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Making the Iraqi Revenue-Generating Deal Work

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Leaders in Baghdad and Iraqi Kurdistan have taken a brave step toward reunifying the country through revenue sharing. The United States should support implementation of the deal.

On December 1 and 2, the federal Iraqi government and Kurdistan Regional Government (KRG) conducted three rounds of negotiations in Baghdad over the sharing of oil revenues in the 2015 budget. The talks marked the culmination of three months of intensifying discussion between federal and Kurdish leaders, which followed more than a year of U.S.-supported discussions between the two sides. The agreement also came against the backdrop of extremely challenging fiscal circumstances for Iraq caused by plummeting oil prices. The arrangement that emerged is foremost a "revenue-generating" rather than a "revenue-sharing" deal because it has been carefully crafted to generate new revenues for both Baghdad and the Kurds.

THE DRAFT BAGHDAD-KRG DEAL

In most years since the fall of Saddam Hussein's regime, the Iraqi federal government instituted a customary form of revenue sharing with the KRG, a subnational entity that encompasses three of Iraq's eighteen provinces. Based on a United Nations estimate that the Kurds constituted 17 percent of Iraq's population, the Kurds received 17 percent of Iraq's net state revenues (gross revenues minus sovereign expenses such as the military and federal oil-contractor payments). As a result, the Kurdish share of Iraqi gross revenues was actually around 11 percent, and dropped year after year as sovereign expenses grew. Against fiscal nitpicking between Baghdad and Erbil over revenue sharing, the Kurds began to independently produce and export oil. Baghdad sought to force the Kurds to contribute this oil to the federal export system, run by the State Oil Marketing Organization (SOMO), inserting punitive language into the 2013 and 2014 budgets to withhold Kurdish monthly budget transfers if SOMO did not receive the prescribed volumes of oil.

In early 2014, the government of Prime Minister Nouri al-Maliki acted on this threat, pushing the Kurds to the brink of bankruptcy and driving them to accelerate their independent oil exports to 300,000 barrels per day (bpd) in November 2014. This independent oil sales path has proceeded very successfully in 2014. Of the twenty-six tanker loads of KRG crude exported by November 1, twenty-five have been bought and paid into Kurdish-controlled bank accounts. The KRG is now exporting around 300,000 bpd of crude through a combination of pipeline and trucked exports. This means that after various deducted expenses, including contractor costs, the KRG can now draw on monthly revenues of around $380 million to set against its monthly salary requirements of around $670 million.

Under the auspices of U.S.-backed reconciliation talks, Baghdad and the KRG have been feeling their way toward a revenue-sharing deal for most of the last year. A deal almost unfolded in March 2014 whereby the KRG would allow its oil to be jointly marketed but only if Baghdad increased Kurdistan's share of Iraqi gross revenues by shaving $14 billion in federal petroleum costs off Iraq's sovereign expenses. Then, in November 2014 the KRG activated a long-planned confidence-building initiative, providing 150,000 bpd of oil to SOMO at the Turkish port of Ceyhan for the last fifteen days of November in return for a onetime payment to the KRG of $500 million. The new deal struck in recent days needs to be written into Iraq's draft 2015 budget law, and provides strong incentives to both Baghdad and the KRG to reintegrate their oil production and export activities.

- *What Baghdad gets.* The draft deal includes a KRG commitment to provide 250,000 bpd of KRG export blend to SOMO at Ceyhan, whereupon SOMO sells the oil using the same mechanisms used for selling oil from Basra or elsewhere in federally administered Iraq. The KRG also agrees to facilitate SOMO's export of 300,000 bpd of oil from the federally administered Kirkuk oil fields. Such oil cannot reach export terminals via federal territory due to insecurity and the destruction of pipeline infrastructure between Kirkuk and Mosul. Instead, Kirkuk oil might be exported via the KRG's secure internal pipeline network to Turkey. This combined 550,000 bpd of new exports will generate just under a billion dollars a month for Baghdad. As a goodwill gesture, the KRG is already providing SOMO with 150,000 bpd of KRG export blend at Ceyhan for the remainder of 2014.
- *What Kurdistan gets.* As a reciprocal goodwill gesture, Baghdad will grant the KRG a new $500 million payment in December 2014 to ease near-term budget pressure. Throughout 2015, the Kurds will see their monthly budget transfers from Baghdad restored. (If oil prices allow a $60 per barrel "netback" -- net revenue after production costs -- for Iraq, and if Iraqi export volumes are in the expected range of around three million bpd, the Kurds will receive around $600 million per month). The Kurds have not achieved a capping or significant reduction of sovereign expenses, but they will, for the first time, receive around $100 million in monthly salaries for their peshmerga fighters as a line item of the Iraqi Ministry of Defense budget -- in addition to their monthly transfers from the federal budget. In addition to these agreed items, there is a high probability that the KRG will implicitly maintain control of all KRG oil production in excess of the 250,000 bpd transferred to SOMO. This excess is currently 150,000 bpd and could be as high as 250,000 bpd by the second half of 2015. After satisfying domestic refining requirements of around 120,000 bpd, the Kurds will independently export the remainder and access further revenues in this manner, in part to pay their contractors -- who are not covered under federal petroleum costs.

U.S. SUPPORT FOR IMPLEMENTATION

Delivered through the energetic midwifery of Iraqi minister of oil Adil Abdulmahdi, the December 2 agreement between Iraqi prime minister Haider al-Abadi and KRG prime minister Nechirvan Barzani now needs to be approved by Iraq's body politic and institutionalized in the forthcoming 2015 budget. Key milestones and challenges include:

- *Drafting the 2015 budget.* The devil is often in the details, and now specific language must be written into the new budget law by a special committee charged with drafting the legislation. To stand the best chance of success, the budget needs to give Iraqi politicians as much latitude as possible in meeting the agreed oil volume targets. This may mean tiptoeing around issues like the KRG's use of excess oil production over 250,000 bpd. Likewise, as noted, the 2013 and 2014 budgets included punitive clauses concerning KRG nondelivery of oil. New efforts to include tough language in the 2015 budget could derail the initiative. All parties entered the current agreement voluntarily, due to mutual economic need and largely driven by domestic Iraqi considerations -- not international pressure, in a departure from previous revenue-sharing initiatives. Both sides can therefore afford to accentuate the positive and demonstrate good faith without issuing punitive threats. In general, the United States should offer its good offices during the drafting process to iron out misunderstandings and guide all parties to keep the budget language positive and not overly detailed.
- *Ratifying the budget.* The budget law needs to be ratified by a simple majority of the 328-seat Iraqi Council of Representatives. The United States should back all efforts by the Abadi government to build consensus for the budget. One potential source of opposition will be the fifteen non-KRG provinces, which receive services through the federal ministries and whose direct per-capita transfers from the federal government are much smaller than those received by the KRG. (Erbil funds its own ministries from the monthly transfers). Oil-producing provinces like Basra may be particularly disgruntled given that they produce oil but cannot directly sell any portion of it, as the Kurds do. U.S. officials and other international actors should reassure such provinces that they will support provincial demands to receive petrodollar royalties in the budget and foreign direct investment, and help develop project management capacity at the provincial level. Likewise, the United States can advise and assist emerging Iraqi government plans to establish Central Bank of Iraq-funded commercial and industrial development banks to provide loans to local businesses within the provinces.
- *Keeping the deal alive.* Any Baghdad-KRG deal will need to be monitored for lapses in implementation. With a Kurd, Hoshyar Zebari, heading Iraq's Ministry of Finance, and with monthly transfers flowing automatically once the budget is approved, the basic implementation of a deal may not be too complex or fragile. The payment of monthly peshmerga salaries introduces an element that could potentially be delayed by Baghdad politics, given that the defense minister needs to approve each payment. Using its leverage as a major security-cooperation partner, the United States should closely track these payments to prevent backsliding.
- *Coping with oil price volatility.* If the average price for Iraqi oil is $70, Iraq's netback is $60. In that case, the draft deal results in the KRG receiving just under $690 million per month from Baghdad -- $600 million in budget transfers plus $88.5 million in peshmerga salaries -- and may allow the KRG to receive around $300 million in monthly independent oil exports as well by mid-2015. This will more than cover the KRG's monthly salaries, which as noted are around $670 million. In a price scenario in which oil prices drop to $40 (with netback to Iraq of around $30 per barrel), both Baghdad and the KRG are critically underfunded. More important, the Kurds could be tempted to withdraw from the deal so as to make about $170 million more a month by independently selling all the KRG and Kirkuk crude -- assuming they still had access

to this and Turkey agreed -- from which they would get $685 million a month, as compared to about $515 million a month under the deal. The United States needs to pay careful attention to the calculations of both sides, particularly if they are under severe fiscal distress due to further oil price reductions. Turkey offers the best means of pressuring the Kurds to forgo destabilizing moves around Kirkuk.

- *Exporting Kirkuk's oil.* SOMO's export of Kirkuk crude is vital to ensuring Baghdad's fiscal upside in the deal, but building Kirkuk exports up to 300,000 bpd will not be easy. Since July, the KRG has extracted more than 120,000 bpd from Bai Hassan and Avana, oil fields that have historically been administered by the federal government's Northern Oil Company (NOC) and are considered "Kirkuk fields" by most Iraqi officials. There will undoubtedly be calls during 2015 for SOMO to regain access to oil from these fields. Baghdad will also seek help from international oil companies to boost production at the remaining NOC-administered Baba field, involvement that the Kurds have previously opposed due to Kirkuk's disputed status. Alternatively, the Kurds may seek to play a larger role within the NOC. U.S. mediation could prove very valuable in resolving disputes and finding common ground in these sensitive locations.

The draft agreement announced December 2 represents a brave step by prime ministers Abadi and Barzani, who are ably supported by oil ministers Abdulmahdi for the federal Iraqi government and Ashti Hawrami for the Kurds. The deal could be cynically used by either side to relieve short-term fiscal and political pressures, with no real commitment to see the agreement through in 2015. But if the deal catches on and is implemented, some profoundly positive outcomes could flow out of a workable revenue-maximizing and revenue-sharing deal in 2015. Export of 550,000 bpd of oil will buttress a desperately overstretched Iraqi war economy. Cooperation in the war against the Islamic State of Iraq and al-Sham, or ISIS, can be optimized, improving the chances of a joint federal-Kurdish recapture of Mosul in the first half of 2015. The basic fabric of Iraq might not only survive but even be strengthened by a successful experience of intercommunal power sharing. As Abdulmahdi said on November 20 at the Atlantic Council Summit in Istanbul: "Oil since the foundation of Iraq has been a reason for wars, and disputes. Now we want it to be a reason for peace, and cooperation."

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