5% of U.S. daily consumption, and 1.1% of world daily consumption.

other consuming countries. If world oil market effects were the major concern, this might suggest that the United States might choose to encourage maximal oil exports from all areas.

Turkey, a North Atlantic Treaty Organization member, appears to be forging stronger ties with the KRG by allowing KRG oil to pass through Turkey, even in the face of legal action from the NG in Baghdad as well as investments in the KRG's ability to develop and produce oil. Any U.S. policy change with respect to KRG oil exports will likely have to balance the effects on U.S. relations with the KRG, Iraq, and Turkey.

KRG Export Status

The controversy between the KRG and the NG over oil exports has made it difficult to track Kurdish oil leaving the Turkish port of Ceyhan. Tankers have changed names, turned off transponders that document location and in general, have tried to mask their destinations. However, some information concerning Kurdish oil loading and location has been reported, as shown in **Table 1**.

Table 1. KRG Ceyhan Pipeline Crude Exports 2014

(thousand barrels)

Date	Volume	Vessel
May 22	1,049	*United Leadership*
June 19	1,048	*United Emblem*
June 21	999	*United Emblem*
June 23	1,049	*United Kalvryta*
July 31	1,049	*Kamari*
August 3	258	*Phoenix An*
August 9	1,065	*Kamari*
August 14	259	*Phoenix An*
August 22	317	*Angelica An*
August 24	944	*Ultimate Freedom*
August 28	600	*United Carrier*
Total	8,637	
Implied Pipeline Flow	88,132 barrels per day	

Source: International Oil Daily, September 3, 2014.

Notes: Implied pipeline flow derived by dividing total volumes by days between first loading (May 22) and most recent loading (August 28), 98 days.

It was reported that the *United Leadership* remains off the coast of Morocco. The *United Kalvryta* remains off the coast of Texas. In **Table 1**, the June 19 cargo of the *United Emblem,* as well as that of the *Kamari* appear to have gone to Israel. The *United Emblem* was off-loaded to the Russian owned *SCF Altai* which delivered the oil to the Ashkelon refinery in Israel.[11] The *United Emblem* returned to Ceyhan to take on another cargo of KRG oil accounting for the quick turn-around reported in **Table 1**. As of the

[11] International Oil Daily, "US Seen Weakening its Stance on Kurdish Oil Exports," July 28, 2014.

end of July 2014 the *United Emblem* and its cargo were reported to be in the vicinity of Singapore. It was reported that the *Ultimate Freedom* was sailing to Korea.[12] The Hungarian integrated oil company Mol contracted to buy 500,000 barrels of KRG oil on July 17, 2014, and dispatched a tanker to Ceyhan, but the tanker *Genmar Strength* refrained from loading at Ceyhan and it is uncertain whether the purchase will be completed.

KRG oil that enters Turkey by truck goes to three terminals near Ceyhan. Condensate, light sweet crude, and mixtures are sent to the Toros, Mersin, and Dortyol terminals respectively. It has been reported that third quarter 2014 truck exports by the KRG are totaling about 55,000 b/d, up by about 10,000 b/d over the first half of the year.[13]

Conclusion

Negotiations between the KRG and the NG with respect to an oil law that specifies a fair division of oil receipts between the key sectarian groups in Iraq have not been successful. An agreement that all parties embraced would likely be the best result for U.S. policy as well as the various groups in Iraq, but does not appear imminent, even with a new government in Baghdad.

Without an agreement on a division of receipts, the KRG must either export oil via pipeline to Ceyhan or cease producing oil. There is currently no alternative pipeline transportation route available other than the Iraq-Turkey pipeline. With funding from the NG cut off, the pressure on the KRG to produce and export oil is strong. The determination of the NG to prevent those exports through the Iraq-Turkey pipeline also appears to be strong. Any entity that involves itself with KRG oil exports is open to legal action instituted by the NG of Iraq.

[12] International Oil Daily,"Kurds Ratchet Up Exports, Increase Volumes Through Iraq-Turkey Pipeline," September 3, 2014.
[13] Ibid.