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ISIS: Immediate risk for domestic supply, not exports

FULL BRIEFING

Even as Iraqi government forces continue to battle the Sunni jihadists of the Islamic State of Iraq and the Levant (ISIS), Iraq's energy exports and sovereign credit ratings are expected to remain stable, although the risks are growing.

The violence that has swept areas of the north of the country won't immediately impact Iraq's external commitments, but it is affecting supplies of domestic energy, analysts tell Monitor Global Outlook.

In the medium term, the turmoil is likely to trim flows of foreign direct investment that would have helped revamp Iraq's energy infrastructure. Prolonged and escalating violence - a scenario that is far from remote - could force Western oil majors such as BP and ExxonMobil to suspend their operations outside Kurdistan.

The immediate risk for Iraqi oil exports is limited

Three-fourth of oil production in Iraq, the second-biggest supplier within the Organization of Petroleum Exporting Countries, is concentrated in the south, with the bulk of Iraqi crude leaving via the southern Basra terminal. The rest of the oil fields are clustered in the northern region of Kurdistan and the neighboring area around Kirkuk.

"The Kurdish-controlled territory is heavily protected and the southern production centers are far from all [sectarian] fault lines, as all producing super-giant fields are Basra-based, and so [are] the export terminals," Luay al-Khatteeb, a senior adviser to the Iraqi Parliament, tells MGO.

Energy infrastructure in Sunni areas has been out of action for months due to militant attacks that predate the ISIS offensive and are similar to those seen in the aftermath of the 2003 US-led war in the country, says

SIGNIFICANCE

As Iraqi government forces continue to battle Islamic ISIS militants, Iraq’s energy exports and sovereign credit ratings are expected to remain stable. The immediate impact of the violence will be a hit to Iraq's domestic refining capacity, which will force the country to rely on more gasoline imports. Steady oil exports, coupled with the size of Iraq's sovereign assets, suggests Baghdad will be able to afford a spike in energy imports, staving off the risk of a credit downgrade.

IMPACTS

Business	A terrorist attack that kills company personnel could push oil majors to temporarily halt production. The violence will also sap energy FDI.
Political	Fuel shortages and the loss of territory have weakened the central government's credibility throughout the country.

Ali Khedery, who served as the architect and chief political negotiator of Exxon's entry into Kurdistan and was the longest continuously serving US government official in Iraq.

"When the insurgency took hold you saw an immediate series of attacks on critical infrastructure - not just the actual oil fields, but power generation plants, refineries, and the electricity transmission lines," says Mr. Khedery, who currently serves as chairman and chief executive of Dragoman Partners LLC, a strategic consultancy headquartered in Dubai.

Production in the Kirkuk area, operated by North Oil Co., has been halted since March 3 when militants blew it up, rendering inoperable the pipeline that runs from the Kirkuk oil fields to the large refinery in Baiji and connects to the Iraq-Turkey pipeline ending in Ceyhan, Turkey.

Though that has shaved off output worth several hundred thousand barrels per day, it does not amount to a significant disruption of Iraq's overall production, which stands at around 3.3 million barrels of a day. Daily exports run around 2.6 million barrels.

International oil companies (IOCs) including Shell, BP, and ExxonMobil have mostly evacuated their foreign staff, but have no known plans to cease operations.

That, though, may change if a terrorist attack kills IOC personnel, says Khedery.

"If that happened, I would not be a surprised to see some of the western IOCs suspending operations in Iraq all together for the foreseeable future," he says. "The current fiscal terms just wouldn't be good enough in southern Iraq relative to the rest of the world to justify their continued presence."

In the medium term, the turmoil is likely to stave off much-needed foreign investment to revitalize Iraq's dilapidated energy infrastructure, according to Khedery.

"It will be a major blow to international investors putting up capital in that country, especially for the strategic projects that require billions in upfront investment," he says.

Iraq will need to step up gasoline imports but can afford it for now

The main oil infrastructure under immediate threat from ISIS is the Baiji refinery - less than 200 kilometers (about 125 miles) north of Baghdad - where fighting between ISIS and Iraqi military forces is ongoing.

Social

There is a deep fear of rekindled sectarian violence, with daily life made all the more difficult by domestic energy shortages.

The largest of Iraq's 14 refineries, the facility processes 310,000 barrels of oil a day and is the main supplier of gasoline and petroleum products to the north as well as Baghdad. Overall, it accounts for about a third of Iraqi refining capacity.

"The immediate impact is on oil products," says Mr. Khatteeb, who is also a visiting fellow at the Brookings Doha Center and runs the London-based Iraq Energy Institute. However, he adds, "the shortfall can be compensated by importing oil products from neighboring countries."

With production at Baiji shuttered since last week, fuel shortages are spreading throughout the country, including to areas administered by the Kurdish Regional Government, where gasoline is already being rationed for residents, analysts based in northern Iraq tell MGO.

However, with oil exports expected to remain steady, Iraq will be able to maintain the foreign exchange reserves it needs to finance stepped up gasoline imports.

Oil is estimated to account for up to 75 percent of gross domestic product, almost 95 percent of government revenues, and 98 percent of exports, Bilal Wahab, a specialist in Iraqi energy policy and assistant professor at the American University of Iraq, Sulaimani, told MGO in a phone interview from Iraqi Kurdistan.

On June 17, the International Energy Agency revised its outlook for Iraq's production capacity down by 470,000 barrels per day, saying it now expects the republic to produce 4.5 million barrels a day by 2019.

Nevertheless, the country still has huge potential for growth, according to the IEA. Within OPEC, Iraq alone is expected to account for just over 60 percent of growth in production capacity, the IEA said.

With oil exports assumed to remain steady, a $5.2 billion fiscal reserve in the Development Fund for Iraq account at the US Federal Reserve Bank of New York, and over $70 billion in reserves - worth about nine months' worth of imports - held by Iraq's central bank, the government will be able to finance its gasoline import needs, according to Raza Agha of VTB Capital.

"The size of these sovereign assets, and the location of Iraq's major oil fields in the north and south - both much better protected than the Sunni-dominated [areas] that have fallen to militants - reduces the likelihood of any imminent stress in sovereign creditworthiness," Mr. Agha says.