

# Iraqi Supreme Court casts doubt over legitimacy of Kurdistan's oil and gas sector

On 15 February 2022, the Federal Supreme Court of Iraq (the **Iraqi Supreme Court**) issued a long-awaited and potentially fundamental decision relating to the ownership and control of oil and gas situated in Kurdistan, as well as the legality of the entire independent Kurdish oil and gas sector.

The Iraqi Supreme Court's decision purports to resolve a long-standing legal and political dispute between the Federal Government of Iraq (**FGI**) on one hand and the Kurdistan Regional Government (**KRG**) on the other. While the decision focuses on the relationship between Federal Iraq and Kurdistan, a semi-autonomous region within Iraq, and the interpretation of the Constitution of the Republic of Iraq (the **Constitution**), it is likely to be very significant for all international oil and gas companies (**IOCs**) who have invested or are considering making investments in Kurdistan. There are many issues at play, but the point in brief is that, while the oil and gas sector in Kurdistan has never been entirely without risk, the likelihood of risk materialising has now increased significantly.

We consider below why the Iraqi Supreme Court's decision is likely to have such profound consequences and summarise the key risks IOCs are likely to face.

## Iraq's constitutional landscape

To fully understand the significance of the Iraqi Supreme Court's decision, we must first consider the constitutional context, which is straightforward to explain.

The key point in contention concerns the interpretation of Articles 111 and 112 of the Constitution:

- Article 111 states succinctly that "*Oil and gas are owned by all the people of Iraq in all the regions and governorates*".
- Article 112(1) provides that "*The federal government, with the producing governorates and regional governments, shall undertake the **management** of oil and gas **extracted** from*

*present fields, provided that it distributes its revenues in a fair manner in proportion to the population distribution in all parts of the country...*".

- Article 112(2) in turn provides "*The federal government, with the producing governorates and regional governments, shall together formulate the necessary strategic policies to develop the oil and gas wealth...*".

Before the Constitution was enacted by a referendum on 15 October 2005, control of Iraq's hydrocarbon industry was a settled question. The FGI was solely responsible for the development, management and sale of oil and gas throughout Iraq. However, after the Constitution, the FGI and

the KRG began to adopt different interpretations of Articles 111 and 112.

The FGI's position is that, read together, Articles 111 and 112 provide that the FGI is exclusively responsible for "*managing*" oil and gas "*extracted*" from "present fields" in Iraq on behalf of the people of Iraq, albeit it must do so "*with the producing governorates and regional governments*", which includes the KRG (recognised explicitly in Article 117(1)). It is therefore the FGI, and only the FGI, which is empowered to determine Iraq's strategic oil policy and to explore, develop, exploit and market oil and gas within Iraq and internationally, including managing any engagement with IOCs.

The KRG's position ultimately rests on the meaning of "*present fields*" in Article 112(1). The KRG contends that "present fields" encompass only those which were producing oil and gas in October 2015 (the time of the enactment of the Constitution), and that the FGI is not therefore empowered to manage oil and gas in respect of any fields which were not producing at that time. The FGI's response is that the term "*present fields*" in the context of Article 112(1) includes fields which were proven but not necessarily actively producing in October 2005.

The KRG also argues that the word "*extracted*" in Article 112(1) limits the FGI's authority to management of oil and gas after extraction, and the FGI does not therefore enjoy the same powers *prior* to extraction, that is to say, during development and exploration. The FGI's response is that Article 112(2) provides it with authority to dictate how *all* oil and gas development activities in Iraq should be undertaken, including exploration and development. The KRG's counterargument is that the FGI only has authority to decide broad brush policies regarding oil and gas, with the KRG empowered to manage the detail in respect of fields within Kurdistan under Article 115, which gives the KRG residual authority to decide matters not exclusively allocated to the FGI under Article 110.

Adding to the constitutional ambiguity, there is no federal oil and gas legislation in Iraq, despite the Constitution requiring one. Although various draft laws have been proposed, including in 2007 and 2011, no federal law has ever been enacted.

Instead, it was the KRG which passed Law No. 22 of 2007 (the **KRG Oil and Gas Law**), under which the KRG granted itself powers to enter into production sharing contracts (**PSCs**) with IOCs.

Notwithstanding the absence of a federal law, the FGI has consistently maintained that the KRG Oil and Gas Law, and all PSCs entered into by the KRG under it, are unconstitutional and invalid, and that the FGI's State Oil Marketing Organisation (**SOMO**) is the only entity entitled to market and authorise the export of petroleum produced anywhere in Iraq.

## What led to the Iraqi Supreme Court's decision?

Until 2013, the KRG exported most of its oil and gas by trucking crude oil across the border into Turkey or Iran to be sold locally or transported to various ports. In response, the FGI threatened to 'blacklist' any buyers of independent Kurdish crude by forbidding them from purchasing the FGI's crude from SOMO or participating in upstream bid rounds conducted by the FGI. In addition, in August 2012, the FGI commenced proceedings against the KRG requesting a decision on the interpretation of the Constitution and the legality of the KRG Oil and Gas Law, a request which the Iraqi Supreme Court has finally addressed in its recent decision, nearly ten years later.

Then, in November 2013, despite stern opposition from the FGI, the KRG built a pipeline spur linking three of its major producing petroleum fields to the Iraq-Turkey Pipeline (**ITP**). The KRG thereby expanded its ability to export crude directly to Turkey and onwards into international markets (typically bound for Europe, Asia or Israel after loading at the Turkish port of Ceyhan).

In response to the ITP pipeline spur, in May 2014, the FGI commenced an ICC arbitration against Turkey and the Turkish state pipeline operator, BOTAS, seeking orders to compel them to stop transporting, storing and loading Kurdish crude without the FGI's consent, and to pay damages on the basis that Turkey's actions violated the agreement governing use of the ITP. That arbitration is still pending resolution. Around the

same time, the FGI sought an injunction from the Iraqi Supreme Court, which the Iraqi Supreme Court declined to give until it had ruled substantively on the legality of Kurdish exports, a ruling it had (until its decision in February 2022) been prevented from giving because the KRG has refused to attend any hearings. At the same time, SOMO wrote to several IOCs, trading houses, refining companies and other third parties advising them not to facilitate the export and sale of Kurdish crude without SOMO's authorisation against a veiled threat of blacklist.

Despite its various threats, the FGI did not take steps against the KRG's independent petroleum sector until a series of incidents involving ships bound for the US carrying Kurdish crude. It appears that as a result of concerns that a successful delivery of Kurdish crude to the US would undermine the FGI's constitutional claims regarding centralised control of oil exports in Federal Iraq and otherwise legitimise the international trade of Kurdish crude, the FGI took decisive action.

- In July 2014, the FGI started proceedings in Houston's federal court to prevent the 'United Kalavryta' from discharging its cargo of 1 million barrels of Kurdish crude at a terminal in Texas. The Houston court initially issued an arrest warrant, but the ship remained off the coast of Texas beyond US waters. After a further ruling by the US courts on jurisdictional grounds, the KRG sent the tanker to offload in Israel instead.
- In June 2017, the vessel 'Neverland' left Ceyhan carrying over 700,000 barrels of Kurdish crude oil, seemingly destined for the US. As the FGI watched, the Neverland turned off its transponder and then reappeared off the coast of Canada, with the Dutch company Vitol understood to be the buyer. The FGI immediately filed a claim against Vitol and two of its subsidiaries, obtaining a seizure order over the Neverland from the Federal Court of Canada, at which point the Neverland changed course and headed back into the Atlantic Ocean, discharging its cargo in whereabouts unknown.

The FGI and KRG were prepared to put aside their differences under the threat of the Islamic State

incursion. The FGI's and KRG's military cooperation, together with the economic pressures faced by both governments in this period, also led them to collaborate in exporting oil: in August 2016, the FGI and KRG tentatively agreed to the joint export of crude produced from the Kirkuk fields through the KRG controlled pipeline to Turkey on the basis that the sales revenues would be evenly split.

However, when the threat of Islamic State receded, tensions ignited again, caused in part by the KRG's decision to hold a referendum on independence in September 2017 which led to military conflict and the FGI assuming control of Kirkuk.

Since then, relations between the FGI and the KRG had appeared to settle into a comfortable unease, with both sides participating in negotiations in 2021 as to the fair allocation of Iraq's oil revenues as part of Iraq's budget. Under the temporary rapprochement in 2021, the FGI and the KRG agreed that the KRG's independent oil and gas sector would continue, provided that the KRG handed over a proportion of its revenue to the FGI in Baghdad. The Iraqi Supreme Court's decision may however fundamentally change the oil and gas landscape in Kurdistan.

## The Decision

In brief, the Iraqi Supreme Court agreed with the FGI's interpretation, finding that oil and gas in Iraq is held on behalf of all of the people of Iraq equally, and that revenues from Iraq's oil and gas must be fairly distributed to all of Iraq's people, regardless of where it is found.

The Iraqi Supreme Court ruled that the KRG Oil and Gas Law is unconstitutional, and that the KRG is required to hand over all production from oil fields in Kurdistan to the FGI. Significantly, the Iraqi Supreme Court also ruled that the FGI (via the Ministry of Oil) is permitted to "*pursue the nullification*" of any contracts agreed between the KRG and foreign states or IOCs relating to the exploration, production, export and/or sale of crude oil from Kurdistan.

Therefore, while the Iraqi Supreme Court's decision stops short of ruling that all PSCs entered into

between the KRG and IOCs under the KRG Oil and Gas Law are unenforceable, it in effect uproots the legal foundations of the independent Kurdish oil and gas sector.

## Impact and key risks

The Iraqi Supreme Court's decision comes ten years after the FGI first commenced proceedings and several years after proceedings were paused in 2019 pending approval to continue from Iraq's then Prime Minister.

Nonetheless, the legal footing of the PSCs entered into between the KRG and various IOCs, previously merely unsure, may now be doubted. Virtually all PSCs came with an inherent legal uncertainty, in part because of the ongoing disputes as to the constitutional validity of the KRG Oil and Gas Law and in part because Kurdish PSCs provide for IOCs to receive a share of production, considered unconstitutional in Federal Iraq, which favours the Technical Service Contract model. That uncertainty has now increased by an order of magnitude.

The Iraqi Supreme Court's decision has potentially far-reaching consequences. If the KRG is not the holder of legal title to the crude it sells, the crude cannot legally transfer to IOCs under the terms of the PSCs, nor can title to the crude ultimately pass to buyers seeking to off-take, whether directly or indirectly, from IOCs selling Kurdish crude. The decision may also affect the relationship between the FGI and Turkey, previously a key importer of Kurdish crude, in particular the ongoing ICC arbitration between the FGI and Turkey / BOTAŞ, where the damages claimed are now said to exceed USD 26bn.

We understand that the FGI has not yet taken any formal action to enforce the decision and that the KRG's recent communications have sounded a note of tentative consensus-building, indicating that the KRG intends to continue working with the FGI to find a way forward. Any steps taken by the FGI towards terminating PSCs between the KRG and IOCs is likely to give rise to fiercely contested disputes, in part because PSCs in effect grant IOCs an interest in the oil itself in Kurdistan. In addition, if the FGI seeks to enforce the Iraqi Supreme Court's decision on the basis that PSCs under the

KRG Oil and Gas Law are a 'nullity', that may give the KRG grounds on which to allege that claims against it under PSCs are barred because the PSCs were never validly entered into. In such cases, the IOCs could in principle have a claim against the FGI under the various bilateral investment treaties to which Iraq is a party (including with France and Japan). It is also worth noting the New York Convention entered into force in Iraq on 9 February 2022, and the recognition and enforcement of non-Iraqi arbitral awards in Iraq should therefore (in theory at least) be more straightforward.

## Contacts



### **Joseph Bentley**

**Senior Associate**

+44 20 7444 3006

Joseph.Bentley@nortonrosefulbright.com



### **Holly Stebbing**

**Partner**

+44 20 7444 5143

Holly.Stebbing@nortonrosefulbright.com



### **Hussain Kubba**

**Partner**

+44 20 7444 3563

Hussain.Kubba@nortonrosefulbright.com