Trouble or promise in the pipeline?

Kurdistan wants to export its own oil to Turkey, in defiance of Baghdad. Richard Devine and Patricia Tiller, from law firm Baker Botts, offer a forensic look at the legal implications

IRAQ'S Kurdistan region benefits from abundant hydrocarbon resources and is enjoying impressive economic growth and relative political stability. By contrast with other regions in Iraq, security conditions are benign and social infrastructure is good.

Major oil companies, including ExxonMobil, Total and Chevron, have made large investments in the region, although they remain troubled by uncertainty relating to the laws governing the hydrocarbon sector and the Iraq federal government's control of oil exports from Kurdistan.

This is more than an academic concern, as the federal government's control over oil revenues and exports has denied some producers in Kurdistan the benefit of their "cost oil" and "profit oil" entitlements.

However, the operating environment for oil and gas companies may be about to change dramatically.

Pipe dream: Kurdistan has plans for oil exports

Turkey deal

The Kurdistan Regional Government (KRG) recently struck a deal with the government of Turkey that will allow the KRG to export oil by pipeline to Turkey and handle oil revenues independently of the federal government. The announcement was not well received in Baghdad, where the federal government said it would take legal action against Turkey if it participated in the scheme. It issued the same warning to any buyers of crude exported by the KRG. At the same time, the draft 2014 federal budget requires Kurdistan to export (under federal government control) 400,000 barrels a day (b/d) of oil in order to qualify for all of the funds allocated to the region in the federal budget. Daily production now is estimated to be well short of this, making Baghdad's position an aggressive one.

The KRG and the federal government have long disputed the extent to which each should control and profit from Kurdistan's hydrocarbon sector, and ambiguity in the legal framework has been exploited for political gain by politicians on both sides.

Despite the merit of the legal arguments, however, the federal government's practical control of export routes and hydrocarbon revenues has given it significant leverage in the dispute with the KRG. The KRG's recently revealed export scheme could radically change that balance of power.

Since the Turkish government would enable the KRG's exports, its continued support will be critical to the success of the KRG's scheme. Turkey has an urgent need for more energy, so it has good reasons to support the plan, and to strengthen the already extensive trade ties it enjoys with Kurdistan. From a political perspective, however, the issue is fraught. The Turkish government must balance a number of factors, including its relationship with the federal government in Baghdad, the implications of a powerful Kurdistan region for Turkey's indigenous Kurdish population and Ankara's wider strategic goal to position itself as the region's foremost political power. What happens next will have a direct, possibly major, impact on international oil companies (IOCs) operating in Kurdistan.

While only a political solution can ultimately eliminate the uncertainty surrounding Kurdistan's energy sector, investors want to see a solid legal basis for the KRG's plans. Not everything is yet clear. Ashti Hawrami, KRG's natural resources minister, announced the deal with Turkey in December 2013, but the KRG has not publicly disclosed the contract. It is assumed that the KRG will export oil produced in the region through one of the two parallel lines that comprise the existing Iraq-Turkey Pipeline (ITP) that runs from Kirkuk – an Iraqi city outside the KRG's boundary, but to which certain Kurdish Iraqis lay claim – across the Turkish border to Ceyhan, on the Mediterranean coast. The KRG wanted exports to reach 2 million barrels of crude by the end of January, rising in steady increments to between 10 million and 12 million barrels in December 2014.

As well as the completed pipeline, the KRG intends to build a second crude export pipeline to Turkey over the next two years. A gas pipeline along the same route is also planned for completion by the end of the decade.

The federal government's position is that it should receive all revenues from oil exports from Iraq, including Iraqi Kurdistan. It will then allocate

them to the Iraqi governorates, including Kurdistan, in accordance with the federal budget. The KRG has a different position: Hawrami confirmed in December that it intends to control the revenues raised from oil sold via the independent export route, rather than remitting the proceeds to Baghdad. Revenue from Kurdistan's exports would be used first to pay IOCs, in accordance with their production-sharing entitlements, and then to buy refined fuel from Turkey. The KRG would only set aside surplus revenue for the federal government "in the next few months or years", Hawrami added, explaining that the KRG wants to recoup all of the money it is owed by the federal government first, including money to compensate it for damages suffered during Saddam Hussein's regime. This accords with the position taken by the KRG earlier in 2013, as indicated by its enactment of Law No. 5 of 2013 on Determining and Receiving the Financial Dues of the Kurdistan Region of Iraq from the Federal Revenues.

Existing exports by truck to Turkey have already established the model on which the KRG would base its new marketing deal. Under the existing arrangements, the KRG granted a Turkish-owned company, PowerTrans, marketing rights for designated volumes of oil supplied by the KRG. In return, the KRG pays PowerTrans a commission, which includes reimbursement of transportation and handling fees. PowerTrans remits part of the revenue to the IOCs in accordance with their contractual entitlement and disburses the rest to the KRG. The new marketing deal will follow the same structure, although the marketing agent will be the Kurdistan Oil Marketing Organisation (Komo).

IOCs will have several important questions about the proposed export route. If the KRG's export scheme proceeds as described by Hawrami, it would seem that all of the IOCs' oil entitlements would need to be transported through the ITP. Given Baghdad's stance, it isn't clear how that could happen. Moreover, the KRG's production-sharing contracts (PSCs) give IOCs the right and obligation to take in kind and separately dispose of their shares of hydrocarbons. Any arrangement that fetters the IOCs' marketing rights or their transportation options will not be acceptable to IOCs. Similarly, the KRG is not likely to accept any solution that transfers marketing and transportation risks from the IOCs to the KRG, unless the KRG is adequately compensated for assuming such risks.

The federal government has consistently stated that the Iraqi State Oil Marketing Organisation (Somo) has exclusive authority to export oil from Iraq, including any produced in the Kurdistan region. Revenue from Somo's exports goes to the federal government for disbursement to the Iraqi governorates and regions in accordance with the federal budget.

Unconstitutional

The federal government asserts that all petroleum contracts entered into by the KRG are unconstitutional and therefore invalid. Based on this position, Baghdad generally has not transferred to the KRG all of the proceeds from the sale of oil produced in Kurdistan. It has, from time to time, paid the KRG for the "cost oil" entitlement of the IOCs producing in the Kurdistan region, insisting that this is analogous to a reimbursement of costs paid for services. But that has left the KRG with insufficient funds to pay to IOCs producing in the region their full share of cost oil and profit oil.

In March 2013, the federal government passed a 2013 budget that fell short of the KRG's requested budget allocation by nearly $3 billion. In response to this, the KRG has sometimes halted exports, at least via Somo. Since last April, PowerTrans has exported some oil to Turkey by truck. There are also reports that oil has been transported in significant quantities by truck to Iranian ports for shipment to the UAE and on to Asia.

Much of the confusion stems from differing interpretations of Iraq's constitution. Until its enactment in 2005, the federal government's control over Iraq's hydrocarbons sector, established with the nationalisation of 1972, was unassailable.

The constitution still provides some support for the federal government's position: Article 112 states that "the federal government, with the producing governates and regional governments, shall undertake the management of oil and gas extracted from present fields". One interpretation of this provision is that the federal government, rather than the regions and governorates such as the KRG, is constitutionally entitled to take the lead role in hydrocarbon matters. While it is clear that the federal government's power must be exercised "with" the regional governments, arguably no independent power is given to the regional governments without the involvement of Baghdad.

However, another interpretation of Article 112 supports the KRG's position that it is entitled to independently market hydrocarbon resources produced in the Kurdistan region. This argument rests on Article 112's mention of "present fields" – fields under exploration or development when the constitution was enacted. The constitution is silent on how future fields are to be managed. A future field might be understood to mean any field where no commercial discovery had been made at the time the constitution was adopted. If so, it would include all the discoveries made by IOCs under the PSCs granted by the KRG. That is the KRG's interpretation. It says that the residual powers in Article 115 give it authority over future fields in the Kurdistan region, including the right to grant PSCs and to export the oil and gas they produce.

Article 115 provides that "all powers not stipulated in the exclusive powers of the federal government belong to the authorities of the regions and governorates…". The exclusive authorities of the federal government are set out in Article 110. There is no explicit reference to the federal government having exclusive authority in respect of oil and gas matters. Similarly, Article 114 sets out the powers to be shared between the federal government and the regional authorities. Again, there is no reference in Article 114 to oil and gas. Accordingly, the KRG can argue that the constitution does not stop it from legislating autonomously, making decisions, and awarding contracts for oil and gas produced from future fields in the Kurdistan region, or marketing the oil itself.

The counter-argument is that articles 110 and 114 are not relevant to determining who has authority over

oil and gas matters, since this issue is specifically addressed in Article 112.

Notwithstanding the KRG's position on all this, it historically appeared to accept that Somo was the only entity entitled to export oil from Iraq, with revenues to be handled and disbursed to the regions in accordance with the federal budget.

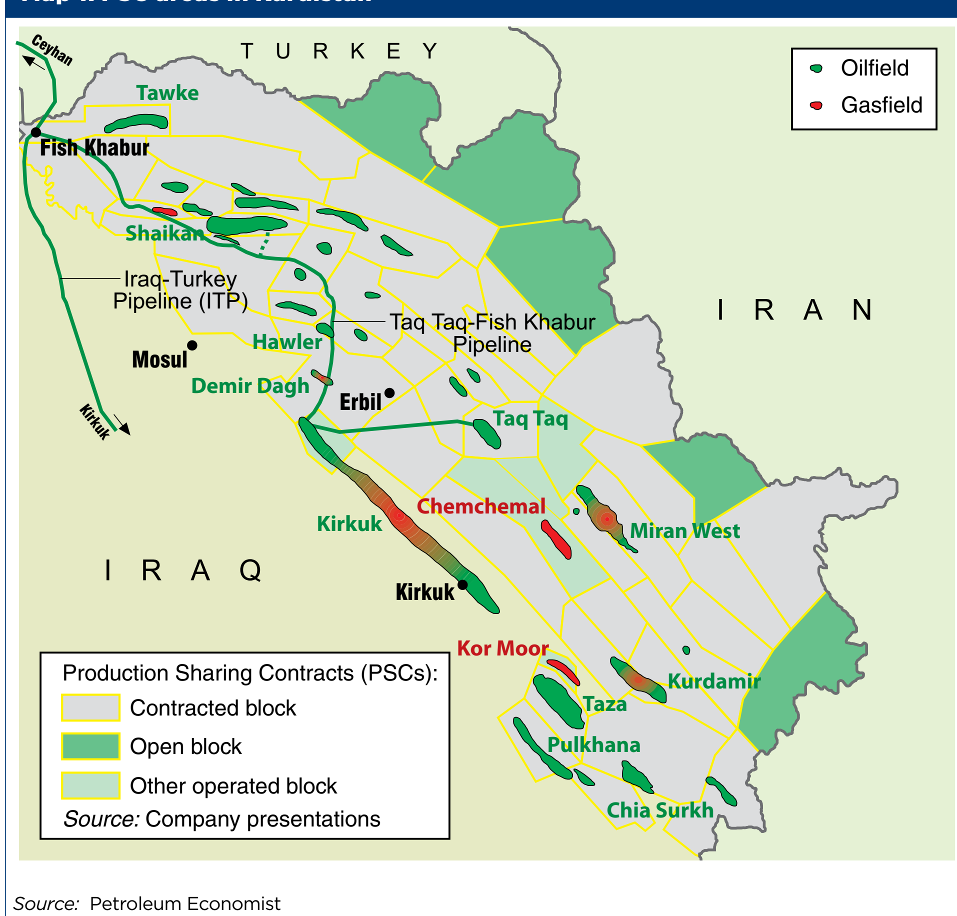
The legal basis for the federal government's position on oil exports appears to stem from Article 5 of the Organisation of the Oil Ministry Law No. 101 of 1976. It grants Iraq's oil ministry the exclusive right to manage the country's oil sector. In 1976, Order No. 1075 of the Iraqi Revolutionary Command Council gave the right to supervise and conduct marketing and all related activities to the vice president and Somo.

Originally, the KRG's practice on oil exports was consistent with the federal government's position, but that changed with the enactment of Law No. 5 of 2013. This piece of legislation sought to identify the federal government's obligations to the KRG in respect of, among other things, oil and gas revenue. It also refers to several categories, including a share of the federal budget derived from oil and gas revenue; a share of crude oil refined and prepared for domestic consumption; a share of the federal budget reserved for reconstruction and development projects; compensation for Saddam Hussein's repression of the Kurds; entitlements to grants, aid and international loans received by the federal government; and a share of "any other" resources or compensation earned by the federal government. Law No. 5 of 2013 attempts to provide the KRG with a self-help remedy in the event that the federal government fails to satisfy its constitutional obligations in respect of oil and gas.

Specifically, the legislation says that in such circumstances the KRG has the right to sell and export hydrocarbons produced in its region in order to recover money that the KRG calculates is owed to it by the federal government. Shortly after the KRG passed the 2013 legislation, PowerTrans sold the first cargo of Kurdistan's oil on the international market.

There is also the matter of the ITP. The existing twin pipeline from Iraq to Turkey was built in the mid-1970s after a 1973 pipeline deal between the Iraqi and Turkish governments. It is operated and maintained in accordance with a number of subsequent agreements, including the Iraq-Turkey Pipeline Expansion Agreement, of 30 July 1985, as well as a 2010 amendment to that agreement. The ITP had an initial capacity of 1.6 million b/d. However, damage to the pipeline during and after the Iraq war has left only one line functioning. Throughput in the pipeline last year was estimated to be just 250,000 b/d.

Map 1: PSC areas in Kurdistan



Source: Petroleum Economist

Export rights

The ITP agreements do not clarify who is authorised to export oil from Iraq, which is a matter of Iraqi law. That said, there is no explicit reference to parties other than the oil ministry as having the right to export oil from Iraq. A joint declaration issued on 19 September 2010 by the Turkish and Iraqi oil ministers also states specifically that the federal government and the Turkish government "confirm their commitment that the sole sovereign authorities for the exploration of Iraqi hydrocarbon resources are the Iraqi Federal Ministry of Oil and (Somo)". The legal effect of the declaration is uncertain. It may simply reflect the political situation at that time. The declaration does not, however, support arguments that any party other than the federal government is authorised to ship crude oil in the ITP.

Moreover, the ITP do not specifically state how the ITP is owned. From a legal perspective one might assume that the two governments own the part of the infrastructure that lies in their countries. Ownership implies a corresponding right to use or determine use. This is important, because ownership of the ITP may determine whether the KRG (or the Turkish government) has any right to use the ITP without the consent of the federal government.

In the KRG's favour, it is clear from the ITP agreements that the ITP is dedicated to "Iraqi oil". While there are no definitions of "Iraqi oil" in the ITP agreements, oil produced in the Kurdistan region would likely be considered "Iraqi oil" because the Kurdistan region is part of Iraq.

On the other hand, there are no provisions that suggest the ITP is a multi-user pipeline, such as provisions allocating capacity in the pipeline to different users. Nor do the ITP agreements include any provisions that would allow the KRG and federal government to determine the ownership of oil after it has entered the ITP. Although the ITP agreements are missing these basic requirements for a multi-user pipeline, if one line of the ITP is dedicated solely to oil

produced in the KRG and this stream is kept separate through to the point of sale in Ceyhan, as is understood to be the plan, then these issues will not present practical problems in relation to the federal government. These issues may, however, present practical problems in relation to IOCs.

While the ITP agreements appear to give the Iraqi and Turkish governments control over the ITP in their respective territories, there are no explicit rights in the agreements for Turkey to transport its own oil. In fact, there are a number of provisions which indicate the Turkish government has no right to transport its own oil through the ITP: for example, references to Somo as a shipper of oil, the federal government's exclusive rights to use any idle capacity in the ITP and the fact that it must pay the transit fees for all oil delivered to the Ceyhan port.

Given the lack of support for the KRG's position in the ITP agreements, it might try a different tack and argue that such agreements are irrelevant. For example, it might be argued that the ITP requires such extensive rehabilitation that if the KRG and/or the Turkish government undertook such work at their expense, the resulting pipeline should be considered as a different pipeline to ITP and no longer subject to the ITP agreements. The chances of such an argument being successful are difficult to evaluate – in part because no one yet knows how much work is needed or how it would proceed.

Even if the KRG were able to establish its authority to export oil, there are a number of logistical challenges to overcome. First, the KRG and federal government continue to debate metering of Kurdish exports. If the KRG must account for oil it exports independently, then the federal government has an active interest in metering of this oil.

Another concern will be the handling and storage of oil produced in Iraqi Kurdistan when it reaches Ceyhan. Until now, the storage facilities at Ceyhan that are part of the ITP have been dedicated to Iraqi oil and the ITP agreements appear to assume that they will be owned by a single entity. So Turkey will need to separate crude into discrete storage tanks if the KRG and Somo both ship oil through ITP, albeit through separate lines. The ITP agreements provide that the Iraqi federal government has exclusive rights to any idle capacity in the ITP. These provisions appear to extend to the facilities downstream of the pipeline, although there is some ambiguity in the language. Unless some arrangement to share tank capacity is reached, new tanks for the exports from the Kurdistan region will be needed.

Other logistical concerns relate to the basis on which the IOCs' oil is transported through the ITP. Assuming each IOC ships its own entitlement to oil through the ITP, then there will need to be an agreement regulating the conduct of the pipeline's operator and those IOCs that ship oil via the ITP. We would assume that this may entail agreements between the shippers, the KRG and the government of Turkey, but how such an arrangement might be structured is not yet known.

Oil mix

One reason why such agreements are necessary is that the oil pumped into the pipeline by multiple shippers will get mixed. That each shipper's oil is indistinguishable from the mixed whole has serious implications for title to ownership of the oil and any risks associated with it. Shippers will, for instance, want to mitigate risks associated with the insolvency of another shipper and eliminate (or limit) claims by the creditors of that insolvent shipper against oil in the pipeline. Formulating adequate legal mitigation will require a thorough analysis of Iraqi and Turkish law.

In some pipeline agreements elsewhere, insolvency risk is mitigated by eliminating competing title claims to oil in the pipeline. The shippers all transfer title to the oil to the pipeline owner or operator, on input and take a certain volume of the blend at the offtake point (with adjustments to account for quality differences). It isn't clear yet whether there is any appetite for this kind of arrangement.

Because the oil put into the ITP will not be of uniform quality, meanwhile, the quality of oil unloaded from the ITP will be different from the quality of oil put into it. That will have financial implications for the shippers, so it is another problem that needs a solution. To give comfort to shippers hoping to use the pipeline, we think any oil transportation agreement would need to address the following issues:

1. entry and exit specifications for oil;
2. metering of oil;
3. the liability regime that applies to shippers in relation to other shippers and the pipeline owner/operator and, potentially, credit support for the same;
4. priority and allocation of capacity in the ITP between shippers;
5. allocation of lost oil;
6. line-fill obligations; and
7. a process accounting for quality differences in oil put into the pipeline and taken out. The treatment of these items would differ based on whether the pipeline owner/operator takes title to the oil and ships on behalf of the IOCs.

The lack of complete disclosure makes it impossible to fully evaluate the KRG's export scheme from a legal perspective. Critical missing information includes details of the KRG's agreements with the Turkish government relating to oil exports and details of the mechanism for ensuring that IOCs transport their production entitlement through the ITP. Disclosure of this information (if it exists) would help stakeholders determine whether there is a solid legal basis for the KRG's plan. Even so, legal certainty could probably only be guaranteed by new or amended legislation.

Much more difficult to assess are the political risks. Baghdad's opposition to the scheme has been consistent and vocal, and if that opposition escalated it would easily overshadow any legal risks. For that reason, before the legal parameters of the new deal are tested, a better outcome would be a tripartite political solution involving the KRG, the federal government and the government of Turkey.

Many commentators argue that a well-timed confluence of factors could make a political solution possible. Despite its opposition to the plans, the government in Baghdad may need the KRG's support to stay in power after upcoming federal parliamentary elections. Moreover, the country is currently riven by sectarian violence. The federal government has been battling for control of the strategic city of Fallujah and most of Anbar province, west of Baghdad. It might be a good time for the federal government to make more friends and reduce the number of its opponents.

The Turkish government is thought to be pushing for just such a political solution involving all three parties, albeit with the imperative of securing more energy supply in the background. The KRG must also evaluate whether it could generate more money from independently exporting oil than through revenue allocations under the federal budget. Nonetheless, the consideration is not a simple economic calculation because foreign investors will always crave political stability and legal certainty.

Assurance about an export route for hydrocarbons has always been a critical concern for IOCs investing in Kurdistan. The KRG's recent announcements suggest a solution could be tantalisingly close. ●

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