

## *Chapter 7*

# Oil, Federalism, and Third-Party Intervention: An Assessment of Conflict Risk in Iraqi Kurdistan

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### **Introduction**

Ten years after the US invasion and one and a half years after the withdrawal of all American forces from the country, Iraq faces a number of challenges to its long-term stability and development, ranging from corruption, poor public services, and persistent terrorist violence to ethno-sectarian tensions in the context of a complex power-sharing system. In this chapter, we focus on one important aspect of the country's contemporary political scene—the dispute between Iraq's federal government and the Kurdish Regional Government (KRG) over management of the country's and the Kurdish region's natural resources and over appropriate mechanisms to allocate revenues from hydrocarbon exports between the federal government and sub-federal entities. The parties have been mired in a costly political stalemate for the past few years. The creation of new pipelines, representing an outlet to international markets for KRG-controlled resources beyond the existing export infrastructure under federal control, offers some hope of ending the stalemate and unlocking the Kurdish region's hydrocarbon wealth. However, US policymakers have expressed concerns that Turkey's move could actually have destabilizing effects for Iraq, starting a chain reaction that could lead to the violent breakdown of the country.

In this chapter, we take part in this policy debate by attempting to make sense of the ongoing dispute between Baghdad and Erbil and to assess the likely impact of the new pipelines on prospects for its resolution or escalation. We do this by combining an informal bargaining model of Baghdad-Erbil interactions and information collected through

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about two dozen interviews with KRG's policy makers, Turkish officials, third-country diplomats and analysts as well as from newspaper articles and analytical pieces on Iraq and Turkey.

We argue that the negotiating stalemate between the federal government and the KRG is to a large extent due to the existence of serious commitment problems on both sides. Erbil is concerned that Baghdad may renege in the future on its revenue sharing promises, and thus it insists on maintaining control of the Kurdish region's hydrocarbon industry and on the adoption of mechanism for automatic revenue allocation to sub-federal entities. On its part, Baghdad likely fears that KRG's control of the region's hydrocarbon industry may enable it to extract further concessions on revenue sharing and other pending issues, while also representing a preliminary step towards a Kurdish secessionist bid. Moreover, Baghdad worries that other sub-federal entities may feel emboldened by a Kurdish success and advance similar requests for control of their hydrocarbon resources, thus weakening the central government and potentially even unleashing a process that could lead to the break-up of the country.

We expect the creation of new pipelines to assuage Erbil's long-running fears of exploitation by Baghdad, which should eliminate a powerful motive for Kurdish secessionist aspirations and thus reduce the corresponding risk of war. Moreover, given Turkey's stakes in the new pipelines, Baghdad is likely to be deterred from resorting to force against Erbil due to the likelihood of Turkish intervention on KRG's behalf. On the other hand, the new pipelines should lead to a strengthening of Erbil's bargaining hand vis-à-vis Baghdad, which could generate incentives for the latter to launch a preventive attack before these effects fully materialize. However, we consider the probability of Baghdad initiating war in the short-term low, due to the federal government's concern with the ongoing civil war in Syria and the corresponding risks of spill-over into Iraq as well as ongoing unrest in Sunni areas. Thus we argue that the United States should abandon its current opposition to the use of the new pipelines but rather focus its efforts on convincing the relevant players (in particular Baghdad in the short-term) not to resort to force to resolve disputes.

Our theoretical argument is relevant to a set of intersecting literatures in International Relations on war as bargaining breakdown<sup>1</sup>,

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<sup>1</sup> The classic references are Fearon 1995 and Powell 2006. For reviews of the literature, see Jackson and Morelli 2011 and Powell 2002.

the effects of natural resources on the risk of different forms of political violence<sup>2</sup>, and the impact of third-party intervention on relations between states and their ethnic minorities<sup>3</sup>. The closest existing works are a book chapter by James Fearon (“Commitment Problems and the Spread of Ethnic Conflict”) and a working paper by Arman Grigoryan (“Commitment Problems, Third Parties and State-Minority Conflicts”), which identify commitment concerns, respectively, by the minority and the government as the driver of violent conflict<sup>4</sup>. We combine elements of the two models by positing that both the government and the minority are haunted by commitment fears when engaged in negotiations over natural resources. As in Grigoryan’s model, we show that third-party intervention in support of the minority can intensify a government’s commitment fears by prospectively strengthening the minority’s bargaining hand, which can prompt the government to launch a preventive attack against the minority. However, unlike in Grigoryan’s model, our argument suggests that short-term preventive war incentives associated with third-party intervention can be offset by a corresponding long-term reduction of the minority’s fears of exploitation and by the deterrent effect towards the government of third-party support for the minority.

The applicability of our finding goes beyond the case of Iraq. As the case study presented in chapter 1 of this volume points out, Austria played the stabilizing role of an international guarantor for the agreement between the Italian government and the South-Tyrolean community. By contrast, international intervention in Bosnia and Kosovo contributed to the escalation of violence<sup>5</sup>. Our argument can help make sense of these divergent dynamics by showing that third-party intervention in government-minority disputes may have competing destabilizing and pacifying effects in different phases of the intervention. When considering the merits of intervention in a specific case, policymakers should carefully weigh the probability of both positive and negative effects on the risk of conflict escalation and design strategies to mitigate the latter.

The remainder of this paper is structured as follows. Section 2 discusses the current state of relations between Baghdad and Erbil and

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<sup>2</sup> See, for example, Fearon and Laitin 2003, Ross 2004, Walter 2006, Caselli, Morelli and Rohner 2013, and Esteban, Morelli and Rohner 2013.

<sup>3</sup> See, in particular, Cetinyan 2002, Fearon 1998, Crawford 2001, Kuperman 2008, Grigoryan 2010 and 2013.

<sup>4</sup> See fn. 3 above.

<sup>5</sup> Kuperman 2008 and Grigoryan 2010.

the ongoing deepening of Turkish-KRG ties. Section 3 presents an analysis of the strategic interaction between Baghdad and Erbil and assesses the likely impact on this interaction of the creation of new pipelines, which Turkey approved. Section 4 concludes by summarizing our findings.

## Snapshot of the current situation

### *Baghdad-Erbil relations*

The toppling of Saddam Hussein in 2003 ushered in the emergence of a federal democratic regime in Iraq. After a long history of Kurdish marginalization and victimization at the hands of the central government, the 2005 Iraqi constitution enshrined Kurdish rights and granted significant autonomous powers to the Kurdish Regional Government (KRG), which had de facto ruled the Kurdish region of Iraq in the decade following the first Gulf war<sup>6</sup>. However, the constitution left unaddressed or ill-defined important aspects of the division of competences between federal government and sub-federal entities, which have been the focus of intense disputes between Baghdad and Erbil in recent years.

One key bone of contention concerns natural resources, which provide for over 90% of the federal budget<sup>7</sup>. Negotiations over the oil and gas sector framework law and the revenue sharing law have stalled since 2007 due to unbridgeable disagreements between the federal government and the KRG<sup>8</sup>. In the absence of federal legislation clarifying jurisdiction over hydrocarbon exploration and development, the KRG passed its own oil and gas law in August 2007, which it claims is consistent with the federal constitution. The KRG has since proceeded to sign production-sharing contracts (PSC) with international oil companies—small companies at first, followed by larger ones and majors such as Exxon Mobile, Chevron, Total and Gazprom<sup>9</sup>. Baghdad disputes the KRG's right to sign contracts with oil companies without its approval

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<sup>6</sup> For good overviews of the recent history of relations between the central government and Iraqi Kurds, see, for example, Gunter 2008 and McDowall 2004. For an analysis of the Iraqi constitution in comparative political perspective, see McGarry and O'Leary 2007.

<sup>7</sup> In 2011, oil revenues accounted for around 95% of the federal budget (International Energy Agency 2012, p. 19).

<sup>8</sup> The package of hydrocarbon laws under consideration also includes the reorganization of the Iraqi ministry of oil and the creation of the Iraq National Oil Company (INOC).

<sup>9</sup> Osgood, Lando and Van Heuvelen 2012. Baghdad adopts technical service agreements. For a discussion of different types of contracts and their fiscal terms, see Johnston 2007.

and in particular claims that, by offering oil companies excessively favorable terms, the KRG's PSCs violate the constitutional requirement of developing "oil and gas wealth in a way that yields the greatest benefit to the Iraqi people"<sup>10</sup>. Besides the specific legal arguments, Baghdad is vocal in its opposition to decentralized development and management of natural resources, which it claims could bring about civil war and disintegration of the country<sup>11</sup>. On its part, the KRG is adamant in saying that, in light of a history of violence against the Kurds by government forces financed with oil revenues, centralization is unacceptable<sup>12</sup>. Kurds' fears of creeping re-centralization of political power are not limited to the hydrocarbon sector, and underlay attempts by KRG President Masoud Barzani to unseat Iraqi Prime Minister Nouri al-Maliki with a non-confidence vote last year<sup>13</sup>.

Revenues from all of Iraq's oil exports go to the federal budget<sup>14</sup>. In accordance with an agreement among Iraq's main political parties included in the annual federal budget law, revenues are then distributed to governorates in proportion to their population, with the exception of the KRG, which receives a flat 17% (before deductions for federal expenditures from which the region benefits). The KRG complains that Baghdad provides it with a smaller share of revenues than agreed upon and that the funds are disbursed capriciously through myriad small installments, which hinders Erbil's policy planning and implementation<sup>15</sup>. Hence the KRG demands the establishment of a mechanism for automatic allocation to sub-federal entities of their share of the federal budget, but, as noted, no progress has been made toward the revenue sharing law over the past few years.

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<sup>10</sup> Article 112(2) of the Iraqi constitution states: "The federal government and the governments of the producing regions and governorates shall jointly formulate the necessary strategic policies to develop oil and gas wealth in a way that yields the greatest benefit to the Iraqi people and relies on the most advanced techniques of market principles and investment promotion" (translated from Arabic in International Crisis Group 2012a). For an example of Baghdad's views, see Lando 2010, which reports an interview with Iraqi Deputy Prime Minister for Energy Affairs, Hussain al-Shahristani.

<sup>11</sup> See, for example, Van Heuvelen 2011.

<sup>12</sup> Interview with Minister Falah Mustafa Bakir, Head of the KRG Department of Foreign Relations, Erbil, 24 October 2012; speech by KRG Prime Minister Nechirvan Barzani, CWC Kurdistan-Iraq Oil and Gas Conference, Erbil, 4 December 2012.

<sup>13</sup> International Crisis Group 2012b.

<sup>14</sup> Iraq does not yet export gas.

<sup>15</sup> Interview with Minister Falah Mustafa Bakir, 24 October 2012; interview with Qubad Talabani, KRG Presidency of the Council of Ministers, Head of Department of Coordination and Follow Up, Erbil, 2 December 2012; interview with KRG Natural Resources Ministry official, Erbil, December 2012; Blanchard 2010.

The natural resources issue is deeply intertwined with territorial disputes between the KRG and the federal government over areas of Kirkuk, Ninewa, Salahaddin and Diyala provinces. These territories are ethnically mixed (mostly inhabited by Sunni Arabs, Turkmens and Kurds) and rich in natural resources, and include Kirkuk and its “super-giant” oil field, an historic flashpoint between Iraq’s Kurds and Baghdad<sup>16</sup>.

The Kurdistan region is landlocked and until recently depended for its oil exports to Turkey on the Baghdad-controlled export infrastructure<sup>17</sup>. Over the past years, Baghdad and Erbil reached a series of stopgap agreements for the export of Kurdistan’s oil by which revenues would be allocated to the federal budget and Baghdad would compensate production companies. Implementation of the agreements was marred by disputes over partial and delayed payments to the companies by Baghdad and over KRG’s compliance with agreed export volumes<sup>18</sup>. The last agreement, reached in September 2012, broke down within less than three months: under pressure from oil companies operating in Kurdistan complaining about Baghdad’s unreliable payments, the KRG essentially stopped its exports through the pipeline. As of the time of this writing (October 2013), Kurdistan’s oil is being sold within the region (at a significantly lower price than on the international market) but small amounts have been exported via truck to Turkey. Baghdad responded by threatening legal action, claiming that unauthorized exports to Turkey represent an unconstitutional infringement of the federal government’s authority<sup>19</sup>.

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<sup>16</sup> There are six other super-giant oil fields in Iraq, five in the south near Basra and one in the center near Baghdad (International Energy Agency, 2012, p. 52).

<sup>17</sup> In principle, Iran and Syria represent alternative export routes. In practice, several geo-political factors undermine their viability. Iran plays an important economic role in Iraq’s Kurdish region but is under oil sanctions and the United States has been pressuring third parties to stop purchasing its gas. In addition, Tehran has much closer relations with the Shia-dominated government in Baghdad (which has been opposing KRG’s natural resources initiatives) and in any case has less of a powerful incentive than Turkey to tap Kurdish resources due to its own resource wealth. The ongoing civil war rules out Syria as an export outlet for KRG’s resources; moreover, Syria is an oil exporter and thus has less of a thirst for Kurdish crude than Turkey (the country imports gas but KRG’s gas exports are unlikely to start before a couple of years).

<sup>18</sup> For a concise overview of Baghdad-Erbil export deals, see International Crisis Group 2012a, pp. 6-7.

<sup>19</sup> Osgood and Al-Najar 2012.

The deterioration of Baghdad-Erbil relations over the past few years stands in stark contrast to the deepening political and economic partnership between Turkey and the KRG. In 2011, Iraq was the second largest export market for Turkey, with the Kurdistan region accounting for 70% of flows; an overwhelming majority of goods sold in the region and about half of its foreign companies are from Turkey (Turkish investment has been especially prominent in construction and natural resources)<sup>20</sup>. Politics has proceeded hand in hand with economics. As Aydin Selcen, Turkish Consul-General in Erbil, put it: “Our prime minister’s vision is full economic integration. One day you won’t notice the frontier between Turkey and Iraq”<sup>21</sup>. In October 2009, Turkish Foreign Minister Ahmet Davutoğlu visited Iraqi Kurdistan with a delegation of officials and businessmen and announced the opening of a consulate in Erbil<sup>22</sup>. In March 2011, Recep Tayyip Erdogan visited the Kurdistan Region—the first time for a Turkish prime minister<sup>23</sup>. Iraqi Kurdish leaders also regularly visit Ankara; KRG president Massoud Barzani’s participation in the general congress of Erdogan’s Justice and Development Party (AKP) in October 2012 was of special symbolic importance<sup>24</sup>.

Relations between Ankara and Iraq’s Kurds were historically much more difficult. For many years, the key driver of Turkey’s policy *vis-à-vis* Iraq’s Kurds was fear that any step toward enhanced Kurdish rights in Iraq would have negative repercussions on Turkey’s own Kurdish “problem”. In 1984 (the year marking the onset of the PKK insurgency), Turkey bullied Saddam Hussein into not signing an agreement on Kurdish autonomy that Baghdad had negotiated with the Patriotic Union of Kurdistan (PUK)<sup>25</sup>. Throughout the 1990s, in spite of Turkey’s contributions to “Operation Provide Comfort” and “Operation Northern Watch” in support of Iraq’s Kurds after the first Gulf War, Ankara remained deeply suspicious of the experiment in Kurdish self-rule in Iraq, both for fear that its example could somehow incite the Kurds in Turkey and because of the ongoing

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<sup>20</sup> Interview with Turkish diplomat, Ankara, 14 January 2013.

<sup>21</sup> Quoted in Fielding-Smith 2010.

<sup>22</sup> Hasanoğlu 2009.

<sup>23</sup> Aqraqi 2011.

<sup>24</sup> Barzani 2012.

<sup>25</sup> Interview with Adel Murad, Secretary of the PUK Central Council, Sulaimani, 15 November 2012.

PKK insurgency, which benefited from bases in Iraq<sup>26</sup>. Analogous concerns loomed large in Ankara's ambivalence vis-à-vis the US-led invasion of Iraq in 2003 and motivated Turkish efforts to prevent recognition of the Kurdish region in the new Iraqi constitution<sup>27</sup>.

The improvement in Erbil-Ankara relations in the past few years reflects both long-term trends in Turkish domestic politics and changes in the strategic environment faced by Turkey. Following the defeat of the PKK and the European Union's grant of accession candidate status to Ankara in 1999, Turkey embarked on a process of political liberalization entailing significant improvements in the human rights treatment of the country's Kurds<sup>28</sup>. The victory of Erdogan's AKP in 2002 (with widespread support among Turkey's Kurds) led to an acceleration of reforms. Erdogan liberalized the political system through legislative and constitutional reforms enhancing freedom of the press, association, and expression as well as lifting the state of emergency in several southeastern provinces and strengthening civilian control over the country's powerful military. Moreover, Erdogan amended Article 28 of the Constitution, which banned the use of Kurdish language in public<sup>29</sup>. These reforms contributed to the emergence of a climate conducive to improved relations between Ankara and Erbil<sup>30</sup>. The recent ceasefire declaration by PKK's jailed leader Abdullah Ocalan and the ongoing initiatives to amend Turkey's constitution so as to reduce its emphasis on Turkish ethnicity, expand Kurdish cultural and political rights, and increase administrative decentralization, are further important steps in the same direction<sup>31</sup>.

Turkey has experienced the fastest growth in energy demand among OECD countries over the past two years, and its energy use is projected to double over the next decade<sup>32</sup>. The overwhelming majority of this growing demand is met with oil and gas imports, mostly from Iran

<sup>26</sup> Phillips 2009, pp. 9-10.

<sup>27</sup> International Crisis Group 2003, pp. 7-9; Yavuz and Özcan 2006.

<sup>28</sup> By 1999, with a series of Turkish military thrusts against PKK bases in northern Iraq and the interruption of Syrian support to the PKK (leading to its leader's, Abdullah Ocalan, arrest), Turkey managed to significantly weaken the insurgent group, which announced it was laying down its arms in 2000 (Cornell 2001). Significant PKK operations in Turkey have resumed since 2011 (International Crisis Group 2012c).

<sup>29</sup> Phillips 2009, pp. 7-8.

<sup>30</sup> Iraqi Kurdish politicians often stress this point (interview with Saadi Pirah, PUK Politburo member, Erbil, 23 October 2012; interview with Jafaar Ibrahim, KDP spokesperson, Erbil, 20 November 2012).

<sup>31</sup> Larrabee 2013.

<sup>32</sup> US Energy Information Administration 2013, p. 1.

and Russia<sup>33</sup>. KRG's natural resources would be a welcome opportunity to diversify from these sources. Iranian gas supplies are unreliable, as they are often cut off during the winter in response to Iran's domestic demand peaks; Ankara has also experienced difficulties in paying for its gas purchases from Iran, due to the tightening of sanctions against the Iranian financial sector<sup>34</sup>. Turkey has long expressed a desire to reduce its dependence on gas imports from Russia so as to gain foreign policy leeway<sup>35</sup>. KRG's resources represent a source of energy security for Ankara because Turkey is their only plausible outlet, which makes them essentially captive sources of supply in the event of disruptions elsewhere; this fact also puts Turkey in a good position to obtain a favorable gas price and/or reduce prices charged by other suppliers<sup>36</sup>. Moreover, access to Kurdish resources serves Ankara's goal of becoming a major energy hub connecting the Middle East, Russia and the Caucasus to Europe, with both geopolitical advantages and economic benefits in the form of transit fees<sup>37</sup>. Finally, the geopolitical value of closer relations with the KRG has significantly increased for Ankara with the deterioration of its relationship with Baghdad in the past few years, as Turkey sees Erbil as a counterweight to Iranian influence on the Shia-dominated government of Iraq<sup>38</sup>.

The rapprochement between Turkey and the KRG has climaxed in a major energy deal based on which a Turkish state company would acquire stakes in several exploration blocks in Iraqi Kurdistan and gas and oil pipelines would be built for export of natural resources under KRG's control to Turkey (the oil pipeline is expected to become operational by the end of the year, while it will likely take a few years for the KRG to start gas exports). The new pipelines would provide an outlet to international markets for KRG-controlled natural resources, thus cir-

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<sup>33</sup> US Energy Information Administration 2013. Turkey's existing plans for nuclear energy would meet only a small fraction of the country's energy demand (Özdemir 2008, p. 100).

<sup>34</sup> Mills 2013, p. 58; Reuters 2013.

<sup>35</sup> Evin et al. 2010, p. 15. Tapping Kurdistan's resources would more generally provide Turkey with increased leverage in its neighborhood (Mills 2013, p 58).

<sup>36</sup> Mills 2013, pp. 57-59; Zualal 2012, p. 152. Mills also notes that Turkish demand for oil could be fully satisfied by the amount of oil that the KRG claims it would be able to export by 2015 (1 million barrels per day), while projected gas exports would be sufficient to entirely replace Iranian exports.

<sup>37</sup> Mills 2013, p. 58.

<sup>38</sup> Baghdad's and Ankara's contrasting positions vis-à-vis the ongoing Syrian crisis have been a major source of tension between the two countries. The deepening of Ankara-Erbil political and economic relations as disagreements between the KRG and the federal government festered has also played a role (interview with Turkish diplomat, November 2012).

cumventing the present deadlock between Erbil and Baghdad over oil exports<sup>39</sup>. Turkish and KRG policymakers, however, have repeatedly stated that any export agreement between Ankara and Erbil would respect the existing revenue sharing scheme by which revenues go to Iraq's federal coffers, with the KRG entitled to 17% of the total.

Ankara's willingness to allow natural resource exports from KRG's territory without Baghdad's permission and in defiance of Washington's warnings seems to suggest that fears that enhanced autonomy for the KRG could lead to more unrest among Turkish Kurds have largely subsided in Turkey's calculus. In fact, it is quite likely that, besides the economic and geopolitical considerations mentioned above, Ankara sees the pursuit of a closer relationship with the KRG as instrumental to solving Turkey's Kurdish "problem". On the one hand, Kurdish areas in the south of Turkey would benefit handsomely from deeper economic ties with the KRG, which in turn should reduce the Kurdish population's willingness to support armed struggle against the state. On the other hand, increasing KRG's economic and political reliance on Turkey is likely to strengthen Ankara's leverage in that relation, thus ensuring that Erbil stick to policy positions on the PKK and the Kurdish issue in Turkey to Ankara's satisfaction.

### **Strategic interaction**

In this section, we informally analyze the interaction between Baghdad and Erbil based on a two-player bargaining game. Our objective is to assess the impact of Ankara's policies toward Iraq on the prospects of cooperation and conflict between Baghdad and Erbil. This analysis entails a major simplification of a very complex reality. However, this stylization is warranted because our goal is not detailed description but rather a simple analytical framework that can shed light on ongoing developments in Iraq and might help us understand other cases with similar characteristics.

In standard zero-sum bargaining games on the distribution of a surplus, the "pie" to be shared is a continuous variable. However, in weakly institutionalized political environments, where the rule of law is weak or absent, the parties may not be able to credibly commit to specific divisions of resources: whatever is agreed upon today could

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<sup>39</sup> Van Heuvelen 2013b; Al Arabiya 2013; Al-Tamimi 2013.

be renegotiated in the future in light of changes in bargaining power. Commitment problems can thus reduce the number of realistic negotiated solutions, making the surplus share variable effectively discrete.

The existence of commitment problems goes a long way in explaining the fact that negotiations between Erbil and Baghdad have focused on the KRG's right to sign its own oil and gas contracts and on procedures for the sharing of national resource revenues rather than the size of each side's shares, and the fact that the gap between their positions has so far proven unbridgeable<sup>40</sup>. Erbil sees as inherently non-credible any revenue-sharing scheme that does not ensure the KRG's control of the region's hydrocarbon industry and does not include a mechanism for automatic revenue allocation to sub-federal entities, as Baghdad could renege on any agreement<sup>41</sup>. On its part, Baghdad is concerned about the possibility that if the KRG gets its way in the ongoing disputes, Erbil would be in a better position to subsequently renegotiate its share of the federal budget or prevail in other disputes with distributional implications<sup>42</sup>. Baghdad may also fear that the KRG covets direct control of the region's hydrocarbon industry as a preliminary step toward outright Kurdish independence from Iraq. Moreover, there is evidence that Baghdad worries about some sort of demonstration effect associated with concessions on control of the Kurdish region's natural resource industry: other sub-federal entities may feel emboldened to advance similar requests, thus weakening the central government and, in the worst case scenario, paving the road to disintegration of the country<sup>43</sup>.

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<sup>40</sup> To be sure, some aspects of the dispute between Baghdad and Erbil can be thought of as bargaining over the share of federal revenues allocated to the KRG. In particular, members of the Iraqi parliament aligned with Maliki have repeatedly tried to reduce from 17 to 12% the KRG's share of the federal budget. Moreover, the amount of federal payments to the companies under KRG's contracts pumping oil through the existing pipeline was a central focus of the negotiations for the 2013 federal budget. However, both of these issues are connected with the broader negotiations over the degree of decentralization of the natural resources sector, with Baghdad trying to use the threat of reducing federal transfers to the KRG and the stalled payments to the oil companies as tools for leverage (Van Heuvelen and Lando 2012; Patrick Osgood 2013).

<sup>41</sup> KRG officials are explicit about the fact that the history of violence perpetrated by the Iraqi government against the its Kurdish citizens makes them distrustful of centralized control of natural resources and of revenue sharing arrangement that leave room for central government's discretion. Interview with Minister Falah Mustafa Bakir, 24 October 2012; interview with Qubad Talabani, 2 December 2012; interview with KRG Natural Resources Ministry official, December 2012.

<sup>42</sup> There is, for example, a long standing dispute between Erbil and Baghdad about whether the KRG's peshmerga forces should be financed via the central government's or the KRG's budget.

<sup>43</sup> For example, Maliki has argued that the KRG's oil policy threatens to unravel Iraq's fragile federal structure by tempting its other oil-rich regions to strike their own independent deals. Similarly, Abdullah al-Amir, a personal advisor to Hussein al-Shahristani, Iraq's deputy prime

Baghdad and Erbil have thus found themselves locked in a costly political stalemate, as the absence of a comprehensive legal framework for Iraq's hydrocarbon sector is widely seen as a deterrent to international investment and therefore a hindrance to its development, while the breakdown of export deals between the federal government and the KRG has curtailed the country's revenues. Erbil and Baghdad have been pursuing diametrically opposite strategies to overcome the stalemate in their favor. Erbil has been attracting international investments in natural resources under its control and lobbying Ankara to provide an alternative export outlet for the corresponding output. These two initiatives have been mutually reinforcing. On the one hand, attracting international companies has required offering some guarantee of their right to monetize (i.e., sell on international markets the natural resources that they extract), which necessitates either a solution of the dispute between Baghdad and Erbil or the creation of an alternative export route through Turkey. On the other hand, Ankara's willingness to allow hydrocarbon exports from Iraq's Kurdistan without Baghdad's permission is a function of the ability of KRG-controlled resources to satisfy its growing energy demand, which crucially depends on attracting international investments to the region. The KRG's ultimate objective seems to be to create facts on the ground so as to convince Baghdad to soften its negotiating position or, if no compromise is possible, to gain *de facto* financial independence from the federal government with oil and gas exports to Turkey.

The federal government's strategy aims to undermine the KRG's initiatives towards international companies and Ankara with the ultimate objective of making Erbil capitulate to Baghdad's demands. Baghdad has increased the legal-political risk of energy companies operating in Kurdistan by threatening legal consequences for signing PSCs with the KRG and exporting oil without the federal government's approval, and by hinting at the possibility of resorting to force if Exxon Mobile were to start its planned drilling activities in disputed territories<sup>44</sup>. The rows over

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minister for energy affairs, argued: "If you have one part of the country producing and exporting and selling the oil, then Basra, the southern part, will do the same, and the other governorates will do the same, and this will have no government planning" (Saber 2013). Baghdad's fear of setting a precedent represents a different kind of commitment concern from those associated with Erbil's behavior after concessions: here the focus is on the lessons that third-parties may draw by observing interactions between the federal government and the KRG (for a theoretical treatment and empirical analysis, see Walter 2006).

<sup>44</sup> Van Heuvelen 2012; Lando 2012a and 2012B. Baghdad has threatened to blacklist companies signing agreements with KRG, but the policy has been inconsistently applied. Baghdad

payments to KRG-contracted companies, which led to the breakdown of export agreements between Baghdad and Erbil, may also serve the purpose of punishing companies working with Erbil and discouraging “fence-sitters” from following in their footsteps. Baghdad has also signaled to Ankara its displeasure at the deepening of relations between Turkey and the KRG through a variety of political and diplomatic channels and has lobbied the United States to persuade the Turkish government not to allow energy exports without the federal government’s approval<sup>45</sup>.

Some ambiguity remains about the extent of Ankara’s willingness to defy Baghdad’s wishes, in particular by importing large volumes of oil through a new pipeline without authorization from Iraq’s federal government. However, Turkey’s decision to invest in KRG-controlled blocks and allow the creation of new pipelines (for simplicity, the “pipeline decision”) is a major game changer<sup>46</sup>. Turkey’s decision signifies the failure of Baghdad’s attempts to discourage Ankara from supporting Erbil in its dispute with the federal government and thus significantly reassures international companies about the viability of the KRG’s natural resource industry. Turkey’s decision on this issue undoubtedly dampened Baghdad’s hopes to undermine the KRG’s strategy with the current policy, while emboldening the KRG. At that point it is unlikely that Baghdad would want to stick to a failing strategy whose costs would be increasing (besides the forgone investments due to investors’ concerns for the absence of a federal hydrocarbon framework law,

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has told Exxon Mobile that it needs to choose between its investments in southern Iraq and in the Kurdistan region, while Chevron has been banned from investing in the rest of Iraq after signing a contract with the KRG. By contrast, the federal government has warned Total and Gazprom that their contracts with the KRG are illegal but has not asked them to choose between investing in the south and the north of Iraq.

<sup>45</sup> Parkinson 2012.

<sup>46</sup> For a variety of reasons Ankara may abstain from making a crystal clear announcement about its pipeline decision for some time and may instead continue to make statements to the effect that unlocking the KRG’s energy potential is in Turkey’s national interest and that there is no provision in the Iraqi constitution that bars the regional government from signing export agreements. However, the emergence of evidence that the pipelines are in fact being constructed and that Turkey has invested in KRG-controlled exploration blocks would likely drastically reduce Baghdad’s uncertainty about Ankara’s intentions. Two recent events are likely to have had this effect. In late April 2013, the KRG parliament authorized independent oil exports to Turkey in case Baghdad did not pay its past dues for KRG-contracted oil companies within 90 days; the timeframe coincides with the expected completion of a pipeline connecting KRG’s gas fields with a power plant on the border with Turkey, which, according to KRG and operating companies’ officials, could be easily converted to export crude (Osgood 2013). Moreover, on his way to a meeting with US President Barack Obama in Washington, DC, Erdogan confirmed a long-rumored investment in KRG-controlled exploration blocs by a Turkish state-run oil company partnering with Exxon Mobile (*Today’s Zaman* 2013).

lost revenues from KRG's oil production would likely grow faster once investors are reassured about their right to monetize). Baghdad would thus face the alternative of making concessions to Kurdish demands on the hydrocarbon framework and revenue sharing laws or escalating by resorting to force.

Baghdad's concessions could be coupled with Kurdish concessions on other pending issues so as to sweeten the pill; this would be particularly useful for Maliki to deflect likely accusations from his political rivals of having made concessions to the Kurds under duress. However, the fact would remain that by making concessions on the key bones of contention of the hydrocarbon framework and revenue sharing laws, Baghdad would be agreeing to live with the commitment concerns mentioned above. In particular, when the new pipelines are fully operational Baghdad would be dealing with a KRG with significantly more bargaining power. On the one hand, the existence of new pipelines would allow Erbil to export oil (and gas at some point in the future) even in case of continued stalemate with the federal government, and to shield itself from the financial consequences of a possible decision by Baghdad to cut off federal budget transfers to the KRG<sup>47</sup>. On the other hand, Turkey's investment in the pipelines and exploration blocks represent a credible signal of Ankara's willingness to intervene on the KRG's behalf in case of violent confrontation with Baghdad. Both factors are likely to increase Erbil's bargaining power and correspondingly weaken Baghdad's.

Baghdad may be tempted to escalate the dispute with Erbil by resorting to force to forestall the increase in the KRG's bargaining power associated with Ankara's pipeline decision. The basic logic here is that Baghdad may anticipate that once the new pipelines are fully operational Erbil will be in a stronger bargaining position, which would

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<sup>47</sup> Back-of-the-envelope calculations suggest that the KRG could offset the loss of federal budget transfers by exporting about 500,000 barrels of oil per day (bpd) in 2015. Assuming that the federal budget grows in 2014 and 2015 at the same speed at which it has been growing since 2009 (17% a year) and that the KRG would be allocated the same percentage as in 2013, federal transfers to Erbil in 2015 would amount to approximately \$17 billion, which would require 500,000 bpd at \$90 per barrel for Erbil to break even (this calculation does not take into account federal expenditures on services that the Kurdish areas benefit from). There is wide variation in estimates of KRG's oil production in 2015: the KRG estimates 1 million bpd, while the International Energy Agency considers this estimate too high and expects between 800,000 and 1 million bpd of overall northern production (including both KRG and non-KRG oil). The International Energy Agency does not provide a breakdown of estimated Northern Iraqi production for 2015 but only for the years 2020 and 2035. Given that for those two years, KRG and non-KRG northern production are approximately equal and the KRG production is expected to grow faster, we can identify 400,000 bpd as the high bound of the International Energy Agency's estimate of KRG oil production in 2015. Thus 500,000 bpd can be considered as an intermediate estimate of the KRG's export potential in 2015.

allow it to prevail in negotiations on the hydrocarbon framework and revenue sharing laws. Baghdad may thus decide to take the gamble of preventive war to coerce Erbil to capitulate now rather than waiting to find itself in the position of having to acquiesce to the KRG's demands in the future<sup>48</sup>. Using force sooner rather than later may also make sense from Baghdad's point of view under the assumption that Turkey's commitment to intervene on the KRG's behalf in case of violent conflict would solidify over time as Ankara sinks more investments in the KRG's hydrocarbon industry. Baghdad may not be very optimistic about Turkey not intervening if large-scale violence were to erupt in the near future, but it may think that its only hope lies in the early use of force as the probability of Turkish intervention would increase with the passing of time.

These short-term destabilizing effects of Ankara's pipeline decision stand in contrast to its long-term pacifying effects. In a sense, Ankara's pipeline decision creates a window of opportunity for Baghdad to use force to forestall an unfavorable change in the balance of power between the federal government and the KRG. Once this window closes, the probability of large-scale violence between Baghdad and Erbil should be lower compared to a scenario in which Turkey decides not to invest in KRG-controlled exploration blocks and not to allow the creation of new pipelines. This reduction in war risk is a function of the attenuation of Erbil's commitment concerns about remaining part of Iraq and the deterrent effect on Baghdad represented by Ankara's increased stakes in the KRG's natural resources. Ankara's pipeline decision entails the important effect of assuaging Erbil's fears that at some point in the future Baghdad could renege on power and revenue sharing arrangements and re-centralize political control. With new pipelines in Kurdish-controlled territory and a vibrant hydrocarbon industry, Erbil would be in a position

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<sup>48</sup> It should be noted that the meaning of successful use of force in this context is less straightforward than in the typical bargaining model, in which it is assumed that victory automatically gives access to the good under dispute (e.g., Fearon 1995's model). This conceptualization makes intuitive sense when the dispute is over territory and victory enables territorial grabs. By contrast, we assume that Baghdad and Erbil are negotiating over institutional arrangements rather than the physical control of some asset. Thus it makes more sense to think of military victory in terms of coercion. For example, victory for the federal government could be represented by a scenario in which the Iraqi army manages to seize KRG-controlled oil fields, essentially forcing Erbil to accept Baghdad's position. Alternatively, a more limited use of force by Baghdad signaling its ability to take control of KRG-controlled oil fields could discourage further investments by international companies in the Kurdish region, thus undermining the KRG's strategy for development of its hydrocarbon industry and prompting Erbil to accept Baghdad's requests. By contrast, a scenario in which Baghdad proves unable to make any headway in Kurdish territory would amount to a Kurdish victory.

to shield itself from the financial consequences of such a development by relying on the revenues deriving from its direct hydrocarbon exports to Turkey. The economic interdependence between Turkey and the KRG brought about by the new pipelines would work as a form of insurance for Erbil against a worst-case scenario of opportunistic behavior by Baghdad (i.e., a naked power grab), which in turn should make the Kurds more comfortable with the idea of remaining part of Iraq. By removing an important motive for Kurdish secession, the creation of the new pipelines reduces the probability of war provoked by a KRG bid for independence. Moreover, as noted, once the new pipelines are fully operational, the probability that Ankara would help Erbil in case of aggression by Baghdad (and thus protect its own investments) is likely to be sufficiently high to discourage Iraq's use of force to settle ongoing disputes.

A critical reader may point out that the creation of a hydrocarbon export infrastructure outside federal control and the prospect of Turkish political and military support may embolden the KRG, which would then advance excessive demands to the federal government and perhaps even attempt secession, thus somehow provoking a war. The logic of our argument does in fact suggest that Erbil's demands *might* grow with its bargaining power. However, this is not necessarily the case: inasmuch as our assessment that commitment fears are a key determinant of Erbil's negotiating position is correct, the reduction of those concerns associated with the creation of new pipelines (in a context in which the KRG maintains its hold on the region's hydrocarbon sector) could lead Erbil to be less intransigent in negotiations with the federal government. Even if an escalation of Kurdish demands does occur, we should not expect this to translate automatically into an increased risk of armed conflict between Baghdad and Erbil, but rather in a bargaining outcome more favorable to Erbil as both players are aware of the KRG's stronger position. (Baghdad may be concerned about the prospect of negotiating from a position of weakness with Erbil and having to make concessions down the road and may thus prefer to fight in the present; this is, however, the short-term preventive war incentive that is already part of our argument.) Moreover, Kurdish politicians are explicit (both in public statements and private conversations) about their preference for overcoming the hydrocarbon deadlock with an agreement with Baghdad and in the framework of the existing 17-83% revenue sharing formula, rather than by achieving *de facto* financial independence or even *de jure* independence. To be sure, they openly acknowledge the

Kurdish people's historic aspiration to statehood, but they also clearly state that this is a long-term goal to be achieved by peaceful means under changed geopolitical circumstances—in particular, Turkish and US support for independence is considered an absolutely necessary condition<sup>49</sup>. There is no evidence that Ankara (let alone Washington) would back a potential secessionist bid by Erbil. Turkey's position toward Iraq's Kurds has certainly dramatically changed over the past few years, but it seems highly doubtful that Ankara would be willing to support the KRG all the way to statehood. Turkey is much more likely to accept a condition of de facto financial independence in which the KRG helps Ankara satisfy its growing energy demand and geopolitical ambitions, without the higher risks of war with Baghdad and the demonstration effect among Turkey's Kurds that de jure sovereignty would entail. The KRG's complete reliance on Turkey for access to international hydrocarbon markets suggests that Ankara should be able to keep Kurdish secessionist aspirations at bay (if needed) by threatening to shut down the pipelines. Carrying out this threat would be costly for Ankara, but the costs would be significantly higher for Erbil given its economy's almost complete dependence on natural resources.

Our theoretical argument identifies competing short-term and long-term effects of Turkey's pipeline decision on the prospects of conflict between Baghdad and Erbil. The key question from a policy point of view is: are the long-term benefits worth the short-term risks? This is an empirical, rather than theoretical, question. The answer hinges on whether Baghdad's preventive war incentives are sufficiently strong to push it to take the gamble of war. We argue that Baghdad is highly unlikely to consider the open use of force against Erbil in the short run as a realistic option. Baghdad is monitoring with great concern devel-

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<sup>49</sup> One could question the reliability of these kinds of statements by pointing out that they are likely tailored to international audiences with the objective of projecting an image of moderation. However, history suggests that minority leaders' moderate political claims should not be automatically dismissed as "cheap talk" because they sometimes adopt hardline positions. The case of Kosovo offers a useful illustration. Several analysts consider it a clear-cut example of an ethnic minority emboldened by the prospect of external intervention (Kuperman 2008; Grigoryan 2010), but its leaders did not try to underplay their aspiration to independence. In 1992, Serbian Prime Minister Milan Panic offered Kosovo Albanians' leader Ibrahim Rugova to reopen schools and hospitals in Kosovo, as well as restore the province's autonomy, but Rugova insisted on Kosovo's outright independence as the only possible solution to the conflict (Vickers 1998, p. 266; Johnstone 2002, p. 226). In 1996, shortly after the Dayton agreement put an end to the war in Bosnia, Slobodan Milosevic expressed willingness to negotiate a compromise, but the Kosovo Albanians' response was the dismissal of any settlement short of Kosovo's full independence and the insurgency launched by the Kosovo Liberation Army, which eventually led to the NATO intervention in 1999 and the Serbian retaliatory ethnic cleansing (Burg 2003, p. 73; Grigoryan 2010).

opments in neighboring Syria. A victory by Sunni rebels in the civil war there would mean a significant risk of political and military spillovers in Iraq, in particular strengthening and emboldening the Sunni protest movement and terrorist groups<sup>50</sup>. The Iraqi government is unlikely to be willing to gamble on war against the KRG when it faces a mounting Sunni challenge both across the border and at home. Moreover, even if the probability of Ankara's intervention in a Baghdad-Erbil war would be highest when Turkish investments and the all new pipelines are in place, there would be a non-negligible risk of Turkey's providing military support to KRG forces in the aftermath of Ankara's pipeline decision, which should be a powerful deterrent to Baghdad's decision to use force<sup>51</sup>.

Baghdad is more likely to consider the use of more limited violent measures, in particular sabotage of the new pipelines, but these are unlikely to pose major obstacles to hydrocarbon flows. Pipelines in northern Iraq are often targeted by Sunni groups but are typically repaired quickly without major impact on export volumes; the attacks tend to occur in areas under federal government rather than KRG control<sup>52</sup>. The federal government would have a hard time carrying out any plan to launch attacks on the new pipelines on a larger scale than under present conditions: the Shia groups that may be willing to help would probably experience serious difficulties organizing and executing operations in Sunni- and Kurdish-dominated areas, while the Sunni groups that may more easily operate in mixed areas are unlikely to offer their services to Baghdad, given the growing ethno-sectarian tensions agitating the country.

In sum, Ankara's pipeline decision would offer the prospect of unlocking international markets for the Kurdistan region's resource wealth. The corresponding significant economic benefits for both Iraq and Turkey (and probably energy-importing European countries) would be coupled with a net reduction in the probability of war between Baghdad and Erbil, in spite of an increased risk of preventive war by Baghdad in the short-run. US policy on this issue should reflect awareness of both the

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<sup>50</sup> See, for example, Londoño 2013, Arraf 2012, and Arango 2013.

<sup>51</sup> Baghdad may feel in a better position to wage war against Kurdish forces after the planned delivery of M1A1 tanks and F-16s (Sullivan 2013, p. 36). However, it is unclear whether this increase in Baghdad's military power would be sufficient to prevail over the factors, discussed above, that make war against the KRG unpalatable in the short-run. In addition, the military equipment may well be delivered after the new pipelines are in place, in which case the increase in Baghdad's military power would likely be dwarfed by the increase in the probability of Turkey—the regional powerhouse—intervening on the KRG's behalf in case of aggression by the central government.

<sup>52</sup> See, for example, Al-Najr 2013 and Van Heuvelen 2013a.

opportunities and risks involved and thus abandon its current focus on discouraging Ankara and Erbil from pursuing closer energy ties for fear that Iraq may once again plunge into civil war. In fact, altering the trajectory of Ankara-Erbil relations may well be beyond Washington's power, given the high stakes for both Turkey and the KRG. However, US policy could help reduce the risk of short-term instability associated with Ankara's pipeline decision by clearly stating that the United States will punish aggression by any party in the Ankara-Baghdad-Erbil triangle and that it expects the parties to solve their disputes in a peaceful manner. Moreover, Washington should carefully time the delivery of military hardware to Iraq's federal government to make sure that the corresponding increase in Baghdad's military power occurs only after Turkish investments and the new pipelines are fully in place, i.e., when Baghdad no longer has an incentive to launch a preventive war. Finally, Washington should pressure Ankara to provide credible assurances to Baghdad that the pipeline decision will not affect Turkey's commitment to Iraqi sovereignty, territorial integrity and the existing revenue sharing arrangement between Baghdad and Erbil.

## Conclusions

Due to deep-seated commitment problems, Baghdad and Erbil are in a political deadlock over hydrocarbon framework and revenue sharing laws. Erbil has tried to attract international investments in hydrocarbons and to persuade Ankara to provide an alternative export outlet with the ultimate objective of mollifying Baghdad's negotiating position or to gain de facto financial independence from the federal government with hydrocarbon exports to Turkey if no agreement emerges. Baghdad has tried to undermine the KRG's initiatives by manipulating the legal-political risk faced by energy companies operating in Kurdistan and voicing to Ankara its unease with closer relations between Turkey and the KRG.

Ankara's decision to invest in KRG-controlled exploration blocks and allow the creation of new pipelines is a major game changer, as it signifies the failure of Baghdad's attempts to discourage Ankara from supporting Erbil in its dispute with the federal government and significantly reassures international companies of the viability of the KRG's natural resource industry. Given its costly and ineffective strategy, Baghdad would face a choice of making concessions to Kurdish demands on the hydrocarbon framework and revenue sharing laws or escalating by resorting to force.

Baghdad's concessions would amplify the prospective strengthening of Erbil's hand deriving from Turkish investments and the new pipelines. The KRG would be in a position to bargain harder because the new pipelines would provide an alternative source of revenues in case Baghdad threatens to suspend federal budget transfers. In addition, Turkish intervention on Erbil's behalf in case of aggression by Baghdad would be more likely after Ankara has made its investments and the new pipelines are fully in place, which also should reduce the federal government's leverage vis-à-vis the KRG. Baghdad may be tempted to launch a preventive war to forestall the unfavorable change in the balance of power, perhaps also in the hope of convincing Turkey to change course. However, we consider the probability of Baghdad's initiating war in the short term to be low, in particular due to its concern with the civil war in Syria and the corresponding risks of spill-over in Iraq as well as ongoing unrest among Iraq's Sunnis. In any case, responsible policy-making requires comparing the short-term increase in the risk of war with the corresponding long-term benefits, which we argue are greater. Ankara's pipeline decision offers the prospect of unlocking international markets for the Kurdistan region's resource wealth, with a strong potential of contributing to Iraq's and Turkey's socio-economic development (and probably to the well-being of energy-importing European countries). Moreover, Ankara's decision would have the long-term effect of assuaging Erbil's entrenched fears of exploitation by Baghdad, which should eliminate a powerful motive for Kurdish secessionist aspirations and reduce the corresponding risk of war. Thus, US policy on the issue should not aim at blocking the Turkish initiative (which, in any case, is unlikely to succeed) but rather attempt to contain the risk of conflict escalation in the short term.

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