

***Iraqi Kurdistan faces
serious challenges:
Can Erbil cope with them
effectively?***

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The Kurdistan region of Iraq (KRI), like many other oil-dependent economies, is going through a serious economic crisis, compounded by security risks, domestic opposition and troubles with its neighbours. It also aspires to full independence through a referendum in the not-too-distant future.

Moreover, KRI is waging a tough war with ISIL, and tensions are as acute as ever with Iraq's central government and some of KRI's neighbours. On top of these issues, the Kurdistan regional parliament was suspended due to an internal dispute over the expiry of the president's tenure. Despite many efforts by the various political parties, we are unlikely to see a breakthrough any time soon.

Since the start of the war on ISIL and the desertion of the Iraqi army, Kurds have taken over a swathe of areas recognised as disputed territories by the Iraqi constitution, from near Mosul all the way south past Kirkuk and close to Khanakeen. Kirkuk has always been contentious because it contains significant oil reserves and has one of the most prolific oil fields in Iraq. Moreover, the demographics of the city have led to tensions among its minorities.

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Kirkuk is under de facto control of the Kurdish Regional Government (KRG) and specifically the Patriotic Union of Kurdistan (PUK). Most of the oil it produces is exported through pipeline to Ceyhan in Turkey. The governor of Kirkuk has been calling for a special status as an independent region but both PUK and the Kurdistan Democratic Party (KDP), the party of KRG president Massoud Barzani, have resisted the move.

An uneasy relationship with Baghdad. Although Kirkuk oil is under the control of the KRG, the yearly budget for the province and salaries are still being provided by the central Iraqi government and not Erbil. Since March 2016, parts of the southern field in Kirkuk were shut off by Baghdad and the oil no longer passes through the Kurdistan pipeline, but the KRG has not taken any action over the management of the field because it fears provoking complications with both Iran and Turkey.

Barzani has been calling for a referendum on independence for some time now but so far the scope and timing is not clear. The referendum is likely to include a question to clarify the status of Kirkuk. If the KRG goes ahead with a plebiscite, it will be a significant step for Erbil as it could alienate both Tehran and Ankara. But the internal dynamics of Kurdish politics are making the prospect of a referendum happening soon less likely. The PUK and Gorran, the largest opposition party in Kurdistan, wants to have a say in the scope and timing of the referendum. It is clear that Barzani cannot press ahead unilaterally.

Iran wants to keep Iraq together and does not want to see the Kurds expand their territory, while Ankara has an eye on the Turkmen minority in Kirkuk and is concerned about Kurdish dominance of one of the region's largest oil fields.

The Kurdish relationship with the federal government in Baghdad has been tumultuous, and although the Iraqi regime changed in 2003 the honeymoon period was short and cracks started to develop quickly. Oil was the main catalyst driving a wedge between the two sides. The result is that Kurds want to go their own way, and started selling oil independently in anticipation. Disputes over the budget, oil rights and territory have made it impossible for the two sides to work coherently together.

In recent weeks, the KRG has hinted that it is willing to do a deal with Iraq and hand oil sales back to Baghdad. However, over the past ten years, Baghdad and Erbil have made many agreements and none has lasted for more than few months. The most recent was at the end of 2014, on a mechanism to sell oil, but the deal broke down after six months. There might be political pressure on both sides from outside and even within to do a deal, but implementing any deal is next to impossible.

Liberation of Mosul. Iraq's second largest city, with a population of nearly two million, now occupies centre stage in the international effort to destroy the ISIL caliphate. Iraqi prime minister Haider al-Abadi has stressed the importance of cooperation with KRI and Peshmerga forces (the KRI armed forces) in the battle to liberate Mosul, saying that ISIL has benefited from political differences to sow discord. Residents of Kirkuk, meanwhile, want to see the speedier liberation of areas south and west of Kirkuk, which are still under ISIS control, before the priority shifts to Mosul.

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The Peshmerga have recently been fortified by an American aid and arms package worth almost half a billion dollars. This was important because Kurdish leaders have often complained that the US has shown a preference for arming and equipping the federal government's Iraqi army rather than the Peshmerga. Though the KRG asked for \$197m per month to cover incremental war costs, the Pentagon rationalised this figure down to around \$60m. This is not an open-ended arrangement: It will only cover the operating expenses of the Peshmerga forces involved in the Mosul operation for the duration of their involvement, totalling around \$415m.

Other forces allied to PUK and the Kurdistan Workers Party (PKK) have also declared a readiness to join in the battle for Mosul. Even the People's Protection Units (YPG) units of the Barzani-allied former Kurdish Democratic Political Union in northern Syria are prepared to stake a claim to a share of the spoils in Mosul, returning a favour to those, including Peshmerga, who fought alongside YPG to repeal ISIL from Kobane in spring 2015. More than a year ago Mosul's exiled governor revealed that Turkish special forces were training both Iraqi and Syrian Turkmen to recapture the city. For more than two years, Turkey itself has deployed forces in Bashiqa, 32 km north of Mosul, despite Baghdad's opposition. Late last year, 150 Turkish soldiers and 20 tanks were deployed to the base, which continues to operate.

Regional pressures. On top of the issues facing the KRG, there are problems emerging from the east with Iran and from the west with Syria. In June 2016, Iranian artillery started shelling Kurdish areas and five civilians were killed. This was the consequence of renewed activity of the Kurdistan Democratic Party of Iran (KDP-I) in the Kurdistan region in Iran. Tehran has already called on the KRG to rein in KDP-I, following a similar plea by Turkey to cut off the supply lines for PKK, against which Turkey is right now pursuing military action.

The latest offensive by KDP-I has been linked to rising tensions among the Kurdish parties in Iraqi Kurdistan. In the past, the Party of Free Life of Kurdistan (PJAK), the Iranian arm of PKK, was leading the more active insurgents in Iran, but for now, it has been concentrating its efforts in Syria alongside the YPG.

The PYD, through the actions of these military units, now has a foothold in northern Syria. Its connections to the PKK have made Turkey very uncomfortable. Turkey has had limited success in stopping YPG from expanding its territory in the Kurdish part of Syria, and has instead concentrated on attacking PKK bases in KRI and fighting PKK urban guerrillas in Kurdish cities in eastern Turkey.

YPG and PKK are now in control of areas like Sinjar, which the Peshmerga were unable to defend when ISIL overran it in 2014. Moreover, PKK and YPG have been the most successful fighting forces fighting

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ISIL in Syria with the help from the US, UK, France, Russia and Iran. But Turkey has been pressing the KRG to do more to curb YPG and PKK logistics by closing its border with Syria. Using a mix of political leverage and the disruption of Kurdish oil flows to Ceyhan, Turkey has been somewhat successful but this pressure has been exerted mostly on the KDP and not the Kurdish Regional Government in general.

The other recent development which could change the political dynamics is the rapprochement of Turkey with both Israel and Russia. Israel has been actively helping the Kurds in Iraq, Syria and Iran. A rapprochement between Turkey and Russia could lead to less support for the Kurds in Syria, and could intensify pressure on the United States to halt aid to YPG.

Kurdistan is in the middle of the changing dynamic of the war in Syria. So far the KRG has managed to balance all interests including Washington, Moscow, Ankara, Tehran and Baghdad. However, once ISIL is defeated, the equilibrium could change and it is far from clear how the jigsaw pieces will fall into place.

Payments to oil companies. Oil companies in Kurdistan have invested heavily in the past decade and are now producing. Payments have been regular in the past eight months but the KRG still owes significant amounts of receivables to these companies. As from 1 January 2016, the KRG's monthly payments to the producing international oil companies active in the region have been based on the contractual entitlements under the Production Sharing Contract governing each licence, which replaced the interim payment arrangements in place since September 2015.

The 2016 payments reflect the revenue derived from each producing field on a netback basis, adjusting for crude quality differentials compared to Brent prices plus deduction of applicable transportation charges. In addition to the entitlements, the KRG makes a further payment, equivalent to five per cent of the respective monthly netback revenue derived from each field, to the oil companies towards the recovery of their outstanding entitlements.

Investment has now dried up, and all eyes are on the regular payments. Several factors will affect the payments going forward. The operation of the pipeline is dependent on the security situation in Turkey. In mid-February until early March 2016, the pipeline was down. Oil prices will also be a factor in keeping the payments under control. The KRG has a huge budget deficit and does not have any other means but oil to fill the gap. It has no access to international bond markets. The only enthusiastic creditor is Turkey: the Turkish government has already advanced significant loans to the KRG.

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KRG internal politics is also an important factor in oil company payments. The main political parties keep drifting apart and the risk of going back to rival, competing administrations is increasing the longer the dispute over suspending parliament goes on.

Moreover, control of Kirkuk fields is essential for the KRG to maintain oil production at the level of the past year. There is little chance the KRG will lose control at this stage as the area is completely under its control administratively and militarily since 2014, when ISIL attacked. However, the oil company operating the fields is under Baghdad's control, and it was protected by an Iraqi military presence, which retreated under ISIL pressure.

The major destabilising factor is the state of KRG's finances. The KRG has been unable to balance its books. The government has 1.4m public servants on its books, and the majority of contractors and other workers are reliant on government contacts. The lack of cash has led to a six-month backlog of salary payments for public servants, and the majority of contractors are out of pocket as well because all major contracts have been halted.

In addition, the KRG, by raiding the savings of businesses and individuals to address the budgetary shortfall, has created a liquidity crisis leaving depositors unable to withdraw cash from the banks. The lack of cash has plunged Kurdistan into a deep recession. Property prices have halved in most areas in Kurdistan since 2014. The rental market has collapsed and many businesses have become insolvent.

This has led to a number of protests (some violent) and many walkouts by public sector workers. Traffic police and some security services went on strike in January 2016, which led to a government U-turn on previously announced austerity measures. The suspension of parliament, the general lack of transparency and corruption have cumulatively strained citizens' patience, and some have openly called for an uprising.

However, the public's frustration has not yet coalesced into a serious risk. Many Kurds feel reluctant to act on their anger as they fear the threat of ISIL and cannot see any viable alternative to the current ruling coalition. For the Kurds, the only near-term option is to maximise the goodwill of international players by treading a fine line, reforming their subsidy-reliant economy, resolving internal disputes and supporting the Mosul battle while simultaneously reassuring regional actors in Tehran and Baghdad.

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