KURDISTAN
Oil & Gas

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Politics casts shadow over energy wealth

Sylvia Pfeifer and **Javier Blas** say the region's natural resources create both alliances and strife

The hills to the north-west of Erbil, Kurdistan's capital city, have witnessed some significant events. In 331 BC, Alexander the Great defeated Darius III of Persia here.

More than 2,000 years later, the forces of Saddam Hussein, the former Iraqi dictator, launched their attack on the city from the hillside.

Today, the same hillside is in the line of sight of the Erbil refinery, a recent addition to the area but potentially just as significant.

The 40,000 barrels a day refinery is a symbol of the sweeping changes that have taken place in Iraq's semi-autonomous northern region over the past decade – changes driven by the wealth that lies underneath its desolate landscape.

The US Geological Survey estimates that Iraqi Kurdistan holds about 40bn barrels of oil – about as much the North Sea has so far produced in the UK – and roughly 60 trillion cubic feet of gas. The region's history means that these reserves have remained relatively untouched, offering industry one of the last great frontiers of conventional onshore oil and gas.

The Kurdistan Regional Government (KRG) has not been idle, astutely using its hydrocarbon wealth to attract billions of dollars of investment from international companies. From a standing start just four years ago, the region's industry has developed to the point where it now produces 175,000 b/d.

More than 40 companies have committed to investing in the energy sector in Kurdistan, from small independents such as Genel Energy (*see page 3*) and DNO, an Oslo-listed oil company, to Spain's Repsol and, as of October, even ExxonMobil of the US, the world's largest quoted international oil company.

In the process, the region, in particular Erbil, has been transformed. Electricity supply has gone from about four hours a day, as in the rest of Iraq, to about 22 hours. Security remains an issue, but the last serious attack was more than six years ago. Erbil itself is a vibrant, bustling city, a booming construction site that has attracted some of the world's leading international hotels, including Kempinski. The region's expected growth rate next year is 12 per cent.

Yet Erbil's energy success has put it at odds with Iraq's federal government. At the conference, Mr Salih said his government sought co-operation with Baghdad and talked of achieving "common goals".

He condemned what he described as "dissenting voices in a few circles in Baghdad", stressing that "there is no way we will let ourselves be held hostage by some bureaucrats".

The dispute focuses on the thorny issue of who owns Iraq's oil. According to Baghdad, the KRG's production sharing contracts are illegal. Erbil, however, considers that the Iraqi constitution approved after the fall of Saddam Hussein's regime gives it the power to manage its own contracts. The split means that, for several years, companies such as DNO were unable to export oil.

"The days when Kurdistan was an economic backwater are over," Prime Minister Barham Salih told delegates at the region's first ever oil and gas conference in Erbil last month. Compared with other oil regions, executives say that security is not a problem.

Iain Wright, associate director at Afren, a London-listed Africa-

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The US Geological Survey estimates that Iraqi Kurdistan holds about 40bn barrels of oil Dreamstime

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Kurdistan: Oil & Gas

Locked in a stalemate: DNO has been unable to make any headway with exports from the Tawke oil well because of the politics between Erbil and Baghdad Getty

The intrepid early prospector gets the government contract

DNO

Javier Blas reports on the benefits and problems of being a pioneer in this region

The Tawke 10 oil well epitomises the promises and pitfalls of the Kurdish oil industry.

The red-painted well, in a remote area of rolling hills in northern Iraq near the borders with Syria and Turkey, lies only 50 metres from a large natural oil seepage, a powerful indication of the natural riches of the region.

But DNO, the company that successfully drilled it, has left the well idle because a political disagreement between Erbil, the capital of the semi-autonomous Kurdistan region, and Baghdad means that the Oslo-listed company can only export a fraction of the production of the Tawke field.

The politics between the Kurdistan Regional Government and Baghdad has haunted DNO since the company arrived in Erbil in 2004, only months after the US-led invasion of Iraq, looking for an oil exploration contract in the region.

Together with privately owned Genel Energy of Turkey, DNO was among the first to arrive in Kurdistan. It signed its production-sharing agreement with the KRG in June 2004, well before the formation of Iraq's national government. The company found oil shortly afterwards.

Since then, DNO has spent $600m developing the Tawke oilfield and another $200m exploring for oil nearby, making it one of the biggest investors in the region.

Yet its bet on Kurdistan has delivered a mixed return. Even as its executives paint a relatively rosy picture, analysts point to one problem after another.

Nearly five years after the company built a 44-kilometre pipeline linking Tawke with the Iraq-Turkey pipeline to export its oil, it continues to sell the bulk of the field's output in the local Kurdish market, where artisanal refineries buy it at less than half the international price.

Moreover, DNO has so far received two payments for the fraction of its production that it is able to export through the international pipeline, although Kurdish officials believe more money is on its way. The difficulties have forced the company to put on hold a plan to nearly treble the oilfield's maximum production capacity to 200,000 barrels a day.

Yet, in spite of all the pitfalls, the Tawke oilfield and DNO are also the best examples of the promise of the Kurdistan region.

As their executives point out, they struck oil at the first attempt, signalling good geology in the area, and were able to build their processing facilities and pipeline in record time.

Michael Alsford, oil analyst at Citigroup, the US bank, says in a recent report that the company is "well placed to benefit" from any improvement in the situation in Kurdistan, particularly if a deal between Erbil and Baghdad opens the door to large exports from the region.

DNO's start was not easy, with security a big concern. It faced an uphill battle to persuade contractors to work in Iraq. When it tendered the seismic work, in which geologists hunt for oil in the subsoil, instead of the usual list of 25-30 companies, only two showed interest. The first choice declined the job, so DNO had only one option.

> In spite of all the pitfalls, the Tawke oilfield and DNO are the best examples of the promises of the Kurdistan region

Even so, the company weathered all the challenges and found a large reservoir soon afterwards. It fast-tracked the development of the field and was ready to export in mid-2007. But then the problems really started, because of the lack of a petroleum law to allow exports of oil from Kurdistan.

Yet, DNO – together with other pioneering companies in the region such as Genel, now merged with Vallares, and Western Zagros – has benefited from its early arrival, as its production-sharing contract was ratified in the Iraqi constitution of 2005.

"In regard to the legality of its contracts, we believe that DNO is better positioned that many of its peers," says Mr Alsford.

As such, DNO is seen as the most obvious candidate to drive a first round of consolidation in the region. Kurdish officials say they would like to see the 40 or so companies operating in the region reduced to about 10-15 large businesses.

Industry executives and analysts say DNO could be taken over by a major seeking quick access to the region, for example, Total of France, Chevron of the US, or Eni of Italy.

"In the coming months, we expect to see a surge in investor interest in Kurdistan," says Al Stanton, an oil analyst in London at RBC Capital Markets, the investment banking arm of Royal Bank of Canada, in a recent report.

But the company could also merge with a rival already established in the region to form a super-Kurdistan oil company.

For months, both DNO and Genel have fuelled rumours about a possible merger. "DNO is our natural partner, so it makes a lot of sense if we can take them into Genel," Mehmet Sepil, president of Genel Energy, said on the sidelines of a recent conference. DNO executives have made similar comments in the past.

DNO itself is already trying to grow in size through merger and acquisitions. The company is taking over assets from RAK Petroleum, a Middle East-based oil company with assets in Oman and the United Arab Emirates.

The shareholders of both companies approved the merger in September and the transaction is expected to close in January 2012. The combined company would be listed on the London Stock Exchange's Alternative Investment Market in addition to the current listing in Oslo.

DNO is also in a better financial shape today than when it ventured into Kurdistan.

The company made profits of $150m in the first half of the year, compared with losses of $106m in the same period of 2010. Revenues surged to $1.1bn, more than double the $543m of 2010.

But with most of its assets in unrest-hit Yemen and politically troubled Kurdistan, DNO remains a difficult investment choice, according to most analysts.

Domestic processing capacity is rising quickly

Refining

Sylvia Pfeifer and **Javier Blas** find that the region's industry is diversifying beyond extraction

Immaculately dressed with neatly cropped hair, Baz Karim gestures to the rows of vehicles lining up in the loading bay outside the Erbil refinery. More than 200 trucks pass through every day, picking up oil products such as fuel oil and benzene, before delivering them to cement and steel factories, and distribution networks around the region.

The Erbil refinery, the fourth largest in Iraq and the largest private sector one, is a shiny new symbol of private, local investment in Kurdistan – and of the region's ambitions.

It is part of the Kar Group that Mr Karim founded in 1999, a services company for the oil and gas industry. The company started in fuel trading during the period of United Nations sanctions on Iraq, before the US-led invasion in 2003, supplying fuels funded by non-governmental organisations to the rural poor in Kurdistan.

Mr Karim's team moved on to help rebuild the country – government ministries needed everything from desks to computers after the war, he recalls.

Unlike international oil and gas companies that have come to Kurdistan to explore, which are blacklisted by Baghdad, local service contractors have managed to bridge the divide.

The company's first contract, in 2004, was with Baghdad for the engineering and supply of equipment to the Khurmala Dome oilfield. In 2008, a rare joint decision by the federal and regional governments determined that the Khurmala Dome would be developed and operated to supply oil for the Erbil refinery. The Kar Group gets a set fee from the regional government for processing the crude – a model introduced to help kick-start the refining industry.

The refinery processes 40,000 barrels a day, but under an expansion plan its capacity is expected to nearly triple to 110,000b/d by the second half of next year. Mr Karim reckons that once the expansion is complete, the refinery will be able to cover close to 80 per cent of local needs.

In addition to Erbil and the refineries at Baiji, central Iraq, Baghdad and Basra, there are dozens of backyard, so-called "teapot", refineries. Together they are capable of processing a total of about 790,000b/d of crude, according to the US Special Inspector General for Iraq Reconstruction. The teapot refineries can only produce low-grade diesel, fuel oil and, in some cases, kerosene. In northern Kurdistan, some of them are able to process fewer than 1,000 b/d of very low-grade products.

The surge in Kurdistan's oil consumption is part of a broader trend within Iraq. The country has seen its oil demand rise to more than 700,000 b/d in 2011, up from just 450,000 b/d in 2003, as economic activity improves, according to estimates by the US Department of Energy.

Power shortages have contributed to the rise in demand, as some areas of Iraq only have a few hours of electricity a day, relying on diesel-powered generators the rest of the time. Although the region has enough refining capacity to meet its rising consumption, years of neglect mean that most plants are only able to run at about half their capacity, forcing Iraq to import refined products from neighbouring countries.

The US Department of Energy estimates that Iraq relies on imports for a third of its petrol consumption and nearly a fifth of its liquefied petroleum gas, including butane and propane.

The lack of capacity has created an opportunity in Kurdistan to build refineries to meet the region's demand, but crucially also to export south towards Baghdad, and beyond.

DNO, the Oslo-listed oil company and one of the first to enter Kurdistan, has built a small refinery at its Tawke oilfield. The 6,000b/d installation was meant to provide the oilfield's power generators with diesel, but since then it has become part of DNO's strategy to market its production, executives say.

The company cannot export as much oil as it would like, because of the disagreements between Erbil and Baghdad, and neither can it sell all its crude oil output into the local market. Thus the small refinery provides DNO with naphtha, diesel and fuel oil, which are in strong demand in Kurdistan.

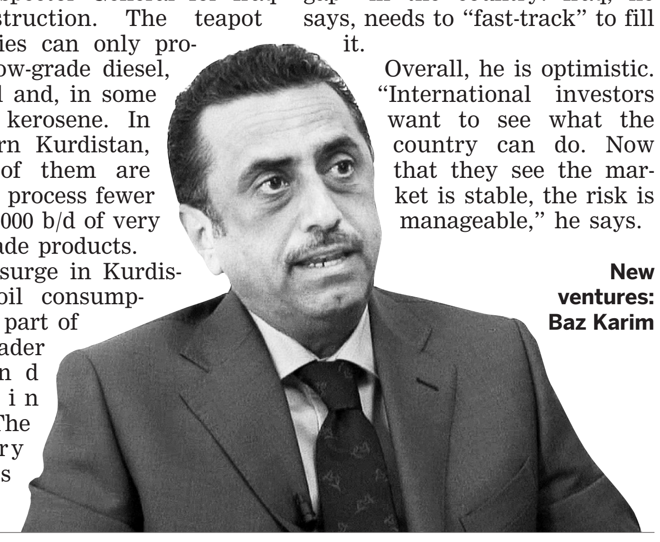
Other explorers, such as Genel Energy, which recently listed on the London Stock Exchange and is headed by Tony Hayward, the former chief executive of BP, the UK oil group, also argue that even if exports remain limited, the domestic opportunity for their product is large.

Baghdad's own plan to expand the refining capacity has so far been delayed. In 2008, the federal government announced a 10-year plan to build four refineries with a capacity of 740,000 b/d, at a cost of $20bn.

At the Kar Group, ambitious expansion plans are afoot. Mr Karim wants to develop the business into an integrated oil and gas player. Over the next five years, he plans to focus on investing in the downstream and midstream sectors – including power plants and petrochemical plants – followed by developing exploration and production capacity.

One of the biggest challenges, Mr Karim says, is the "20-30 year management and skills gap" in the country. Iraq, he says, needs to "fast-track" to fill it.

Overall, he is optimistic. "International investors want to see what the country can do. Now that they see the market is stable, the risk is manageable," he says.



New ventures: Baz Karim

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focused oil explorer, told the same forum: "For those of you who have worked in Nigeria, Kurdistan is a walk in the park."

Using energy as its calling card, the KRG has also managed to establish strong links with Turkey. Only four years ago, Ankara's diplomats referred to the senior leadership of the KRG as "terrorists", blaming the region for the attacks of the PKK party, which is seeking to unite the minority ethnic Kurds in Syria, Iran, Iraq and Turkey in one, independent country.

But the large deposits of natural gas of Iraqi Kurdistan and a booming bilateral trade – together with a better mutual security understanding – have led to much-improved relations.

At a recent energy conference, Aydin Selcen, Turkish general consul in Erbil, summarised Ankara's attraction for the region: "We need to diversify our supply of oil and gas."

The presence of Mr Selcen and other senior Turkish officials was, according to oil executives, the clearest sign that the relationship between Ankara and the KRG was on the right track.

"Simply, the presence of a deputy energy minister and a consul would had been impossible only four years ago," an oil executive with large interests in Iraqi Kurdistan says, noting that both sides had been talking openly since 2010.

There has been some progress. This year, a deal between Baghdad and Erbil allowed the Kurdish government to pay oil companies for the first time in more than two years.

Exports have resumed via the Kirkuk pipeline to Ceyhan in Turkey. The two sides have agreed to raise exports to 175,000 b/d from next year, from 100,000 b/d today. But the deal is provisional and a permanent solution depends on both sides agreeing a petroleum law, delayed since 2007.

An agreement was expected in early 2012. The arrival of ExxonMobil in Kurdistan could play both ways: sour relations further or act as a catalyst.

The political problems are huge, but for those companies active in the region, the geological and business attractions are clear. "It's about ideology, not about Arabs and Kurds. Are you pro private sector, pro investment or pro state control," says Majid Jafar, chief executive of Crescent Petroleum and a board member of Dana Gas. "Exxon entering the market in Kurdistan is the market telling you what the correct model is," he adds.

> 'We may have five-star hotels being built, but we don't have a proper hospital'

Companies face little exploratory risk: over the past two years, eight of each 10 wells have found hydrocarbons. "Kurdistan's large discoveries coupled with the low-cost operational environment have allowed operators to proceed with the fast-track development of some of the discoveries made in the past decade," says Michael Alsford, oil analyst at Citigroup, the US bank.

Ashti Hawrami, KRG natural resources minister, believes the string of oil discoveries will allow the region to boost its production to 1m b/d by 2015. Yet some oil analysts believe the target is overly ambitious, particularly with the petroleum law still pending approval.

And without an increase in production, other projects, including a new pipeline through Turkey, may fail to materialise.

The region is also facing challenges on the domestic front. Among these is a bloated civil service – more than 1m people of an estimated population of 4.8m are on the government payroll – and no institutional capability.

"A wall of money is going to hit them and they still don't have the financial infrastructure to deal with it, the breadth and experience are not there yet," said one western diplomat.

Corruption remains an issue, according to executives in the region, particularly lower down the supply chain.

Hiwa Osman, a writer and former adviser to Iraqi president Jalal Talabani, and now setting up a news network, points out that while there is a lot of oil money, there is little domestic manufacturing.

"Everything is imported, mostly from Turkey. We may have five-star hotels being built, but we don't have a proper hospital."

These are issues the government is well aware of, says Bayan Sami Abdul Rahman, high representative to the UK on behalf of the KRG. It is government policy to reduce the number of people on its payroll, but with "no other safety net available, we need to do it carefully," she says.

Kurdistan has attracted a huge investment but the next few years will be critical. "We do have an important guarantor in the shape of elections every four years. We are eight years ahead of other Middle East countries," says Mr Osman.

Exxon move shocks the sector

Big oil

It is the first of the supermajors to sign a deal with the north, writes **Sylvia Pfeifer**

As a sales pitch it takes some beating. Hussain al-Sharistani, Iraq's deputy prime minister for energy, told an audience in London last month that his nation has 143bn barrels of proven oil reserves – about 10 per cent of the world's total. The country boasts further probable and possible reserves of about 200bn, he said.

They are numbers that every oil industry executive will know. They are also the reason why, when Iraq in 2009 offered access to its oil for the first time since nationalisation more than 30 years ago, the world's biggest companies came knocking at the door.

First BP, and then eventually its peers, ExxonMobil, Royal Dutch Shell and Eni of Italy, all secured contracts to develop some of Iraq's biggest fields despite the tough terms being offered by the federal government. Instead of production sharing contracts, the companies agreed to less lucrative service contracts.

Two years later, Exxon has shocked the industry – and officials in Baghdad – by signing contracts to explore in Kurdistan, Iraq's semi-autonomous northern region. The move, the first by one of the world's supermajors which had until then kept away from the north for fear of antagonising Mr Sharistani and his colleagues, has sparked a heated reaction.

Baghdad has always maintained that any contracts signed for oil and gas exploration with the Kurdistan Regional Government (KRG) are illegal.

At the time of writing, the federal government is still considering "its actions" against Exxon and whether to cancel its contract as operator to develop the huge West Qurna field in the south of the country.

So what prompted Exxon, the world's largest international oil company by market capitalisation, to risk turning its back on the vast reserves held in the south and take a bet on Kurdistan's relatively more modest, 40bn barrels of oil reserves?

While executives from other majors have talked to the KRG, none of them has so far agreed an actual contract. Indeed, Shell, the Anglo-Dutch group, is understood to have been negotiating in parallel with Exxon to secure acreage in the north, but decided at the last minute not to proceed as it sought to protect its investments in the south of the country.

Even the US State Department revealed it has repeatedly warned American companies "that they run significant political and legal risks if they sign contracts with any parties in Iraq before there has been a national agreement to work out the complex issues having to do with oil revenue distribution within Iraq".

For its part, Exxon has so far kept resolutely silent on its move but industry executives believe the slow rate of progress in the south, hampered by security concerns, bureaucracy and logistical bottlenecks, must have played a part. Iraq's daily production has only recently returned to 2.8m barrels a day – the level it was at before the US-led invasion in 2003. The country has an ambitious target of 12m barrels a day by 2017.

Michael Shipster, a director at Rolls-Royce, told the same conference in London that the company had spent the past two years looking at entering Iraq, but had been hindered by bureaucracy.

"We have had difficulties getting decisions out of ministers, and there is a shortage of available financing for companies," Mr Shipster said.

"It can look daunting from afar," admitted one senior oil industry executive operating in the south. "There are issues with visas, the import procedures need modernising and the port facilities need improving."

There is also a level of bureaucracy around invoicing that means every receipt is checked in detail – leading to delays in payment to international companies.

Nevertheless, the view at least from this executive, is that none of this has come as a surprise. Given Iraq's huge exploration potential, it is something many companies continue to accept.

Despite Exxon's silence, what is clear is that the government of Prime Minister Nouri al-Maliki now faces a difficult balancing act. Taking too hard a line against the US company might sour future investments in the south at a time when the country is anxious to boost its production after years of conflict.

Being seen to be too lenient on Kurdistan may give greater incentive to the other regions looking for more autonomy from Mr Maliki's central government authority.

Optimists believe that Exxon's move into Kurdistan could prove to be a catalyst for the country at a time when US troops prepare to withdraw. Nor is it only Exxon's interests at stake. The company is also leading a multibillion-dollar water injection plan that is critical to bolstering the output from the southern oilfields and several industry executives said they thought this might help shield Exxon from being completely ejected by Baghdad.

Speaking at Kurdistan's first oil and gas conference in Erbil last month, Sir Jeremy Greenstock, former UK ambassador to the UN and a director at Lambert Energy Advisory, told delegates "a crunch moment" was coming as US troops withdraw.

Next year, he added, "will be a genuine test for a united Iraq".

Executives from Exxon, who had been due to attend the conference in Erbil but withdrew after news of its agreement broke, will surely have been listening.

> Being seen to be too lenient on Kurdistan may give more incentive to the other regions looking for more autonomy

Let there be light: in contrast to southern Iraq, electricity supplies in Erbil, above, and the surrounding area are almost continuous Alamy

Natural gas North looks to tap into long-term export potential of vast reserves

At night, a reddish glare surrounds Basra in hydrocarbon-rich southern Iraq. Yet the city has electricity for just four hours a day; none at the night. The glare is the effect of "flaring", or burning off, vast quantities of natural gas from the huge Rumaila, Zubair and West Qurna oil and natural gasfields.

Erbil, the capital of the semi-autonomous region of northern Iraq, is alight too, though not from the glare of natural gas burning, but because it has electricity 22 hours a day. This is no small matter but is a sign of the different fortunes of the natural gas industries in northern and southern Iraq, with significant implications for the Kurdistan region.

The US Geological Survey estimates Iraqi Kurdistan has 60,000bn cubic feet, more than the estimate for gas reserves in Libya.

While crude oil attracts most attention from industry executives, diplomats are particularly interested in natural gas, because Turkey is short of supplies and Ankara has signalled it is ready to import and serve as a corridor for exports.

Selahattin Cimen, deputy undersecretary at Turkey's Ministry of Energy and Natural Resources, says Kurdistan could supply the country with gas for power generation. "Turkey is the natural direction for exports of hydrocarbons from the region [of Iraqi Kurdistan] to the world's market," he says.

Turkey is particularly keen to import natural gas for power generation, and perhaps build a gas pipeline from the fields near Sulaimaniya, the second-largest city in Kurdistan, to the Turkish Mediterranean port of Ceyhan. Kurdish and Turkish officials talk about building an export facility to supercool natural gas so it can be transported by ship, although industry executives say such a facility is years, if not decades, away.

Aydin Selcen, Turkish general consul in Erbil, says his country depends on Russian natural gas for 70 per cent of its imports. "The most commercial alternative seems to be the Kurdistan Regional Government (KRG). We have a long shared border."

Turkey is even talking about connecting an export pipeline from Kurdistan to the projected Nabucco pipeline, which would link the gas-rich Caucasus and Central Asia to energy-hungry European nations.

A second option suggested by officials in Baghdad, and with less support in Erbil, is the so-called Arab Gas Pipeline (AGP) project.

According to the US Department of Energy, the AGP would deliver gas to Syria and then to Lebanon and the Turkish border. But the recent violence in Syria means the project faces an uncertain future.

While plans for exports mature, in Kurdistan the domestic natural gas industry is growing rapidly. The biggest companies are Crescent Petroleum and its affiliate, Dana Gas, which signed an agreement in April 2007 with the KRG to developed several gasfields. Two years later, the companies signed a deal with OMV of Austria and MOL of Hungary to develop two key fields.

The companies started production in October 2008, with the gas supplying local power stations that produced about 1,620 megawatts of electricity – about the same as a nuclear power plant.

"This has ensured an almost continuous power supply for 4m people in the Kurdistan region, in contrast to the electricity crisis in other parts of Iraq, and has provided savings of over $2bn annually in fuel costs for the government," says Majid Jafar, chief executive of Crescent Petroleum.

But analysts believe the export market will be the most important over the medium term. "In the absence of local demand, gas exports remain the only option of monetising these large discoveries [of natural gas]," Citigroup wrote on a recent report about the oil and gas sector in Kurdistan.

Javier Blas

Former BP chief explores the final oil frontier

Case study
Genel Energy

Cash, international expertise and local contacts set it apart, says **Sylvia Pfeifer**

Kurdistan's new national oil champion stepped on to the world stage in the plush surroundings of the Lanesborough Hotel in London.

On a Friday morning in June this year, Tony Hayward, the former chief executive of BP who resigned in the wake of the oil group's devastating Gulf of Mexico spill, arrived for an appointment. His guest was Mehmet Sepil, chief executive of Genel Energy, a small Turkish-backed explorer with assets in the region.

The two men made unlikely breakfast companions, but each had something to offer: Mr Hayward, who had just listed an investment vehicle, Vallares, with financier Nat Rothschild, offered a fast route to the London market and close to $2bn of cash. Mr Sepil brought an opportunity in the shape of Kurdistan's largest oil producer.

The meeting had a happy outcome and a merger was agreed. Last month, Genel Energy listed on the London Stock Exchange. It joined other Kurdistan-focused explorers listed in London, including Gulf Keystone Petroleum and Petroceltic.

Genel has been one of the pioneers in Kurdistan's oil and gas industry, thanks in large part to the efforts of Mr Sepil, who first arrived in the region in 2002. Two years later, Genel, which was backed by Turkish investors, agreed a production sharing contract with the Kurdistan Regional Government to develop a licence area called Taq Taq, about an hour from the regional capital Erbil.

Today, two things make it stand out: its cash pile and the presence of Mr Hayward, the chief executive, and his lieutenants. They include Rodney Chase, former deputy group chief executive at BP and now Genel's chairman, and Julian Metherell, a former Goldman Sachs banker and the company's chief financial officer.

Genel plans to use its cash and the new management's expertise to consolidate Kurdistan's explorers, and target other companies in the Middle East. Aspect Energy and Longford Energy, two small players with Kurdish operations, are the latest companies being screened, according to industry bankers.

Informal talks have also been held with DNO, the Oslo-listed producer and a joint-venture partner of Genel. Genel, Mr Hayward told reporters in Erbil last month, has some special assets in one of "the last great oil and gas frontiers still accessible to private investors".

He continued to list "a strong asset base ... that would normally belong in the hands of a supermajor; a balance sheet of about $2bn; a management team that is a bit bigger than the company we have today; and a Turkish brand, a very interesting attribute at a time of change in the region".

Genel has an interest in two producing fields, Taq Taq and Tawke. Recovery rates are high, says Mr Sepil, adding that the total cost per barrel is a cheap $3-$4.

Taq Taq produces 75,000 barrels of oil a day. The crude is either trucked to Fishkabur, where it is metered and pumped into Iraq's export pipeline to Turkey's Mediterranean port of Ceyhan, or sent to a local refinery for the domestic market.

Genel also plans to build a $400m oil pipeline to link the field with the Kirkuk-Ceyhan pipeline. It hopes to start construction on the 400,000 b/d pipeline in the spring. The plan is to more than double production capacity at the field to 200,000 b/d by 2014.

Despite Mr Hayward's enthusiasm, Genel's prospectus lists no less than 53 separate risk factors for investors. Top of the list is political risk, specifically the possibility that the Iraqi oil ministry, which has historically disputed the validity of Kurdistan's production-sharing contracts, may dispute Genel's rights to its assets. This has held up the agreement on a long-disputed hydrocarbon law and has also hampered exports.

If it worries Mr Hayward, he does not show it. Investors, he says, should not forget the domestic market, which may pay a lower price for the crude, but is in need of supplies.

> The Iraqi oil ministry, which has queried some production-sharing contracts, may dispute Genel's rights to its assets

"Iraq is importing 50 per cent of its products for domestic use," he said, describing it as "a significant insurance policy", if payments for exports are not forthcoming.

There are other challenges. While Mr Sepil, now president of Genel, is a star in Turkish business circles and will be invaluable in helping manage the operations of the company, he is not without baggage.

He was fined just under £1m ($1.6m) last year by the Financial Services Authority, after admitting insider dealing in fellow Kurdistan explorer Heritage Oil.

Mr Hayward, however, is adamant that when it comes to corporate governance, the structure of the group is impeccable, noting that unlike many resource stocks that listed in London recently, Genel offered 50 per cent of its shares to the market. Nor can investors expect public spats such as that in Mr Rothschild's other venture, Vallar, now called Bumi.

The relationship between Mr Hayward and Mr Sepil is crucial. Industry executives in Erbil noted Mr Hayward had yet to adjust to running an independent explorer. Mr Hayward argues running Genel is "analogous to running a business unit within BP".

He will be hands-on, insists his new partner. If there is a problem, says Mr Sepil, "it will be Tony who gets the call".

Federal or regional is question for Iraq's petroleum

Guest Column
J. JAY PARK

The Republic of Iraq is blessed with one of the world's greatest treasures of petroleum. It is now creating the laws and contracts that will govern how it develops and uses those resources to benefit its people.

These laws and contracts will define how well the country's petroleum assets will be converted into prosperity for Iraqis.

The history of petroleum development in Iraq, as in many other countries, is not a happy one. The country now has an unparalleled opportunity to do things better.

Its oil and gas potential is so large that it can benefit not just Iraqis but all energy users, so it is useful to observe Iraq's progress.

The combination of rules that govern petroleum development in a state are referred to as the petroleum regime. It comprises the constitution of the state, its petroleum laws and regulations, and the contracts that the host government uses to award the right to conduct oil and gas operations.

Iraq's constitution is the first and most important piece of its emerging petroleum regime.

The constitution, adopted in 2005, establishes that the Republic of Iraq is a federal state. It has a federal government, as well as governments within the regions and governorates.

Similar to the constitutions of other federal states, the federal government and the regional governments are allocated certain exclusive jurisdictional powers, and some that are shared.

Authority for petroleum does not appear in the list of exclusive federal powers or shared powers. Regional governments are given jurisdiction over all other matters which are not exclusive federal powers or shared powers. It follows that petroleum is a matter where the regional governments have authority.

However, the constitution has some special provisions that govern petroleum matters. This alters the suggestion that petroleum is solely a regional power.

It is expressly stated that "oil and gas are owned by all the people of Iraq in all the regions and governorates", confirming the right and title of the Iraqi people to the ownership and benefit of petroleum.

Also, the constitution provides that the federal government shall manage oil and gas from current fields. The federal government must apportion fairly the resulting revenues throughout the country, proportionate to the population distribution. The constitution requires that these matters be regulated by a law.

These constitutional provisions provide some direction, but they also create questions.

What is a current field? How will the federal government award contracts to develop current fields? And how will regional governments award contracts to explore for other fields?

These questions were answered in a draft federal oil and gas law that was prepared in 2007, but despite the fact that this document includes the most advanced principles of petroleum regulation, it has not yet been enacted.

> Authority for petroleum does not appear in the list of exclusive federal or shared powers

The 2007 version has been modified by more recent oil and gas law drafts, which are now before Iraq's Council of Representatives (the country's main elected body) for review and approval.

In the absence of the petroleum law that the constitution demands, the federal government has awarded more than a dozen service contracts to develop discovered fields, and the Kurdistan regional government has awarded more than 40 contracts to explore for new fields.

These governments appear to have been acting within their constitutional jurisdiction in doing so, notwithstanding claims to the contrary.

The terms of these contracts have been very attractive to Iraq, because international oil companies, excited by the excellent geology in the country, have offered generous terms.

The next key step that Iraq needs to take to complete its petroleum regime is to enact the petroleum laws and regulations that will lock in the development benefits that Iraqi citizens are demanding.

These rules will ensure that the discovered resources will in fact be produced and monetised. When Iraq's federal and regional legislatures have completed this task, Iraq will be poised to realise the rewards of its oil and gas treasure.

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Kurdistan: Oil & Gas

Pace of growth straining capital's infrastructure

Erbil

The economic boom is uneven as construction thrives but services falter, say **Javier Blas** and **Sylvia Pfeifer**

The view from the 23rd floor of the Divan, Erbil's newest five-star hotel, which opens early next year, provides the perfect vantage point from which to survey the construction boom that is gripping the capital of Kurdistan, northern Iraq's semi-autonomous region.

In blocks immediately surrounding the Divan, some of the world's leading international hotel groups are busy erecting new towers, including the Marriott Group and Kempinski.

Next to the hotels are two residential blocks, the Italian Village and the English Village, where expatriates – most of them working in the oil industry and also for Turkish companies – and wealthy locals live in neat, almost identical two-storey houses.

Cem Saffari, business development manager at the Divan who has been in Kurdistan since September, says there are not "enough five-star hotel rooms" available to meet demand. The room shortage is one of the most striking examples of the oil boom.

The economy of the small territory, sandwiched between the rest of Iraq to the south, Turkey to the north, Iran to the east and Syria to the west is growing so fast – local officials venture a 12 per cent year-on-year rise – that it is straining the infrastructure.

Barham Salih, prime minister of the Kurdistan Regional Government (KRG), says that per capita income has risen from $375 in 2002, the year before the US-led invasion, to an estimated $5,500 in 2011. The region has seen a big improvement in living conditions, observers say.

Electricity, for example, runs 22 hours a day; in the rest of Iraq, and particularly in the south, shortages are so acute that most cities only receive four hours a day. The city has also opened an airport, with flights to European cities such as Vienna and Frankfurt, daily services to Istanbul, and links to Dubai and Amman, among others. Yet, the economic boom has been uneven. Health services, for example, cannot keep pace with people's needs and truck traffic clogs the roads.

Mr Salih told a recent energy conference in Erbil that he is planning to tackle some of those problems with a huge expansion of the budget next year. Government expenditure is set to jump 30 per cent to $13bn, up from $10bn this year. Back in 2002, before the US-led invasion, the region's embryonic government had a budget of just $100m.

Kurdistan produces about 175,000 barrels a day of oil currently, but only exports about 100,000 b/d. Oil export revenues do not go directly to the region, but to the federal government's treasury. Since 2004, the regional government has received about 17 per cent of the federal budget of Iraq, although Baghdad deducts "administrative costs" from that amount.

As oil prices surge above $100 a barrel and the country's overall production – from the south and from Kurdistan – increases, the region's budget has ballooned. The International Energy Agency, the western countries' oil watchdog, estimates Iraq's oil production has recovered to the prewar level, reaching 2.8m barrels a day, up from 2.5m b/d in 2009 and less than 2.0m b/d in 2006.

The budgetary expansion looks likely to continue, as both Baghdad and Erbil plan a big increase in oil production.

Kurdistan itself is aiming to boost oil output from 175,000 b/d currently to about 1m b/d by 2015. Although oil executives say the target is ambitious and may take a couple more years to achieve, it would transform Iraqi Kurdistan into one of the leading oil producers in the world, on par with Opec cartel members such as Qatar and Ecuador.

In the meantime, Baghdad is aiming to boost production in the oil-rich south of the country to 12m b/d by 2017 with the help of international oil companies such as BP, Royal Dutch Shell and ExxonMobil, although analysts believe a target of about 6m b/d by the same date is more realistic.

The proposed rapid increase in production means the oil boom should continue. But observers worry that Kurdistan, like many other countries rich in natural resources, could fall victim to the oil curse.

Erbil exhibits worrying signs already: Turkish exports, in particular, are flooding the market as a strong currency, sustained by oil revenues, encourages overseas buying. Costs and salaries are also increasing rapidly. So too, therefore, is inflation.

Oil executives say that a local qualified employee with three years' experience could take home about $2,500 a month, up more than 50 per cent from five years ago. Housing costs, particularly for expatriates, have doubled also over the past five years. Small villas are rented for between $3,500 and $6,000 a month.

Besides oil, security is the other great economic engine of Kurdistan. While terror attacks in the Shia-Sunni conflict continue to be a daily routine in the rest of Iraq, the northern region, with its ethnically homogenous population and increased prosperity, has seen little violence over the past few years.

Mr Saffari, who previously worked in London where his family still resides, says: "I was worried because of the bombings and violence in Iraq, but in Erbil I feel safer than in London. When I tell my family they think I am joking."

In demand: new hotels are springing up on the Erbil skyline as pressure grows to supply accommodation for the influx of oil workers Reuters

'I was worried because of the violence in Iraq but in Erbil I feel safer than in London'

Cem Saffari, Hotel manager

Ethnic interests could trump economic sense

Guest Column
JOOST HILTERMANN

These days, Erbil has the feel of one of those gold prospecting towns of the old US west.

Investors of all stripes descend on the Iraqi Kurdish capital to spend their dollars, lured by high – indeed inflated – figures for suspected oil and gas reserves and promises of commensurate returns.

Some need little encouragement, but with each new contract signed, and as exports climb, even relatively conservative companies are taking the plunge, fearing they might lose out if Kurdistan proves the bonanza its leaders make it out to be. ExxonMobil was the latest, and the biggest, to dip a toe in the water.

It has been the Kurdistan regional government's genius to sell itself as the last frontier in oil exploration and as virgin territory receptive to private enterprise, holding out development contracts with terms far more favourable than those Baghdad offers for Iraq's huge southern fields.

Few seem to understand, or care, what Kurdistan's strategy is, and appear content to be part of the game if it generates huge profits. Yet, that strategy, and its success or failure, will determine how much oil and gas will be exported and how much money stands to be made.

The Kurdish government has long seen its attempt to attract international oil companies as a strategic imperative, building up from small wildcatters such as Norway's DNO via bigger companies such as Houston-based Marathon Oil to supermajors such as ExxonMobil.

It has made every effort to diversify the countries of provenance, signing contracts with outfits from the US, UK, France, Germany, China and others to bring international recognition and legitimacy to itself – and perhaps also to secure the region's protection, should the need arise, or support for an eventual bid for statehood.

Underlying this strategy is Kurdish leaders' drive to maximise the territory they control and the autonomous powers they exercise within it.

Hence their expansive interpretation of an Iraqi constitution they were instrumental in drafting, and their unrelenting struggle to incorporate "disputed territories" they claim were part of a historic – albeit undefined and undelineated – Kurdistan.

Several factors will probably constrain the Kurdish leadership in its attempt to free the region from the chains binding it to Iraq, a profoundly unhappy relationship of duelling nationalisms.

One is precisely those disputed territories. When Kurdish leaders say they hold reserves of 45bn barrels of oil and upward of 100,000bn cubic feet of gas, they neglect to mention that most of these reserves lie outside the Kurdistan region in areas whose status is yet to be determined – through a process that has become increasingly obscure – and whose riches constitute a potential casus belli for both Baghdad and Erbil.

When ExxonMobil entered the disputed-territories fray in October, by signing exploration blocks across the Green Line – the Kurdistan region's constitutional boundary – it further increased the area's strategic importance.

It has been the Kurdistan regional government's genius to sell itself as the last frontier in oil exploration

A second constraint is the unresolved relationship with the rest of Iraq.

Negotiations have dragged on for years over draft federal hydrocarbon legislation that would define Erbil's powers, especially in signing contracts, as well as its right to export the region's oil and gas through the national pipeline network.

The two sides have been far apart on an issue that goes to the very heart of their federal arrangement. Baghdad is accusing Erbil of seeking to tear up the country, and has incurred the reciprocal Kurdish charge that Iraq's rulers are unreconstructed Arab nationalists using outmoded systems of governance.

A third constraint is the fact that Kurdistan is landlocked and therefore must depend on its neighbours for access to world markets. The most likely candidate, Turkey, has indicated that, while it is eager to serve as the principal export channel for oil and gas, the Kurdish government will have to co-ordinate its sales through Iraq's state marketing board. This throws the Kurds back on to Baghdad and its centralising tendencies.

A final constraint is the eventual ceiling on Iraqi oil exports. For now, Baghdad is content to have Kurdish exports contribute to national revenues. However, if and when Iraq succeeds in producing the volumes currently bandied about – even at the estimates' lower end – its neighbours are bound to weigh in and, through Opec or otherwise, seek to limit Iraqi exports in order to keep control over world prices and protect their own status as producers.

Once that limit is reached in the next few years, and if Iraq's southern fields can satisfy demand by themselves, would Baghdad still consider giving a share to those pesky Kurds?

Baghdad and Erbil would be well served by a fundamental deal to settle these concerns, but their conflict would not be the first in which ethno-national interests have been allowed to trump sound economic and commercial sense.

Joost Hiltermann is the deputy programme director, Middle East and north Africa for the International Crisis Group, a non-government conflict resolution organisation

Joost Hiltermann: Kurdistan is still tightly tied to Iraq Getty