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Introduction

Oil has often been described as part of the glue that holds Iraq together. And yet, few issues have proven more divisive to the fabric of the state since 2003 than those related to the management of the natural resource base and the distribution of the revenue accrued from its export. Rather than acting as a catalyst to strengthen the fiscal and political relationship between Baghdad and Erbil, and encouraging accommodation between them over key constitutional issues related to sovereign authority, both sides have used control of their oil sector (and related revenue-distribution mechanisms) as a mechanism to bolster their thus-far irreconcilable power-sharing agendas. Independent licensing of acreage, and management of the production and sale of crude oil, has been the cornerstone of KRG efforts to bolster its autonomy from the central government, and to lay the foundations for possible secession. As the federal government has belatedly recognized this fact, it has adopted more draconian revenue-sharing sanctions, essentially cutting Erbil off from most of its share of the national budget. The result has been heightened acrimony and a greater separation between the two sides, just at a time when fiscal and security pressures place a premium on cooperation and maximizing revenue generation.

This situation is primarily the result of putting long-term political objectives above concerns about investment and the optimal development of (and monetization of) the hydrocarbon sector. Protecting political prerogative has been a paramount goal for both Baghdad and Erbil, and in the absence of a compromise power-sharing formula, each side has operated according to its own interpretation of the constitution. As a result, the passage of new legislation designed to guide the development of the sector has been blocked, as have related laws on revenue distribution and the structure of the local industry. These elements have combined to increase uncertainty and perceived risk for investors in Iraq, undermining the full development in the sector, especially in Kurdistan. More importantly, these contests have cost both the regional and federal governments precious revenue.

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There are signs, however, that the political status quo that this impasse imposes is becoming more fragile. What Iraq needs is a new durable power-sharing formula that respects the basic sovereign prerogatives of the government in Baghdad while at the same time meeting at least the the minimum KRG demands for autonomy. Moreover, Iraqi factions – Arab and Kurd – need to decide whether this can be achieved within the structure of a unified state, or whether more radical secession arrangements need to be negotiated.

These decisions will determine how the structure of the Iraqi oil sector – north and south – evolves in the future. One thing is clear from the past 13 years: oil-sector and related revenue-sharing mechanisms cannot be a vehicle for resolving the power-sharing dispute. Quite the contrary. A bottom-up approach that uses practical solutions in the sector as the basis for confidence building and deeper cooperation between Baghdad and Erbil has not just proven impossible; it has been actively eschewed. Both the federal government and the KRG have been much more intent on cutting off their noses to spite their faces for the sake of political principle, and in the case of some Kurdish leaders, the long-held dream of independence (no matter how impractical this goal may be). Thus, the potential of Iraq's – and Kurdistan's – hydrocarbon sector, and the revenue benefits that can be derived from it, will depend on what the ability of Iraqi leaders to negotiate a new power-sharing arrangement that works, and where oil is not regarded as the means of reaching an accommodation, but rather one of the elements that helps sustain it in the long term.

Structural Fault Lines in Iraqi Politics

Management of the oil and gas sector, and the related issue of hydrocarbon revenue sharing, have been a point of deep dispute between the Iraqi Federal Government and the Kurdistan Regional Government (KRG) since Saddam Hussein's regime was removed in 2003. Beginning with the US-led Coalition Provisional Authority (CPA), successive post-war Iraqi administrations have attempted to negotiate a settlement of the impasse through legislative and constitutional measures, but to no avail.

Baghdad and Erbil have remained obdurately wedded to rival and unbridgeable interpretations of their constitutional prerogatives and competent legal authority. Their approach has been shaped by politics; in particular, their very different – and irreconcilable – views regarding power-sharing in the post-2003 Iraqi state. Arab political leaders in Baghdad have, for the most part, favored a system that protects central-government authority, although some Shia parties, notably the Islamic Supreme Council of Iraq, have at times backed a looser structure. By contrast, the main Kurdish parties have supported extensive decentralization of political and administrative power, in which all but a very limited and welldefined number of powers are devolved to the provincial and (in the KRG's case) regional governments. In the minds of the Kurds, the competent authority of the federal government should derive from the consent of the regions and provinces.[1] Moreover, as time has gone on, Kurdish independence ambitions have increasingly come to the fore, leading Erbil to adopt an even more determined policy of separation from the clutches of federal-government control, while also promoting the extensive devolution of power from Baghdad to Iraq's non-KRG provinces.

The tension between these rival views has been evident since the moment the Saddam regime fell. Pre-war proposals by Iraqi oppositions groups, including the Kurdistan Democratic Party (KDP) and the Patriotic Union of Kurdistan, envisaging federation between a Kurdish and an Arab regional government quickly gave way to the reality of a more unified state structure in the chaos that followed the 2003 war.[2] The CPA that administered the country in the immediate post-war period emphasized the need for a more decentralized government in its policy statements, but it shied away from defining exactly what relationship between the central government and regions/provinces would be in the new federal arrangement. Moreover, the paucity of competent provincial-level institutions outside of the KRG meant that the central government authority prevailed in practice.

Efforts to clarify the power-sharing structure since have failed to bridge the gap. While Article 1 of the constitution declares Iraq to be a "single, federal" state,[3] Baghdad and Erbil have remained at odds over the precise power-sharing framework that should be applied and the balance of power that should exist between the central government and the KRG. Repeated national legislative efforts to define the operational parameters of federalism have proved futile, as both sides have stuck doggedly to rival interpretations of decentralization that are incompatible and implacable.

Not surprisingly, management of hydrocarbon resources and revenue has been a focal point of this dispute.[4] Political leaders in both Baghdad and Erbil have always recognized the fact that money equals power, and, therefore, that control

1. See for example, Raad Alkadiri, "Oil and the question of federalism in Iraq," International Affairs, Vol. 86, Issue 6, Pp. 1315–1328, November 2010; Sean Kane, Joost R Hilterman, Raad Alkadiri, "Iraq's Federalism Quandary," The National Interest, March-April 2012, http://nationalinterest.org/article/iraqs-federalism-quandary-6512.
2. See e.g. the July 2002 Declaration of the Shia of Iraq, http://www.al-bab.com/arab/docs/iraq/shia02a.htm#9.
3. For the text of the 2005 Iraqi constitution, see http://aceproject.org/ero-en/regions/mideast/IQ/Full%20Text%20of%20Iraqi%20Constitution.pdf/view.
4. Christopher Blanchard, "Iraq: Oil and Gas Legislation, Revenue Sharing, and U.S. Policy," CRS Report for Congress, http://www.au.af.mil/au/awc/awcgate/crs/rl34064.pdf.

over Iraq's main revenue-generating resource is critical to the success of their political agenda. Consequently, the main Kurdish parties, particularly the KDP, have championed a hydrocarbon-management and revenue-sharing regime that was largely autonomous of Baghdad's control, and which would eventually facilitate fiscal autonomy (and, therefore, the preconditions for eventual political independence). Moreover, the KRG has sought to attract foreign companies, partly in the hope that, by giving the firms a stake in Kurdistan's economy, it would bolster Erbil's lobbying power in key international capitals, including Washington. The federal government, by contrast, has taken the opposite approach, rejecting any federalism proposals that would significantly weaken its fiscal and political power in the hydrocarbon sector. Thus, while Baghdad has been willing to (grudgingly) consider some measure of administrative devolution, in practice it has jealously guarded its oil-management and revenue-distribution prerogatives, not just with regards to the KRG, but with regards to Iraq's provincial governments as well.[5]

Constitutional ambiguity and the hydrocarbon sector

Not surprisingly within this context, legislative efforts over the past 13 years to reconcile rival views of the federal government's and KRG's hydrocarbon-sector-management and revenue-sharing mandates have failed almost entirely. Kurdish efforts to enshrine in national law the KRG's primacy in managing the sector began in 2004, during negotiations over the Transitional Administrative Law. However, these attempts were rebuffed by the CPA, which recognized the sensitivity of the issue (and the associated risk that tackling it would doom efforts to conclude the law). Instead, senior CPA officials allowed the pre-war status quo of centralized control over the sector to prevail, believing that Iraqi parties would be able to reach a compromise agreement on a new arrangement by themselves at a later date.

However, these US hopes were shown to be unrealistic relatively quickly. Intensive efforts by Iraqi leaders to resolve the federalism dispute during the drafting of the new constitution in 2005 came to naught, as rival factions remained wedded to their positions. In the absence of compromise, the drafters resorted to an ambiguous formula that was open to wide interpretation, and which has served to fuel enmity between Baghdad and Erbil ever since.[6] Both sides have been willing to accept Article 111 of the document, which bestows ownership of oil and gas on "all the people of Iraq in all the regions and provinces." But the

5. International Crisis Group (ICG), Iraq and the Kurds: trouble along the trigger line, Middle East report 88 (Brussels: ICG, 2009), pp. 1–3.
6. On the issues of dispute in drafting the constitution, see, for example, Saad N Jawad, The Iraqi Constitution: Structural Flaws and Political Implications, LSE Middle East Centre Paper Series / 01, November 2013, pp. 10-13.

intent of subsequent articles related to competent authority (especially Article 112, which is the only other article that refers to hydrocarbons directly) have been hotly disputed. Proponents of centralization have interpreted provisions in the article related to the management of "present" oil and gas fields by "the federal government, with producing governorates and regional governments" as giving primacy to Baghdad in directing oil production and developing discovered acreage. Moreover, they have regarded the subsequent provision for all three levels of government to formulate "together" the necessary strategic policies to develop Iraq's oil and gas wealth as further reinforcing the central government's role.

By contrast, the KRG has insisted that the constitution is designed to limit the federal government's remit only to acreage that was producing in 2005, and that, even then, it must be done in conjunction with producing governorates and regional governments. Erbil has further justified its claims to competent authority by pointing to two later articles: 115 and 121. The first limits federal government authority to the exclusive powers stipulated in Article 110 (which does not include hydrocarbon management), stating that, with regards to other shared powers, "priority shall be given to the law of the regions and governorates note organized in a region in case of dispute." Meanwhile, Article 121 states that if regional and national laws in respect to matters outside the exclusive preview of the federal government are in contradiction, the regional government has the right to amend the "application of the national legislation within that region."[7]

This constitutional impasse remains unresolved. In 2008, Erbil sought and received an independent legal opinion from international law firm Clifford Chance supporting its assertion that it had authority to manage its oil and gas sector independently under the terms of its own regional oil and gas law.[8] The report opined that Articles 115 and 121 gave precedence to regional law over federal law in all areas not set out in Article 110 of the constitution, including oil-and-gas-sector licensing and management; Article 112 simply gave the federal government joint power in the areas of processing, transportation and export, and even then only with respect to acreage in production when the constitution was passed. The law firm's report also asserted that Article 112 did not confer any legislative authority (exclusive or shared) on the federal government to manage Kurdistan's oil and gas sector. Furthermore, it concluded that KRG management of its sector did not require prior passage of national oil-and-gas or revenue-sharing laws, although it did acknowledge that the federal government was

7. The Iraqi constitution, op. cit.
8. For the text of the report, see Kurdistan Regional Government, "International law expert confirms KRG's authority to manage oil & gas resources," February 5, 2008, http://cabinet.gov.krd/a/d.aspx?s=010000&l=12&a=22631.

constitutionally required to enact this legislation given its right to manage “post-extraction” oil and gas from producing fields.

However, this legal opinion has done nothing to sway the federal government’s view. Prevailing opinion in Baghdad has consistently rejected the Kurdish claim to a constitutional mandate in the hydrocarbon sector, and federal government policy-makers have operated according to their own interpretations of the constitution and their own political and fiscal priorities.[9] They have disregarded Erbil’s repeated reference to the finding of the legal report, continuing to insist instead on the federal government’s mandate to set policy, approve upstream contracts, sell hydrocarbons, and collect and distribute export revenue nationally.

Futile Attempts at Legislation

The absence of any resolution to this constitutional dispute has had a trickle-down effect, blocking all attempts since 2005 at passing a legislative blueprint for national hydrocarbon-sector management and revenue sharing (laws that were seen as critical to clarifying the constitution and building on its intent). Each successive effort at passing oil-and-gas and revenue-sharing laws in the federal Council of Representatives (CoR) has only served to highlight the irreconcilable nature of the opposing views of power-sharing, and underscored the degree to which they represent very different visions of governance and, ultimately, of the virtue of a unified Iraqi state. As former Deputy Prime Minister Hussain al-Shahristani put it in a private conversation with the author in 2012, the quarrel with the KRG was not an administrative or fiscal one; it was an existential issue.

Early post-war efforts to pass oil-and-gas legislation culminated in February 2007, when a draft law shepherded by the US Embassy in Baghdad was published. However, while it was hailed as significant progress in some quarters, the text simply underscored the difficulties of reconciling the stark underlying different opinions between the federal government and the KRG over power-sharing.[10] The draft emphasized the federal government’s policy-making mandate, but it also acknowledged the constitutional articles that effectively made Baghdad’s authority moot in Erbil’s opinion. Upstream contract approval authority was fudged, with the federal government and KRG subsequently disputing where final say-so actually lay; and ownership and management authority over mid-stream infrastructure was inconsistent in the text.

The depth of overall disagreement over hydrocarbon management, and the absence of any effective mechanism for reconciliation of views, was quickly

9. Blanchard, op. cit, pp. 8-10.
10. For the text of the draft law, see http://cabinet.gov.krd/uploads/documents/Draft%20Iraq%20Oil%20and%20Gas%20Law%20English__2007_03_10_h23m31s47.pdf

underscored when the federal cabinet's consultative council, which reviewed the February draft legislation to ensure that it conformed to the constitution, produced a revised version in July 2007 that was significantly different to the original text in key areas. Reflecting the prevailing opinion of Prime Minister Nouri al-Maliki and his key Islamist-Shia allies in government and the CoR, the July draft resolved the ambiguities in the earlier text by emphasizing the primacy of the central government rather than the KRG. Upstream management and contract approval was firmly restored to the central government, with the federal ministry of oil reinstated as the key policy-making body. The consultative council also watered down language on oil contracts, shifting away from the production-sharing agreements that Erbil (and some of Maliki's Shia rivals) preferred.

Predictably given its interpretation of the constitution, the KRG rejected this draft, and talks to resolve the issue quickly broke down, with the Kurds moving quickly to pass their own legislation to manage the Kurdistan sector independently.[11] Since then, no meaningful progress has been made to resolve the impasse. The last serious attempt to win CoR approval for a law, in 2011, ended in a similar stalemate as before, with a compromise over competent authority once again proving impossible. On that occasion, a CoR Oil-and-Gas-Committee draft that built on the February 2007 text (and which was supported by the KRG and by the Iraqiyya faction in the CoR) was rejected by the Maliki government, which subsequently produced a rival document much closer to the July 2007 version.[12] Moreover, the government insisted that its draft was henceforth the only valid one, as the CoR did not have the constitutional authority to initiate legislation, only the right to approve it. Erbil's reaction was immediate and furious. It rejected the cabinet's text, and accused the Maliki government of "a breach of trust conducted in an authoritarian manner that is designed to impose a centralized method and to consolidate dictatorial economic decision-making and place the reins of all in the hands of a few."[13] Amidst acrimonious counter-accusations, the legislation was left in abeyance, with no signs since of any initiative to revive it.[14]

Efforts to pass revenue-sharing legislation have fared similarly badly, and exposed even more sharply the contrasting KRG and federal-government views on the structure of the state. Discussions in 2007 culminated in an initiative to put

11. Blanchard, op. cit., pp. 8-9; Kurdistan Regional Government, http://www.krg.org/pdf/2_English_Version_Kurdistan_Petroleum_Law.pdf.
12. Iraq›s cabinet approves delayed draft oil law, Reuters, August 28, 2011, http://af.reuters.com/article/commoditiesNews/idAFL5E7JS0AM20110828.
13. Kurdistan Regional Government, "Presidency's statement on Iraq Council of Ministers' passage of federal hydrocarbons law," September 6, 2011, http://cabinet.gov.krd/a/d.aspx?a=41371&l=12&s=010000; "Kurds could bring down Al-Maliki over Iraq's Hydrocarbon Law," Ekurd Daily, September 7, 2011, http://ekurd.net/mismas/articles/misc2011/9/invest728.htm.
14. See, for example, Iraq has little interest in pushing oil law forward –Janabi, Reuters, February 7, 2013, http://www.reuters.com/article/iraq-oil-idUSL5N0B790Z20130207

draft legislation to a CoR vote in the summer of that year.[15] But ultimately, no compromise could be found between KRG efforts to limit the government to a narrowly distributive role and Baghdad's insistence on preserving a wider degree of fiscal and monetary authority. Both sides agreed that revenue from all hydrocarbon sales payable to the state, royalties, production bonuses, taxes and any additional resources resulting from oil and gas contracts would be collected in a fund held by the Central Bank of Iraq. There was also an apparent willingness to cap sovereign and strategic project spending by Baghdad, and to transfer to the KRG 17% of net national revenue as a block grant before funding federal government ministries.

However, the KRG also demanded that the federal government distribute immediately any future fiscal surplus, calculated monthly, as well as assume responsibilities for fiscal shortfall.[16] Non-Kurdish parties in Baghdad – including Islamist Shia factions previously more closely allied to the KRG on federalism issues – balked at these demands, interpreting them as an effort by Erbil to eviscerate the central government's long-term fiscal authority and potentially weakening Iraq's territorial cohesion. With neither side willing to budge, the prevailing central-government-controlled system remained in place.

As with oil-and-gas legislation, subsequent negotiations over a revenue-sharing law has remained mired in the fundamental dispute over power-sharing, with no significant shift in either Baghdad's or the KRG's position on the issue. Agreement to pass both these laws has been an element of a number of political deals over the past few years (including the one that facilitated Prime Minister Haider al-Abadi's appointment in 2014),[17] a fact that reflects the continued political saliency of these issues, and an appreciation by both sides that how the dispute is resolved will form the cornerstone of any long-term power-sharing arrangement. But in the absence of a workable compromise on defining Iraq's federal structure, actual legislation has proved impossible.

15. For the draft, see Kurdistan Regional Government, http://web.krg.org/pdf/English_Draft_Revenue_Sharing_law.pdf.
16. Personal interviews with US State Department officials, June 2007.
17. See, for example, "Kurds send 19 conditions to Allawi and Maliki," Ekurd Daily, August 18, 2010, http://ekurd.net/mismas/articles/misc2010/8/state4137.htm;
https://en.wikipedia.org/wiki/2010_Iraqi_government_formation; Mohammed A Salih, "Iraqi Kurds unhappy partners in Abadi's government," Al-Monitor, September 16, 2014,
http://www.al-monitor.com/pulse/originals/2014/09/kurds-unhappy-iraq-abadi-government.html

Partial Agreements Similarly Doomed

Even attempts to reach partial agreements on oil exports have been undermined by this fundamental dispute over power-sharing and respective mandate. Driven by Erbil's ability to develop its sector (despite Baghdad's opposition), political expediency, and fiscal need, the federal government-KRG has concluded three oil export agreements in the post-Saddam era, in 2009, 2011 and 2014. The scope of each was narrow and the terms relatively cursory, reflecting the refusal of both the federal government and the KRG to establish any precedent that could prejudice their long-term constitutional and legal claims. Yet none of these agreements proved lasting, as disputes over power-sharing – particularly competent authority over oil sales – quickly overwhelmed them.

The first of these deals, in 2009, took months to negotiate due to Erbil's initial refusal to acquiesce to Baghdad's demand that the State Oil Marketing Organization (SOMO) must manage all sales and revenue collection of Kurdish crude sold via the main Iraq-Turkey pipeline (ITP) from Kirkuk to Ceyhan, with the KRG simply receiving its 17% of receipts from the federal treasury. A bilateral agreement was eventually struck in May 2009 for the export 60 mb/d of crude from the Tawke field via the ITP,[18] but it was quickly undone by a dispute between Tawke operator DNO and the KRG, which led to the suspension of all Kurdish crude exports in September that year.

A second export pact was inked in 2011, after the KRG completed the initial stages of an independent pipeline linking Kurdistan's producing fields directly with the Turkish portion of the ITP, which gave Erbil the means to transport crude autonomously of Baghdad. Acceptance of SOMO's sole sales authority was once again the cornerstone of the export agreement, and the federal government also tried to link KRG export-volume commitments to Erbil's federal-budget entitlements, although the initiative was blocked by the CoR. This export deal broke down the following year, however, this time due to a dispute over financial disbursements levels from the federal government.[19]

Nevertheless, the deal did establish the precedent of linking KRG crude exports to budgetary entitlements, with the KRG committed to supply 175 mb/d as part of the 2012 budget. Baghdad also pushed, and failed, to include a penalty clause in this and the following year's budget. In 2014, the dispute over the terms of Kurdish exports and the federal government's determination to manage them and

18. http://cabinet.gov.krd/a/d.aspx?r=223&l=12&s=02010100&a=29364&s=010000; "Iraq will export oil from Kurdistan fields," Energy-Pedia News, May 10, 2009, http://www.energy-pedia.com/news/iraq/iraq-will-export-oil-from-kurdistan-fields.
19. "Iraq Kurdistan oil export restart may be temporary," Reuters, August 2, 2012, http://www.reuters.com/article/us-kurdistan-oil-idUSBRE8710E120120802.

to control revenue flows blocked the passage of the national budget altogether, and led to the severance of revenue disbursals from Baghdad to the KRG. It was only when Erbil agreed to resume the sale of specific volumes of crude through SOMO in November of 2014 as part of a limited exports-for-revenue deal that limited federal-government disbursements were restored, with Erbil trading 150 mb/d of crude for a $500 million transfer from the federal treasury.[20]

This last deal proved to be the precursor for the most ambitious attempt at an export agreement between Baghdad and the KRG. Struck in December 2014 at a time of plummeting oil prices, and enshrined in the 2015 budget, it mandated the restoration of monthly budget transfers to the KRG in return for Erbil allowing 550 mb/d of crude to be transported through its pipeline system and into the ITP (300 mb/d of crude from federally-controlled Kirkuk-area basins and 250 mb/d of Kurdistan-produced crude).[21] Once again, SOMO was to act as the marketer for this crude, and a punitive penalty clause for non-transfer of volumes was also included in the national budget.

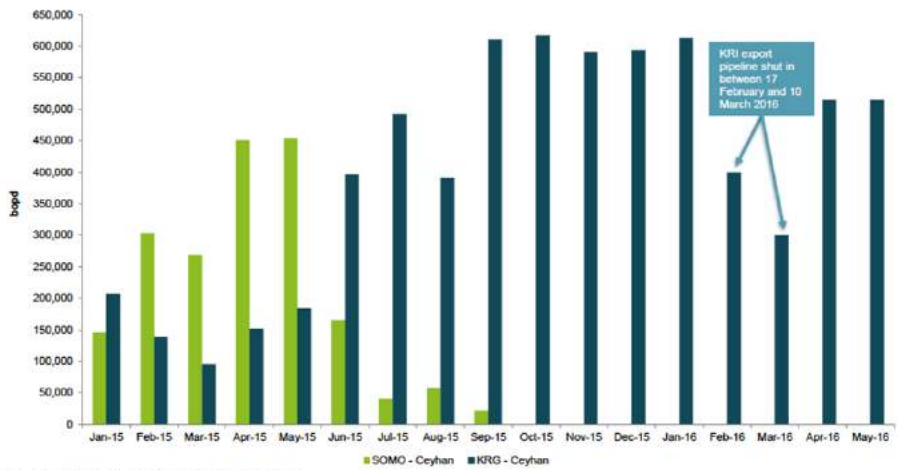
However, as with the earlier pacts, this one did not survive long; by August 2015, it lay in tatters, with the KRG refusing to transfer any exports and the federal government once again cutting off monthly budget transfers. The speed with which the agreement unraveled, and the recriminations that were subsequently exchanged by Baghdad and Erbil, illustrated very well the virtual impossibility of concluding any agreement relating to oil-sector management without resolving the wider issue of power-sharing in one way or another.

The pact was nominally undone by a dispute over implementation of its terms: Baghdad rejected the KRG's insistence that Kurdish and northern Iraq export volumes should be calculated on an annual basis not a monthly one, thereby allowing for shortfalls in deliveries in the early months without financial penalty; for its part, the KRG refused to acknowledge that monthly disbursements could not be set independent of actual revenue accrued, which was less than budgeted due to lower-than-anticipated oil prices (meaning that the dollar/dinar value of the KRG's 17% had fallen).[22] But what really led to the collapse of the deal was the underlying determination by both sides not to relinquish their perceived prerogatives over managing crude production, sales and revenue collection, irrespective of the financial cost or the impact on the hydrocarbon sector, including investor interests. Political considerations once again trumped immediate practical concerns.

20. Iraq and Kurds Reach Deal on Oil Exports and Budget Payments, The New York Times, November 13, 2014.
21. "Iraq and Kurdistan Agree on Oil Deal," The Wall Street Journal, December 2, 2014.
22. "Kurdish oil deal with Baghdad unravels as tensions rise," Reuters, March 13, 2015, http://www.reuters.com/article/us-iraq-kurdistan-oil-idUSKBN0M91MQ20150313; "Iraq, Kurdistan Oil Deal Close to Collapse," The Wall Street Journal, July 3, 2015.

This resolve was particularly stark on the part of the KRG, which paid a heavy price for its decision in terms of fiscal solvency and sanctity of contract. Erbil's insistence that its monthly revenue claims from Baghdad were immutable had some validity on the face of it; the 2014 budget law made no contingencies for revenue shortfalls. But the Kurdish approach was politically narrow-minded at best, and at worst suggested that hawks in Erbil were eager to find a convenient excuse to undermine the deal as quickly as possible before any precedents were established that undermined KRG autonomy. After all, lower oil-export income during the early months of 2015 had forced the federal government into across-the-board spending cuts nationally, and had led to reduced disbursements to all Iraqi provinces. This tightening of belts made it politically impossible for Prime Minister Haider al-Abadi and his federal government to deal with the KRG preferentially. Moreover, KRG leaders also ignored public promises from federal Finance Minister Hoshyar Zebari, a senior KDP leader himself, that disbursements would be restored to budgeted levels if and when oil prices recovered and revenue grew.23 And all of this at a time when the KRG was insisting that it could not physically deliver the volumes promised to Baghdad, while at the same time maintaining significant volumes of independent exports and recouping the revenue directly (see figure 1).

Figure 1 – KRG exports January 2015-May 2016



Source: Genel Energy, Investor Presentation, June 2016

23. See "The Third Annual Sulaimani Forum: Fertile Crescent in Turmoil: Challenges and Opportunities," pp. 36-37, http://auis.edu.krd/sulaimaniforum/sulaimaniforum_procedings_2015.pdf.

Kurdish officials insisted that these early export shortfalls and autonomous sales were part of the original export-for-revenue deal, with the latter necessary in part to pay foreign producers in Kurdistan. But the KRG's overall approach to the agreement was an indicator of Erbil's priorities, and its desire to preserve its autonomous control over the oil sector at all costs. Having finally secured a mechanism for independent crude exports with Turkish help in 2014, and with overall volumes rising – especially with the inclusion of federal-government-controlled barrels as part of the export-for-revenue deal – Erbil appeared loathed to give up the very source of financial independence that it had long dreamed of. Moreover, it was clear that it was willing to prioritize these independent sales, and eschew revenue from Baghdad in the process, even at the cost of being forced to sell Kurdish crude at a discount to market prices (because of the risk premium continued legal challenges by Baghdad to the title of the oil put on these barrels)[24] and thereby exacerbate the fiscal crisis that Kurdistan was already suffering.

What Does Erbil Want?

The fiscal pressure that Erbil has been willing to put itself under since 2015, and the impact it has had on the local economy, is perhaps the clearest indication of how the KRG sees the local oil sector contributing to its wider political agenda. It also reinforces the broader point: that the oil sector has not and will not be a vehicle to facilitate wider political compromise and accommodation between Baghdad and Erbil.

The regional government has run massive fiscal deficits since the export-for-revenue deal broke down, with receipts from independent exports significantly less than the KRG's operating budget.[25] Estimates at the beginning of 2016 put the budget for public-sector salaries alone at $730 million/month, and the budget deficit was estimated at over $350 million/month.[26] Since then, senior KRG officials have suggested a lower deficit,[27] although gross revenue from oil exports (before payments to operators and repayment of pre-export financing) has only hovered around $450-500 million/month on average since the start of 2016. Nevertheless, Erbil has been forced delay the payments of wages to civil servants and some parts of its security services, and to consider sweeping public-sector

24. "Iraq prepares legal crackdown on Kurdish oil sales," Financial Times, September 4, 2014; "Kurdish Oil Gambit Hits Troubled Waters," The Wall Street Journal, July 21, 2014.
25. Mohammed A Salih, "Low oil prices complicate Iraqi Kurdish independence," Middle East Institute, http://www.mei.edu/content/low-oil-prices-complicate-iraqi-kurdish-independence.
26. See Official KRG Response to Statements made by Prime Minister of Iraq, Haider al-Abadi, February 17, 2016, http://cabinet.gov.krd/a/d.aspx?s=040000&l=12&a=54240; KRG Deputy Prime Minister Qubad Talabani state that the deficit was even larger, "Monthly budget deficit in Iraqi Kurdistan reaches $406 million," Ekurd Daily, January 27, 2016, http://ekurd.net/kurdistan-monthly-deficit-millions-2016-01-27.
27. See Talabani quoted in "Kurdistan government needs support to plug $100 million monthly deficit," Reuters, April 13, 2016, http://www.reuters.com/article/us-mideast-crisis-iraq-usa-idUSKCN0XA1SQ.

reform,[28] all at a significant political cost, particularly to the popular credibility of the KDP, which has effectively controlled the regional government since 2015. The KRG has also reportedly built up significant domestic and international debts, including those accrued from pre-export financing deals inked with international oil traders in 2015 that appear to have been signed at higher-than-realized crude prices.[29]

Financial pressures have also limited the scope of KRG payments to producing companies in Kurdistan, which in turn has led to slow-downs in capital investment in the hydrocarbon sector. Erbil was able to regularize payments for the first half of 2016 in response to company pressure, but this remuneration has only compensated for current claims; debts to companies for production in previous years remain partially outstanding (find some numbers). Moreover, at times of particular financial stress, even these current payments appear to have suffered.[30]

Continuing the export-for-revenue deal with Baghdad would not have been a panacea for Erbil's fiscal woes. The federal government has suffered a fiscal crisis of its own since 2014, due to lower oil prices; and it was unlikely to have offered respite in terms of compensation to KRG investors (Baghdad has always insisted that the KRG was responsible for remunerating companies operating in Kurdistan out of its 17% of the budget as Erbil concluded those deals independently of the federal ministry of oil).

However, in net terms, the KRG would probably have been in a less woeful fiscal situation had it negotiated a continuation of the export-for-revenue arrangement with Baghdad. The roughly 600 mb/d that Erbil now exports represents roughly 17% of overall Iraqi exports, so the pact would not have a cost to the KRG in volumetric terms. Meanwhile, Erbil would almost certainly have been able to export this crude at higher prices had it continued to allow SOMO control, as the concerns over title would no longer apply, and therefore any discount on the crude would be lower. Furthermore, the netback price to the KRG – and Iraqi – treasury would have been higher, as the costs of transporting and marketing this crude would have almost certainly been less than the current arrangement, including Turkish intermediaries, that the KRG has used instead to ensure independent exports.

28. "KRG slashes payroll to stave off budget collapse," Iraq Oil Report, February 4, 2016.
29. Salih, op. cit.; "Turkey gives loan to Kurdistan," Daily Sabah, February 25, 2016; press release by Regional Government Kurdistan Regional Government, Ministry of Natural Resources, August 20, 2015, http://mnr.krg.org/index.php/en/press-releases/474-mnr-setting-the-record-straight-on-oil-export-and-revenue-for-the-people-of-kurdistan-to-judge-for-themselves.
30. "KRG revenue plummets in July, IOCs await payment," Iraq Oil Report, August 5, 2016.

The KRG Ministry of Natural Resources has regularly published production and export figures, but actual netback prices, and, by extension, the price that the KRG is paying to maintain independent exports, have never been publicly revealed; even officials from international financial institutions operating in Kurdistan admit privately that they are unsighted on the actual net sums the KRG receives from exports.[31]

Erbil has argued that Baghdad cannot be trusted to make disbursements, and that by relying on independent exports, the KRG can be sure that it receives all of the funds due to it.[32] But even this claim is questionable. The federal government has repeatedly indicated that it is ready to revive the export-for-revenue agreement, and there have been intermittent attempts to negotiate its reintroduction. The 2016 national budget also included the same export-for-revenue mechanism as the 2015 law (550 mb/d in return for 17% of the net budget), although it added an amendment to account for oil price – and hence gross revenue – volatility. Obviously, given current oil prices, federal disbursements would not fill the fiscal hole facing Erbil; however, the KRG would arguably be in better financial shape, and it would have access to Iraqi federal reserves and international borrowing that is currently denied it because of the oil-export stalemate.[33]

In other words, the KRG has arguably put itself under necessary domestic political and financial strain simply to preserve an independent export mechanism that aligns with its perceived constitutional prerogative, and, for some Kurdish leaders, provides the foundations for fiscal and political independence. Yet the oil sector looks unlikely to be able to provide the basis for this financial autonomy for some time. While the lack of precise figures makes it impossible to provide exact estimates, it is clear that ensuring the netbacks necessary to fund current spending and obligations to investors would require exports well above current levels, even with higher oil prices. Kurdish oil officials have promised rapid

31. Personal interview with international financial institution official responsible for Kurdistan; See Gulf Keystone numbers. According to a Gulf Keystone investor presentation in August 2016, the per barrel quality discount and truck/transport costs for its crude was $37.50/b at a time when Brent crude prices were around $45/b (see Gulf Keystone Petroleum - H1Results 2015, http://webcasting.brrmedia.co.uk/broadcast/55daf1b1f67ebc1c6ff85179.

32. Press release by Regional Government Kurdistan Regional Government, Ministry of Natural Resources, op. cit.

33. In its 2016 letter of intent requesting IMF support, the federal government stated that it was “looking into” ways to revive the oil-for-exports deal with the KRG, including allowing independent KRG exports to be audited at year end, and netting out those receipts from disbursement due to Erbil under the 2016 budget. However, the language is conditional, reflecting the absence of any mechanism of overcoming the political impasse. See International Monetary Fund, “Iraq: Letter of Intent, Memorandum of Economic Financial Policies, and Technical Memorandum of Understanding,” June 19, 2016, p. 8, http://www.imf.org/external/np/loi/2016/irq/06192016.pdf.

increases in exports for some time, with a 1 mmb/d target regularly repeated.[34] However, in reality, production increases have been more modest, with Kurdish output benefiting as much from formerly federal-controlled acreage that it seized militarily after June 2015 as from increases in local production.[35] It could yet add volumes from the Baba dome of the Kirkuk field to those figures, which would add an additional 150 mmb/d + in the short term, but that would still not be sufficient to get them to a level of financial self-sufficiency, and a recent upsurge in attacks on infrastructure in the Kirkuk area illustrate its vulnerability to sabotage.[36]

Significantly higher production performance appears some way away. The obstacle is not a below-ground one, although a better understanding of the resource base and its complexity has led companies to a more sanguine appraisal of the production potential in Kurdistan. Instead, the challenge is an above-ground one, which again illustrates the risks that the KRG has taken in pursuing its oil-sector policies for the sake of wider political goals. By adopting the independent route at a time of fiscal crisis, the KRG may have done its oil sector long-term damage. Remuneration delays and unpaid receipts have imposed limits over capital spending, thereby undermining the medium-term outlook for output growth.

They have also hurt Kurdistan's reputation as an attractive new oil and gas frontier.[37] The regional government's policies have underscored the sense that the KRG's political agenda is more important than the commercial and monetization considerations of investors, a misalignment that can be toxic for investment. Firms are increasingly questioning their ability to monetize their investments, despite new infrastructure and independent export arrangements. The KRG has still not convinced many companies that it can guarantee that the oil they produce will get to international markets at international prices, and that they will be paid according to their contracts. The gradual exit of some explorers is testament to this fact, and even smaller companies, whose portfolios are overwhelmingly dependent on Kurdistan production, have periodically reduced or slowed down their investment, while in some cases quietly seeking to divest some or all of their acreage. Kurdish officials may still seek to paint a positive picture with

34. See, fore example, KRG Minister of Natural Resources Ashti Hawrami quoted in "Build it better: the path forward for the Kurdistan Region of Iraq," The Oil and Gas Year, December 17, 2014, http://www.theoilandgasyear.com/interviews/build-it-better-the-path-forward-for-the-kurdistan-region-of-iraq/.

35. KRG domestic production in 2015 averaged around 570 mb/d (see KRG Ministry of Natural Resourcs, "Oil Production, Export, and Consumption Report 2015," p. 5, http://mnr.krg.org/images/monthlyreports/KRG_MNR_Full_Annual_Report_2015_2.pdf. Following the ISIS offensive in northern Iraq in June 2015, KRG Peshmerga forces seized control of the Avanah dome of the Kirkuk field, as well as Bai Hassan, which added almost 200 mb/d to these domestic production figures.

36. "Bomb attack hits Bai Hassan oil field," Iraq Oil Report, August 10, 2016; "Oil well blown up in northern Iraq, North Oil Company says," Al Arabiya, August 10, 2016, http://english.alarabiya.net/en/business/energy/2016/08/10/Oil-well-blown-up-in-northern-Iraq-North-Oil-says.html.

37. "Oil Companies' Bet on Kurdistan Turns Sour," The Wall Street Journal, April 26, 2016;

considerable upside, and producers are keen to support this view; but the scale of the fiscal-deficit and debt obligations that the KRG has taken in order to go it alone suggests a different reality, which will likely include a formal contract renegotiation and a toughening of terms (to go along with the unofficial changes that have been witnessed over the past few years) that will make the investment fiscally viable for the KRG.

Baghdad's Toughening Policy

The KRG's financial challenge is further complicated by the palpable shift that has taken place in Baghdad's policy towards the KRG since 2014, as it has sought to assert its own sovereignty. After years of acquiescing to Kurdish demands (despite rhetorical challenges to Erbil's oil policies), the federal government has adopted a more punitive approach, essentially allowing the KRG to pursue its own course but refusing to provide financial support for the Kurdish agenda. In one sense, this change is an acknowledgement of the limits of Baghdad's ability to restrict KRG decision-making, but it also reflects a frustration and weariness with Erbil, and an acknowledgement that the federal government has more pressing security and fiscal priorities to deal with than reacting to Kurdish complaints and a recalcitrant KRG leadership. Thus, at the same time as Erbil has become more determined to set its own independent political and financial course, Baghdad has been more willing to see ties with the KRG loosen, including imposing fiscal costs on Kurdish decisions. As a result, Erbil now finds it harder to maintain the duality of being part of Iraq and a quasi-independent at the same time.

The federal government has not sought to sever oil and financial ties completely, leaving the door open for a future rapprochement and a negotiations of fiscal arrangements; but it has made it clear that a resolution will need to take account of Baghdad's priorities, including the sale of Kurdish crude through SOMO. This position reflects a number of considerations. First and foremost, it is practical politics, as the federal government is well aware that, given the national financial crisis, if it makes financial and oil-sales concessions to the KRG, it will quickly face similar demands from oil-producing provinces in central Iraq, which are angry at the short-flow in budget disbursements as a result of the fiscal crisis, and which are critical of the autonomy already enjoyed by the KRG. The Abadi administration dare not offer the Kurds preferential treatment – both in terms of disbursements and sales mechanisms – for fear that it will spark a chain reaction in southern oil-producing provinces that will severely undermine the overall authority and control of the federal government.[38] The prime minister has not

38. Local leaders in Basra have recently renewed calls for establishing the province as an autonomous region. See "Basra threatens to sue for autonomy if Baghdad ignores pleas for better services," Rudaw, January 11, 2016; "Basra pushes toward financial autonomy," Iraq Oil Report, March 23, 2016.

sought to escalate the conflict with Erbil over KRG policy in other areas, such as the extension of KRG control over what was formerly federal-government-controlled oil production. But on fiscal issues, he has been rigid.

But this tough approach also reflects a shift in sentiment among Islamist Shia politicians, many of whom in the past regarded the Kurds as their strategic allies, but now increasingly see them as an impediment to securing Shia interests. Iraq's main Islamist Shia parties have always held a range of views on relations with the KRG, with some, such as ISCI, far more closely aligned to Erbil's views on federalism than Dawa or the Sadrists. Nevertheless, as KRG and federal government priorities have diverged, and increasingly clashed directly, many Islamist Shia politicians have privately come to the conclusion that there is little value in paying the price for forcing Kurdistan to remain part of Iraq if the KRG does not want to. There is no clear vision among these Shia officials about the precise terms of separation, especially with regards to territorial borders. Nevertheless, there is a growing willingness to countenance Kurdish secession in the future. Kurdish separation is no longer universally seen among Shia political leaders and rank-and file as meaning the inevitable fragmentation of Iraq; in the minds of some Shia leaders, a negotiated divorce will strengthen what remains of the Iraqi state and facilitate political deals among Arab Shia and Sunni Iraqis that will help to stabilize the country.

Ultimately, a key federal-government-level arbiter of the debate over Kurdish separation will be the Shia clerical leadership, the Marjaiyah, and the senior-most of them, Grand Ayatollah Ali al-Sistani. The Najaf-based marja remains one of, if not the, foremost proponents of Iraqi unity and a strong federal government, to the point of having quietly questioned the virtue of the 2005 constitution in the run up to its introduction for fear if its potential impact on Iraq's territorial and political cohesion.[39] This position has put Sistani, and other senior clerics, at odds with Erbil's political agenda, and led to tacit support for Baghdad's resistance to Kurdish moves towards greater autonomy. It has also kept Islamist Shia politicians who would support Kurdish secession – and regional autonomy for southern Iraqi provinces – at bay, as they dare not challenge the Marjaiyah's opinion openly.

Nevertheless, there are subtle signs of disagreements between the senior clerics themselves over the issue of Iraqi unity.[40] Some are now willing to countenance a looser form of ethno-sectarian federalism in order to protect the interests of the Shia community in Iraq. This shift is prompted as much by anger at the atrocities heaped on Iraq's Shia by IS and other Sunni extremists as it is by Kurdish

39. Personal interview with Sistani representative, April 2005.
40. Personal interview with Iraqi official with close ties to Najaf.

policy; but the result is effectively the same, namely a softening of opposition to renegotiating Iraq's domestic political framework (and in some cases, active encouragement of such change).

If this becomes the mainstream Marjaiyah view, and especially if Sistani adopts this position publicly, it is likely to expose a rich vein of Shia parochial politics in Baghdad and the predominantly Shia provinces of the south that will make the federal government even more resolute in its dealings with the Kurds. With clerical strictures lifted, the private view of many Shia leaders that their constituency, and Iraq, is better off without an indifferent KRG partner will be given full rein. This change could bring the many quarrels that are currently simmering, including disputes over mandate and territorial control in Iraq's oil sector to the surface immediately, setting the stage for a far more confrontational period of domestic politics in the country, with Baghdad – or at least the Islamist Shia parties that dominate government there – pushing its agenda for more forcefully than it has done so far.

Considering New Power-sharing Options

Ultimately, these dynamics point to the need to address the deeper malaise that is eroding the cohesion and effectiveness of the Iraqi state: the failure to resolve disagreements over federalism and power-sharing, which both the KRG and the federal government regard as existential questions. The lack of a resolution of this issue has blocked the federal government ability to reach an accommodation with the KRG over the long-term management of Iraq's oil wealth that would allow both sides to maximize financial returns from the oil sector. Over the past 13 years it has become ever-more clear that the mainstream Kurdish leadership – especially members of Masoud Barzani's KDP – are ambivalent at best, and, in many cases, actively opposed to remaining part of the Iraqi state. As a result, it is impossible to resolve disputes over competent authority and sovereign mandate in the oil sector (and elsewhere) via bottom-up legislative mechanisms.

The need for this overarching political deal is becoming more urgent as time goes on, as festering political disputes, compounded by the ambiguities of the constitution and associated rival visions of federalism, have undermined the foundations of the Iraqi state and its cohesion. Combined with the marginalization and, in some cases, withdrawal of key constituencies from the political process (including the KRG in many respects), it has led to a gridlocked federal government and an ineffective legislature unable to pass key laws. By not addressing the most fundamental questions relating to how power-sharing in Iraq should be structured, Iraqi leaders have increased the risk of an unmanaged domestic political unraveling and violent fragmentation along ethno-sectarian lines. If Erbil goes ahead with its threatened vote on independence in the near future (even a non-binding one), it will create additional destabilizing ambiguities and further exacerbate centrifugal tensions, all of which will have deleterious effects on the oil sector.

What is needed in Iraq in is a new political compact between the KRG and the federal government (as part of a wider deal that includes all of Iraq's main factions – Shia, Kurdish and Sunni) that establishes an unambiguous, long-term power-sharing framework, codified in constitutional amendments, and underpinned by a body of enabling legislation. As part of this process, Baghdad and Erbil need to decide once and for all whether the relationship between them will be some form of political and economic co-existence in a unified state (and if so, under what terms), or whether to negotiate separation. Moreover, this deal will need to be based on compromise and accommodation by both sides, rather than insisting that there must be joint consensus on all issues, which in practical terms has allowed both the federal government and the KRG to maintain maximalist and unyielding policy positions.

The political equation in Iraq has changed over the past 13 years, and simply asserting the primacy of the federal government in a heavily centralized state is no longer viable, nor representative of facts on the ground. At the same time, however, the new arrangements that govern power-sharing need to be acceptable to all. What is required is the comprehensive rehabilitation of the Iraqi state, including wholesale constitutional reform, the restoration of functioning institutions on a nationwide scale, and the implementation of rule of law. Clearly, the eventual formula needs to be acceptable to the KRG.

However, it will also need to provide a government in Baghdad with real executive powers, as most non-Kurdish factions want. An eventual deal cannot be at the expense of one side or another, nor can it simply be imposed by either one. Rather, it will need to be a win-win arrangement that ultimately meets the basic fiscal and political demands of both the federal government and the KRG, protects their core interests, and does not have negative knock-on effects on the ability of either to govern effectively the territory under its control. Ideally, these arrangements would also bolster national finances and the economy, in part by resolving the issues related to competent authority over the oil sector, and to the legal parameters and mechanisms for revenue sharing.

Independence

Formal secession by the KRG is one option. Erbil's efforts to ensure autonomous control over the region's oil sector and export revenues over the past 13 years appear to be driven in part by a desire to ensure fiscal independence from Baghdad,[41] and therefore the basis for a political separation. Many senior Kurdish leaders, particularly those affiliated with the KDP, have made no secret of their desire to eventually establish an independent Kurdish state. Recent statements by KDP officials (including Barzani) characterizing the Iraqi state as a failed historical enterprise that should not be repeated represent a long-held private conviction,[42] and KDP leaders appear to see in the current domestic circumstances in Iraq – and those prevailing regionally – an historic opportunity to achieve the long-standing dream of independence.

Thus, KDP rhetoric appears to be less a negotiating tactic for future negotiations with Baghdad over new power-sharing arrangements or a symptom of internal discord in Kurdistan, as some critics assert,[43] and more a statement of actual intent. Important parts of the Kurdish leadership, including groups that presently dominate the KRG, do not want to be part of Iraq, as their policies in the oil sector have demonstrated.

Whether Erbil goes ahead with the much-heralded Kurdish referendum on independence will be an important indicator of how serious a proposition secession actual becomes. Even if does, and the vote is in favor of secession (as seems inevitable)[44], for the transfer of power to be peaceful, the KRG will need to negotiate the terms of its divorce from Iraq, as well as to ensure regional and international acquiescence and support. KRG assertions that changes in territorial control since the IS offensive in 2014 have created immutable facts on the ground in disputed territories, for example, belie the eventual need to negotiate boundaries and the status of existing populations in mixed areas as part of any stable, long-term relationship with the rest of Iraq.

Similarly, the new legal and fiscal arrangements – including how to deal with existing obligations to foreign investors – will need to be agreed. The KRG has

41. See, for example, Iraqi Kurdistan close to economic independence, says oil minister," Rudaw, November 6, 2014; Exclusive: How Kurdistan bypassed Baghdad and sold oil on global markets, Reuters, November 17, 2015, http://www.reuters.com/article/us-iraq-kurdistan-oil-idUSKCN0T61HH20151117.
42. "Masrour Barzani: Kurdish independence would help defeat IS," Al-Monitor, July 2, 2015; "Barzani: Time is ripe for referendum; Kurdish independence brings the region peace," Rudaw, February 2, 2016; "Barzani: 'Kurdistan is ripe for independence'," Rudaw, May 23, 2016.
43. See, for example, Denise Natali, "Stalemate, Not Statehood, for Iraqi Kurdistan," Lawfare, November 1, 2015, https://www.lawfareblog.com/stalemate-not-statehood-iraqi-kurdistan.
44. In a non-binding referendum on independence in 2005, 98.8% of almost 2 million voters cast ballots in favor of secession. See Seth J Frantzman,, "2016: The Year Kurdistan Finally Breaks from Iraq?" The National Interest, February 26, 2016.

tended, thus far, to legislate independently when arrangements with Baghdad have not suited Kurdish purposes. Negotiating separation will be more complicated, and unpicking the ties that have bound Kurdistan to Iraqi for almost a century will necessitate a more erudite approach.

One key question is: would an independent Kurdish state be financially viable under current circumstances? Having isolated itself from federal government funds and access to international borrowing and reserves over the past three years, the regional government has exposed its weak financial foundations and the unsustainability of the region's patronage-based political-economy. Secession would allow Erbil to negotiate directly with international lenders and donors, but the cost of that borrowing is likely to be onerous, given how leveraged the regional government is already,[45] and its pattern of default and debt-renegotiation, especially in the oil sector.

Indeed, the sector, far from proving the vehicle for independence, has arguably undermined KRG finances by creating the chimera for Kurdish leaders that the regional government could sustain itself financially without depending on revenue transfers from Baghdad. Pipeline infrastructure has been built, and export deals struck, which have allowed a growth in independent crude sales. But the drive for autonomous control of the sector has cost the KRG dearly in terms of lost revenue (in part due to the need to sell its oil at a discount), and a slow-down in capital investment.

Clearly, resolving the sovereign status of Kurdistan would help to eliminate the need for politically driven discounts on its crude exports. But as a land-locked state, an independent Kurdistan would still be vulnerable to political pressure from transit states, some of which (notably Turkey) have made it clear that they see Kurdistan as the source of cheap energy imports, and are likely to negotiate tough transport and sales arrangements accordingly, which would have a negative impact on net government oil receipts. As is the case now, at least some of that cost is likely to be passed on to investors.

This risk points to a bigger challenge for an independent Kurdistan, namely securing ongoing investment in the oil sector. Companies will not just walk away from the resource base, but the remuneration terms that are in place now have proven very difficult – if not impossible – for the KRG to honor. Independence will not change these circumstances markedly, as the state will still be fiscally dependent on oil receipts to fund its budget in the medium term, and therefore prices and export volumes would need to rise significantly to reverse the current deficit, even if major public-sector reforms can be implemented (a policy that

45. "Debt crisis exposes flaws in Kurdistan›s economy," Middle East Eye, 24 February, 2016.

will prove difficult to implement for political reasons). Thus, an independent Kurdistan is very likely to be forced into a significant contract renegotiation with investors in order to secure a greater state share of oil receipts and stabilize state income. The ability of foreign operators to monetize their investments fully according to agreed contractual terms would improve under these circumstances (as a Kurdish state would be able to pay what it owes investors according to the contract); but those amended terms will promise less of the pie to investors, by definition, which could undermine the attractiveness of investment in the new state.

Confederalism

Experience suggests that, as long as political sentiment trumps fiscal reality, these risks may not easily deter those presently leading the KRG from pushing for independence. Nevertheless, they have been careful to present secession as one of a number of possible devolution options to solve the power-sharing dispute with the federal government. Even the most vocal KDP advocates of independence have suggested that they would acquiesce in the interim to an ethno-sectarian, decentralized framework for the Iraqi state, which would devolve extensive powers to regional governments across the country at the expense of Baghdad.[46]

Some type of new decentralized structure makes practical political sense for these Kurdish leaders in the short term. First and foremost, it avoids the need to take a hasty decision on secession, and to face the fiscal and political uncertainties that would accompany it, while at the same time delivering most of the benefits the KDP is seeking from independence. Second, the formulation aligns more closely with the views of non-KDP party leaders in Kurdistan, who have reservations about the wisdom of secession at this point in time. Both the Patriotic Union of Kurdistan and Gorran have independently and jointly argued in favor of retaining formal ties to the federal government, partly for fiscal reasons, but primarily because the two parties fear that the drive for independence is part of a KDP power-play to consolidate its long-term political and economic control over Kurdistan. As the schisms between the KDP and its Kurdish rivals have grown wider over the past 18 months, the differences in opinion over independence have become more apparent.

Third, a decentralization initiative is likely to garner support from other Iraqi communities as well. It is not just the KRG that is demanding a different power-sharing model in Iraq: some Sunni leaders are increasingly convinced that their interests can only be protected in a self-governed entity; and, the federal

46. "Masrour Barzani says post-Islamic State Iraq should be 'confederation or full separation'," Ekurd Daily, June 16, 2016, http://ekurd.net/barzani-iraq-confederation-2016-06-16.

government dysfunction, maladministration, and the revenue squeeze caused by lower oil prices have prompted calls by provincial leaders in central and southern Iraq for a greater devolution of power.

The fragmentation of the political situation, the rival demands of different constituencies, and the federal government's waning ability to impose its authority nationally in the face of fiscal and security crises, certainly suggest that the prevailing power-sharing arrangements in Iraq are not sustainable in the medium term. The current security crisis has diverted attention from the long-running debate over the most appropriate decentralization arrangement for the country, but it is increasingly clear that some new formula will be needed, especially once ISIS is dislodged from north-west Iraq and the underlying schisms in Iraqi politics are once again imposed.

Given the realities of Iraq and the rival demands of different factions, nationally and locally, a new power-sharing system will need to be complex, multi-faceted, and potentially involve different levels of decentralization if it is to provide a lasting basis for a new political compact. The past 13 years have provided ample illustration that there is no "one size fits all" model that can act as the basis for broad political agreement. Instead, the different aspirations of competing factions will likely need to be accommodated in a hybrid system that addresses the bottom lines of the different communities.

From the perspective of the KRG (or at least the KDP that dominates it), a confederal system that devolves considerable decision- and policy-making power over political and fiscal affairs to the individual constituent units of the state appears to be the minimum level of autonomy that it will accept.[47] Just like Baghdad, Erbil is determined to give up as little of the independence it enjoys at present. Nevertheless, for devolution within a unified confederal state to work, even in the medium term, the KRG leadership will need to consider some important compromises. Critically, Baghdad (or an Arab region or regions) is likely to demand that, if the KRG wants to benefit financially from access to revenues generated outside of the Kurdistan region, it will need to curtail its current decision-making autonomy over fiscal, defense and oil issues.

Baghdad has made it increasingly clear over time that it will not assume spending obligations for Kurdistan without a higher level of influence and coordination over decision-making than exists at present, and this insistence is likely to be echoed by an Arab regional administration in a confederal arrangement. As the past few years have shown, a policy whereby the KRG insists it is effectively sovereign, but also expects the federal government (in other words, the rest of Iraq) to shoulder part of the fiscal burden that sustains that autonomy, is an anathema to many Arab

47. Ibid.

Iraqi leaders. Kurdish officials can insist all they want that, according to their legal interpretations of the constitution, they are within their rights to assume competent authority over defense and oil policy. But the relevant language in – and intent of – the constitution is disputed, and it would certainly need to be revised if a confederation is established. More importantly, in practical terms, administrations outside Kurdistan will control their own revenue pool, and will have little political incentive simply to acquiesce to Kurdish demands.

Thus, it will be difficult to achieve a workable formula that is founded simply on what concessions on sovereignty areas outside Kurdistan are willing to offer Erbil, as the discussion tends to be framed by Kurdish leaders at present. The process will have to be a two-way give-and-take for it to appeal to the interests of Iraqis outside the KRG (who may or may not choose to be represented by the government in Baghdad). As such, the debate needs to be recast as a process of negotiations between Arab and Kurdish leaders to agree the sovereign authority of a new confederal government that sits above, and joins, what will effectively become two or more autonomous regional administrations.

Official Kurdish formulations of a confederal structure, in as much as they have been offered, have tended to emphasize the need to make the federal government in Baghdad more of a distributive hub, limiting its fiscal (especially spending) and security control, amongst other sovereign powers. But Arab Iraqis in a new confederal structure are likely to question why their much larger oil revenue should be pooled and shared with the KRG, unless there is genuine, two-way power-sharing in key financial and security areas. In other words, for confederalism to be enticing for Arab Iraqis, Erbil will have to offer some material inducements in terms of joint decision-making

A New Hydrocarbon Arrangement

While it has been demonstrated repeatedly since 2013 that oil-management and revenue-sharing mechanisms will not be a stepping stone to broader political compromise between the KRG and the federal government, these areas will nonetheless be the cornerstones of an any sustainable confederal deal. Establishing institutions and workable legal and fiscal frameworks in these two areas that balance the interests of Arab and Kurdish entities will be critical to the long-term viability of the new sovereign state. A delicate mix of political (decision-making) and administrative autonomy that provides a sense of security to the sub-entities while encouraging them to remain under a united banner will be required.

In the oil sector, maintaining some of the established institutional structures and processes are likely to be a sine qua non. For example, the KRG has made it perfectly clear that it will not under any circumstances devolve management of its sector, which to all intents and purposes has been exclusive of Baghdad's influence and control for almost a decade. Nevertheless, coordination and alignment over licensing would benefit what are currently competing oil provinces (Arab and Kurdish) at a time when international oil companies are avidly seeking new access to upstream opportunities.

Defusing this rivalry – and enhancing joint strategic planning between the two – is also likely to require a greater alignment of contract terms, something that potentially offers far more benefit to the KRG than it does to areas currently under Baghdad's authority. The current terms offered by Erbil, while attractive on paper, have proven unsustainable in practice, as the regional government has systematically defaulted on its payment obligations, at least until recently. With the KRG unable to afford its contractual terms, and Baghdad refusing to supplement Kurdish obligations to investors on contracts that the federal government has no oversight over or approval of, something has to give, and a confederal arrangement that revises Kurdish terms may offer a practical fiscal solution to an otherwise intractable political problem.

However, the key areas where new mechanisms will need to be agreed are oil sales and revenue distribution, which remain the heart of the fiscal dispute between the federal and regional governments. Once again, a deft touch will be required to ensure early confidence building. But the key will be absolute transparency to ensure that all sides know exactly what revenue is being received before deciding how to apportion it. The current system favored by Erbil, whereby is sells its oil independently and Baghdad tops up any shortfall of revenue due to the KRG under the federal budget, can only work if there is a full audit of sales and revenue-collection. Critically, Erbil will need to reveal the real netback price that the regional government treasury receives for its crude exports; without this figure, calculating actual national income will be impossible, and the lack of transparency will reinforce Baghdad's distrust of Erbil and its reluctance to assume a share of KRG hydrocarbon-sector obligations.

If confederation is the goal, a better system for both sides would be an independently audited, joint-marketing company on which officials from regional governments are fully represented. This would allow Iraq – as a unified confederal entity – to sell its oil in a coordinated fashion with the goal of maximizing national receipts (rather than simply establishing markets at any cost, which has been Erbil's approach). Revenue distribution, meanwhile, would be decided by a confederal budget, agreed annually by the two sides. How this money is spent would be the competent authority of regional finance ministries, but both administrations would have full oversight – and joint control – over the revenue flows. This sales-and-revenue-distribution formula would allow the financial whole to be greater than the sum of its current parts, creating an incentive for closer policy cooperation between the administrations.

Ultimately, all of these mechanisms and arrangements will need to be enshrined in new oil-and-gas and revenue-sharing legislation, negotiated and agreed by all the confederal units of the country. This will not be a straightforward task, as untangling and aligning existing contractual frameworks will take time and necessitate the approval of outside parties, including foreign investors in Iraq. Nevertheless, assuming the parameters of confederalism are commonly agreed (and interpreted) in advance, approving new legal frameworks to govern the hydrocarbon sector and the management of export receipts should be a much more straightforward task than it has been so far, as the most poisonous political issues will have been resolved in advance.

Conclusion

This outline of options for alternative mechanisms for power-sharing and hydrocarbon-sector management in Iraq is cursory. It is not designed to be an in-depth examination of the constitutional, legal, and fiscal mechanisms that would need to be put in place. Moreover, there are clearly other power-sharing arrangements that could be adopted to resolve the underlying dispute between the federal government and the KRG.

Nevertheless, they do present a broad outline of possible political solutions to one of Iraq's most intractable problems, which has contributed to the gradual collapse of the state since 2003 and stymied resolution of the dispute between the federal government and the KRG over oil-sector management and revenue sharing. Absent a new power-sharing formula, both Baghdad and Erbil will persist with their present confrontational approach, guarding their independent mandate over the sector as a means of pushing their wider political agendas. In the KRG's case, this is likely to mean expanding its autonomous control at the expense of the prevailing centralized model, primarily by establishing sales and marketing precedents, and creating facts on the ground. Under these circumstances, the federal government's position is likely to become more intractable.

The fact that Erbil has pursued this oil-sector policy despite the heavy political and fiscal costs involved over the past few years illustrates its determination to protect a mandate it believes is constitutionally its right. But it also underlines how broken the political system is at present, and the lengths to which the dominant faction in Erbil will go to establish what it hopes will be eventual fiscal – and political – autonomy. These KRG leaders appear to believe that cost in terms of lost revenue, rising intra-Kurdish political strains, and diminishing popular support are worth it.

The increasingly punitive fiscal measures that Baghdad has imposed in response to Kurdish policy have shown little sign of forcing the KRG to rethink its strategy; if anything, it has eroded further what little trust existed between the two capital, and made Erbil more determined to go it alone. Nevertheless, the toughening of federal government policy since 2014 demonstrates that Baghdad too has lost patience with the KRG and what it perceives as Erbil's willful erosion of the federal government's sovereign mandate. This in turn has prompted the beginnings of a rethink among Shia leaders about the overall relationship with Erbil.

This change potentially creates an opportunity to negotiate a new long-term power-sharing framework that accommodates the basic requirements of both sides, but only if they both seize the chance. Mutual antipathy, and a preoccupation with more immediate political and security issues, have precluded serious negotiations so far. However, events on the ground, particularly the much-anticipated liberation of Mosul, may act as a catalyst for talks addressing power-sharing arrangements. Signs that the operation may bring to the fore festering disputes over territorial control, security responsibility, and decentralization are already evident in a low-level war of words between Baghdad and Erbil. These issues will become more immediate after liberation, inevitably escalating tension between the two sides. If wider estrangement – and possibly violent conflict – is to be avoided, resolution of the current power-sharing relationship and the constitutional articles underpinning will more than likely need to be addressed, as they represent the core source of dispute.

This in turn would allow competent authority in the hydrocarbon sector and revenue-sharing mechanisms between Baghdad and Erbil to be clarified once and for all, providing a greater measure of policy stability for both governments, especially the KRG. Moreover, reaching a deal on these issues would likely be easier if they are part of a wider political pact as they will reflect the broad parameters of any power-sharing pact, rather than being seen as establishing a potential precedent for any future arrangement. Hydrocarbon management will no longer be seen as influencing long-term existential issues; rather the arrangements will flow out of the prior decisions about coexistence. At that point, policy can be framed according to a different set of priorities, based on how to sustain the new arrangement rather than how to determine it in advance.