Event Summary: Panel Discussion on Instability in Iraq and Implications for Global Energy Markets

June 24, 2014

On June 19, Columbia University’s Center on Global Energy Policy convened a panel of experts on the Middle East and energy markets to discuss the turmoil in Iraq, its implications for the global oil system, and U.S. options for involvement. Center Founding Director Jason Bordoff chaired the panel, which consisted of Dr. Edward Morse, Managing Director, Global Head of Commodities at Citigroup; Dr. Meghan O’Sullivan, Director of the Geopolitics of Energy Project at Harvard University’s Kennedy School; Daniel Sternoff, Senior Managing Director at Medley Global Advisors LLC; Helima Croft, Managing Director at Barclays Capital; and Dr. Austin Long, Assistant Professor of International and Public Affairs at Columbia University.

Overview

“The Iraqi-Syrian border does not exist.” – Daniel Sternoff

The Islamic State in Iraq and Syria (ISIS) has made a rapid advance through Iraq in recent weeks, taking the northern city of Mosul and other cities as government security forces crumbled. The radical Sunni group, which already held parts of Syria including the Raqqa oil field and has been advancing in Iraq since late 2013, took Fallujah in January and claims lands in both countries toward its goal of creating an Islamic caliphate. ISIS’s thrust into Iraq has been welcomed by some of the country’s Sunni population, which has been largely marginalized within the government of Prime Minister Nouri al-Maliki. The Kurdistan Regional Government (KRG) has taken advantage of the crisis and seized the Kirkuk oil province, giving it further leverage in its drive for greater independence from Baghdad. ISIS has also been fighting to take the Baiji refinery, the largest fuel plant in Iraq, which would give it greater resources and reduce fuel supplies to the rest of the country.

Following the certification of April elections, Iraq must now form a new parliament and cabinet. The Obama administration has pressed for the formation of a more inclusive government during this process. Last week the U.S. announced that it would send in 300 military advisers in to assist the Iraqi military in addition to 275 troops sent to protect U.S. embassy staff. Shia militia forces have been mobilized in Baghdad, and have been blamed for extra judiciary killings of Sunnis in the city, increasing sectarian tensions. Iran has said it will defend holy sites in Iraq.

Iraq’s oil exports from the north to Turkey’s Ceyhan port have been disrupted by ISIS attacks on the Kirkuk-Ceyhan pipeline, but flows from the main production region in the south continue. For a full primer on Iraq’s oil sector, see the Center’s issue brief (PDF).

Iraqi Military Breakdown

“The Iraqi intelligence picture is pretty poor.” – Dr. Austin Long

Participants in the Center’s Iraq panel said that the politicization and corruption of the Iraqi security forces has been growing in recent years, especially after the 2011 withdrawal of the United States. The cronyism that
emerged when Maliki replaced independent, professional commanders with Shia partisans led to an overall weakening of forces. They noted that the speed of the breakdown of Iraqi security forces in the north came as a surprise to many, given the training that they had received before the U.S. withdrawal of forces in 2011.

The Iraq government has also struggled to get good internal intelligence of the situation, said Dr. Austin Long. When the U.S. pulled out in 2011, the assumption was that human intelligence would compensate for the lack of technical intelligence that had been provided by the United States. But the alienation of the Sunnis under Maliki has made gathering intelligence on the country’s Sunni population more difficult.

Dr. Long said that the U.S. decision to send military advisers to Iraq will be an important step toward improving Washington’s ability to assess the situation and make decisions.

Iraqi security services also struggle with critical logistical issues, including supplying troops, Dr. Long said. This makes it difficult to support troops that could be deployed to retake northern areas under ISIS control. Conversely, as the front gets closer to Baghdad, these issues diminish as the length of the supply lines shrink, making the forces more effective. In addition, the southern region is more Shia than Sunni, and troops are expected to put up a much stronger resistance to ISIS here.

**U.S. response**

“All the options are bad.” — Dr. Meghan O’Sullivan

The United States has called for political reform in Iraq, but Dr. Meghan O’Sullivan said that military assistance was required now and that there was not enough time to solve the political problems as a condition for military aid. Forming a new government in Iraq and renegotiating the political contract takes time, she said, adding that if the Iraqi government does not get U.S. military assistance it could be forced to seek greater help from Tehran, which could further inflame the conflict by fanning Sunni concerns.

The Obama administration faces a host of tough decisions with Iraq, Dr. O’Sullivan said, noting that under no circumstances did she expect to see a deployment of U.S. troops on the ground and that U.S. involvement would likely be capped at providing air power or supporting Iraqi troops.

Panelists said that the sectarian splits in the government -- and the overall failure of government -- under Maliki would make finding a solution to the Iraq crisis under which he remained in power and kept the country united difficult.

Dr. Long suggested that there were three ways in which the international community could attempt to remove him from office, including trying to broker a political coalition that excludes Maliki, which would be difficult considering his party recently won a plurality in April elections. At the same time, attempts to convince him to step down would likely be unsuccessful, although Dr. O’Sullivan said the fact that Iraq is currently in the process of forming a government following elections could make this a possibility. Dr. Long said that forcing Maliki to step down – either directly or indirectly – would likely create unintended consequences that would exacerbate the situation.
Sternoff noted that Maliki has elite military units which are loyal to him, and that even if a replacement deal could be brokered, it was not clear if they would switch their allegiance to a new leader.

**Iranian involvement**

*“Even if the Iranians are trying to restrain the Shia militias, it inflames Sunni paranoia.” – Dr. Austin Long*

While Tehran has reportedly tried to rein in Shia militias, panelists stressed that the involvement of Iran could further increase tensions with Iraqi Sunnis, and potentially give Iran a stronger foothold in Iraq. The involvement of Iran in southern Iraq brings up a question of Tehran’s oil interests. Iran benefits if Iraq produces less oil as it puts further pressure on the sanctions Western nations have imposed on Tehran, Dr. O’Sullivan said. Still, she added that Iran could play an important role in the government formation process currently underway in Iraq. Overall, while Baghdad would prefer to rely on the United States for support during the turmoil, absent strong support from Washington it could have to turn to Iran, Dr. O’Sullivan said.

**Fragmentation of Iraq**

*“The Kurds are the big winners here, taking everything they ever wanted in Iraq.” – Daniel Sternoff.*

Dr. O’Sullivan outlined three phases of turmoil that could occur in Iraq. The first wave, currently underway and which involves the advancement of ISIS into Iraq and taking over Sunni-dominated areas of the country, could give way to a second wave of conflict based on wide-scale sectarian violence.

The third wave would be the fragmentation of Iraq, Dr. O’Sullivan said, noting that the Kurds had already moved to take control of areas it already contested with Baghdad, including Kirkuk. This could mark a critical moment for the Kurds to press for confederation if not independence, panelists said. Dr. Ed Morse said that the seizure of contested Kirkuk oil fields would be good leverage for the Kurds against Baghdad to the degree the government needs money.

Iraq’s main oil producing region, Basrah, could also use the deterioration of the central government’s control to call for more autonomy, Dr. O’Sullivan said.

**Oil market risk**

*“Markets are reacting to tomorrow’s conditions.” – Dr. Ed Morse*

The conflict in Iraq has led to a 4-5 percent increase in oil prices at the front-end of the curve and a 3-4 percent increase at the back of the curve, said Dr. Morse. However, he added that nothing had changed yet in terms of Iraqi oil supplies and that in the near-term fundamentals actually did not look too tight. The price reaction in later months of oil futures contracts was caused by consumers such as utilities, airlines, and refineries buying call options as insurance against the potential of a wider Iraqi conflict to disrupt anticipated supplies, Dr. Morse said.

In the near-term, U.S. oil production growth is looking stronger than many had forecast, offering an additional buffer to markets, he said. Currently 3.5 million b/d of oil production is offline globally, spread across eight countries, and yet oil prices have barely budged as rising flows of unconventional oil from the
United States help offset that loss. There may be limited spare global oil production capacity with which to absorb more large-scale disruptions, however, Dr. Morse said. Increased U.S. crude oil exports by the end of the year -- within the boundaries of current limitations on sales abroad -- could bring additional barrels to the global market, he added.

Dr. Morse said that while many forecasts anticipate strong growth in Iraqi oil production over the medium to long term, especially in the key southern oil producing region, those levels would have been difficult to achieve even without the current unrest. Southern Iraqi production targets of over 6 million b/d, nearly double current levels, will be restricted by a 4 million b/d limit on the OPEC nation’s dock space in the Persian Gulf from which oil can be shipped, he said.

Foreign oil company presence

“Any violence in the south would accelerate the movement out of foreign company workers.” – Helima Croft

Thus far, the conflict with ISIS has been largely concentrated in northern Iraq, far from the country’s main oil producing fields in the south, where international oil companies largely operate, Helima Croft noted. That said, some companies had already pulled out some workers from the region, and given the contract terms under which they operate, they would likely be quick to remove others were violence to spread to the Basrah region.

Oil companies working in Iraq have been widely unhappy with the terms of the technical service contracts they signed in 2010 through which they receive a per barrel fee for increasing production above certain targets, rather than an equity stake, Croft said. There are also issues with corruption and the country’s overall reputation for having a difficult operating environment. Exxon’s decision to sign a contract with the KRG to develop northern fields in the Kurdish region – risking its existing contract with Baghdad for fields in the south – could be seen as a sign of these poor terms and conditions, she added.

The difficulties companies have had in working with Baghdad would likely increase if violence within Iraq escalates, stymying the ability of companies to get critical business decisions from Baghdad, Dr. O’Sullivan said. The deteriorating conditions could further sway oil companies away from investing in Iraq, with countries such as Russia and potentially Mexico offering better terms and a more stable investment climate, Dr. Morse said.

What to watch for going forward

While the situation in Iraq is very fluid at the moment, panelists identified several key factors for U.S. and regional policy makers and oil markets to watch closely. These include: how ISIS controls the territories it has taken; if ISIS is be able to advance in the Shia-dominated south; how inclusive the Iraqi government formation process will be; how much the Kurds take advantage of the situation to push for greater independence from Baghdad; and the potential for the ISIS advance to create wider unrest throughout the region.