BY TOM BERGIN
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In this part of Iraq, the hillsides sweat oil. Without any coaxing, the sticky black treasure oozes from the layered rock and gathers in pools that bubble as dissolved gases surface. Gradually, as the crude slips down the hillsides, it solidifies into a grey mass that resembles a hardened lava flow.

It’s a good metaphor for the progress of oil from the semi-autonomous Iraqi region of Kurdistan over the past five years: big on promise, small on delivery.

Last month, after years of wrangling between Kurdistan’s regional capital Erbil and Baghdad over revenues, exports finally started to flow. Foreign investors -- among them Russian oligarchs, a British mercenary boss, U.S. politicians, a former diplomat, and funds controlled by the billionaire investor George Soros -- who have sunk $5 billion into Kurdistan’s oil fields, hope they will finally begin to enjoy the rewards.

There’s just one problem: Baghdad may have given the green light for exports, but it has yet to agree on how the companies who produce the oil should be paid. This has happened before. For a few months in 2009, oil companies exported their product without payment. When neither side could agree on the oil companies’ cut, exports were turned off again.
This time, Baghdad says it is prepared to recognise the contracts the regional government has signed with foreign oil companies. But the central government is sticking to its line that the deals must be rewritten, in a way the companies oppose because it will cut into their profits.

So is Kurdistan on the brink of an oil bonanza, or will the promise end up hardening like the oil from its crude-leaching hills?

“The route to getting paid is looking good,” says John Gerstenlauer, Chief Operating Officer of Gulf Keystone, which says it has discovered a field with up to 7 billion barrels of oil. “At the end of the day, none of us are working for a charity so everybody’s going to want to get paid.”

FIRST IN
IT WAS THAT SORT of optimism that prompted Norway’s DNO to become the first western firm to drill for oil in Iraq after the U.S.-led invasion in 2003. Oil companies typically use a complex array of tests -- satellite imaging, seismic surveys, magnetic and aerial mapping -- before deciding where to sink their multi-million dollar wells. But the Chief Executive of DNO had no such problem when he came to drill in Kurdistan.

“It wasn't really based on a lot of in-depth technical studies,” says Helge Eide. “You could see the surface features ... the oil seeps. It was a little bit of the stomach feeling ... sometimes you have to base your decision on these simple things.”

But if finding the oil was easy, getting paid for it has proved frustratingly difficult. Caught in the dispute between Baghdad and the regional government, DNO has spent more than seven years waiting for word to start exporting.

Late last year, just 20 feet from a spot where oil weeps from the hillside in the middle of one of the region’s two main oilfields, DNO's production manager Eric Aillaurd spoke of the long-building sense of anticipation. Nearby a red wellhead, its five-foot tall “Christmas tree” idle, sat unconnected to any pipeline that could ship the crude to market. But, said Aillaurd, the company was just waiting on the word. “If I’m told to start exports, we are ready to start producing in 15 minutes,” he told Reuters. “We have the capacity to produce over 50,000 barrels per day once we get the signal.”

WEALTHY PROSPECT
SURROUNDED BY MAPS, seismic charts and photographs of well sites in his office on a leafy residential street in the Christian quarter in northern Erbil, Adnam Samarrai illustrates the risk and reward of Kurdish oil. He’s experienced both personally.

In 1962, while working as a geologist for Iraq’s state oil company, he was abducted by Kurdish militia and held captive for six months. He was released with a message for his bosses: no more exploration in Kurdistan.

Forty seven years on, Samarrai returned to northern Iraq for Gulf Keystone Petroleum, a small producer listed on London’s AIM exchange. This time, in what’s called the Shaikan field, Samarrai had more luck, finding what Gulf Keystone says is at least 7 billion barrels and may prove more than double that -- easily one of the world’s largest oil discoveries in recent years.

“I always knew there was oil here,” says Samarrai, 75, whose white moustache matches the few whiskers of hair on his head.

The Kurdistan Regional Government (KRG)
estimates its territory holds reserves of 45 billion barrels. That figure has not been independently verified, but if it's right, it would mean Kurdistan has more oil than the North Sea has produced over the past 40 years.

Little wonder that oil producers have wanted to get into the region for so long. Foreign oil investment first reached Kurdistan in the Saddam era. Nine years ago, in the last days of the regime, Turkish construction magnate Mehmet Sepil agreed to develop the Taq Taq field, which now has a capacity of 60,000 barrels per day (bpd). Sepil joined forces with Turkish billionaire Mehmet Emin Karamemhet to form a company called Genel Enerji, of which he remains CEO.

“EVERY OIL COMPANY’S DREAM”

AFTER THE U.S.-LED invasion, other firms from western Europe, Asia and the United States moved in. The quest for oil bosses from the United States and Europe over the past 30 years has involved taking on more political and geological risk to secure fresh reserves. Charged by Beijing with feeding China's energy-hungry economy, state-backed Chinese oil companies have joined that search.

For many, Kurdistan -- and Iraq more generally -- is the great prize. “There is no other place in the world where structures of this scale, in a known petroleum system, remain undrilled,” says Alex Cranberg, CEO of Aspect Energy, which is drilling in northern Kurdistan.

Wolfgang Rutenstorfer, Chief Executive of Austria’s OMV, the biggest European oil company active in the region, says Kurdistan is the answer to oil producers' biggest challenge: “reserves replacement and access.”

One early entrant was British-based Heritage Oil, whose CEO and largest shareholder is Tony Buckingham, an ex-soldier who got into resources via companies he formed to supply mercenaries to fight in African conflicts. In May 2009, Heritage announced a 10 billion barrel find in the Miran block, in which Genel also has a stake. Dallas-based Hillwood International Energy, which is owned by the family of billionaire and former U.S. Presidential candidate Ross Perot, also won a license, as did Norbest, a unit of Alpha Access Renova, the investment vehicle held by four oligarchs who own half of BP's Russian unit, TNK-BP.

Other investors include Canada-based Longford Energy, which counts Soros Fund Management as its biggest shareholder, Korea's state oil company, and Chinese state-controlled Sinopec.

In all, the Kurdish government says it has signed deals with more than 40 companies. Numerically, Canada and the United States have the strongest representation, with the biggest cash investments coming from Britain, Turkey, Austria and Norway. Investors include such institutional names as Fidelity, Legal & General, JP Morgan and Elliott Management -- one of the world's largest and most publicity-shy hedge funds.

More recently, hopes for a breakthrough on the revenue impasse have attracted oil majors such as U.S.-based Marathon Oil and Murphy Oil, who have both signed contracts worth hundreds of millions of dollars, including signature bonuses for the Kurdish government worth tens of millions, in the past few months.

Like DNO, many have found the exploration phase a breeze. Genel’s eight wells in Taq Taq have all struck oil -- the lightest, most gasoline-rich and valuable variety possible. "It's every oil company’s dream," says production supervisor Victor Barkworth. But blocks in the southern part of Kurdistan have dangerous high-pressure reservoirs, as Canada's Western Zagros discovered when

Ttwenty minutes drive west of Erbil off the road to Mosul, 10-15 large silver-skinned storage tanks appear in the dusty brown landscape. These belong to the Turkish-owned La Naz Asfalt Company.

Past the entrance guarded by Peshmerga Kurdish army soldiers with AK-47s sit four crude processing units, like barrels on their sides. These tanks with rounded ends are simple mechanisms for heating crude oil, constructed at a total cost of $700,000. Similar devices have sprung up across Kurdistan to process the region’s growing crude output. Foreign oil executives dismissively describe the devices, usually imported through Turkey, as “kettles.”

This is one of Kurdistan’s larger topping plants. It operates 24 hours a day, seven days a week, processing 700 tonnes of crude each day. Towering above all the tanks is the tall, slender distillation tower, where La Naz collects gasoline and diesel produced by heating the crude.

The company sells the fuel into the local market but is left with heavy fuel oil, which is then processed again in steam-heated storage tanks to produce asphalt to supply Kurdistan's roaring road-building business. Asphalt is the heaviest and but one of the least valuable of the products extracted from crude.

Beside one large storage tank, six-foot flames roar into the sky, bellowing dark smoke. Workers deliberately started the fire to heat the solidified heavy fuel oil inside. Where the flames wouldn't reach, they attached blocks of foam to retain the heat.

In a western refinery, smoking a cigarette would earn a worker instant dismissal. Here, beside a raging blaze, no one bats an eyelid. The site’s manager explains: “We built it wrong.” When the fuel oil storage tank was built, they forgot to install the steam heating system that would prevent the fuel coagulating.

The site was built on land donated by the Kurdistan Regional Government to encourage development. The manager says business is good, even though imports of cheap asphalt from the rest of Iraq have dented prices. The site is surfaced with concrete in parts, elsewhere gravel and dust.

On the other side of the facility, which occupies the space of around two football pitches, a worker washes out a diesel tank, the contaminated water falling onto the ground below.

Stains on the top of one tank suggest it has previously overflowed. Dark stains litter the walls of another, where the welds between the panels appear to have failed, allowing fuel to seep out. There's a heavy oily smell, not the headiness of gasoline you get on a filling station forecourt.
it suffered a well blow-out in May 2010. The blow-out took nine months and $100 million to bring under control.

As producers have waited for an agreement between the Kurdistani government and Baghdad, some have pumped small amounts of oil and sold it at knock-down prices on the local market. It's hardly been lucrative. With so few high-value oil products extracted from the crude, companies make as little as $20-$25/barrel -- less than a quarter of current world prices.

According to local officials, surplus heavy fuel oil is also trucked over the border to Iran for onward export to complex refineries in Asia that can convert it into gasoline and diesel. The United States says it opposes such exports as they support the Iranian oil industry. But oil executives say opposition is weaker today that in the past. The U.S. State Department denies any change in policy, but oil executives believe the U.S. understands stopping the trade would hit Kurdistan's industry and political stability.

A BAD SMELL

VISITORS TO TAQ TAQ are warned of the danger of landmines and told what to do in case of an armed attack. The most obvious hint of risk, though, is the smell of rotten eggs around the central processing facility, which indicates the presence of toxic hydrogen sulphide gas. That must be treated with care, because besides burning eyes, nose and throat, it can cause blindness or paralyse the respiratory system.

Hydrogen sulphide is not the only bad smell to emanate from Kurdish oil. While companies have spent the last few years waiting for word to begin exports, the sector has been hit by a series of scandals.

In 2009 the Oslo Stock Exchange fined DNO nearly 1 million crowns ($170,000) for not providing enough information about a deal on the sale of 44 million shares, or 4.8 percent of its stock, to the Kurdish Regional Government. The shares later ended up in the hands of DNO's rival and partner Genel Enerji, whose CEO is Mehmet Sepil. Investors were only told of the deal after DNO's shares had risen to double where they had traded when the deal was sealed. DNO said it was unaware who was purchasing the parcel of shares, and the Kurdish Regional Government denied it had profited from the transaction, releasing a statement saying the revelations had caused it "unjustifiable and incalculable harm."

Months later Sepil himself was in trouble, receiving the UK financial regulators' largest ever fine of 967,005 pounds ($1.57 million) for insider dealing. Sepil and two Genel colleagues had bought shares in Heritage Oil, their partner in the Miran block, after Heritage told them of a major oil discovery at the block. Hours after the find was announced to the stock market, the executives sold their stock and made over a million pounds in profit.

Perhaps most damaging was DNO's disclosure last October that it would have to pay $55-75 million to a former U.S. diplomat and a Yemeni company, for an interest in Tawke DNO had given to them in return for helping the company secure its licence. The diplomat, Peter Galbraith, son of the famous economist John Kenneth Galbraith, had been on the staff of the U.S. Senate Foreign Relations Committee since 1979 where, according to his website, he uncovered and helped stop Saddam Hussein's genocide against the Kurds. He was also a U.S. ambassador in Europe in the early 1990s. Galbraith maintained that because he had never served as a U.S. envoy in Iraq he was free to do a deal. But he was criticised in the United States for having acted as a cheerleader for Kurdish autonomy after the Gulf War, penning columns in the U.S. media, without disclosing that he could benefit financially from this.

The whiff of scandal has weakened the Kurds' position in negotiations with
Baghdad, proving a boon to those who argue for a centralised Iraq-wide system of awarding oil contracts. Among Kurds, it has also fuelled concerns about corruption which in turn has helped build support for the opposition political party, Goran, in its bid to break what some Kurds see as a cosy political power-sharing cartel between the PUK and PDK political parties, which have dominated since the 1990s. Goran, which means ‘change’ in Kurdish, campaigned on a platform of fighting corruption in Kurdish parliamentary elections last year and won nearly a quarter of the seats.

“THE 17 PERCENT”

STILL, OIL MONEY has already helped Kurdistan. Brightly painted new schools and all-weather sports grounds abound. The larger towns and cities sport shiny, aluminium-clad municipal buildings, wide roads with multilingual signage, and brand new traffic lights. In the countryside, criss-crossed with glistening new pylons, journeys are constantly interrupted by road works as brand new diggers carve their way through hillsides and rollers flatten the uneven earth.

The boom has attracted home exiles like Said Hemn Moustafa, 29, a civil servant who returned one and a half years ago after seven years in the United Kingdom. “When I left, my country was not safe. Now all is good. No one has any problem. Everyone has job,” says Moustafa, out for an afternoon stroll among the fountains of the newly landscaped Shar Park, at the foot of the ancient, mud-brick walled Citadel which marks the centre of Erbil.

Kurdistan’s capital is packed with new high-rise buildings and shopping malls. The newly built ring roads and overpasses teem with recent-model Korean and Japanese compact cars and the occasional high-end off-roader. Hosts of foreign oil company offices give the sense of an emerging oil town.

Ask people what’s behind the new vehicles and buildings and the green lawns, rose beds, fountains and sculptures that occupy the roundabouts and traffic islands and the answer is always the same: “the 17 percent.” Signature bonuses have probably raised several hundred million dollars, according to executives in the region. But the real money comes from Kurdistan’s share of Iraq’s oil revenues, based on its population. This equates to 17 percent of the earnings from the 2.5 million barrels or so per day pumped from giant fields in the south of the country.

Can Kurdistan -- and Iraq -- boost these export earnings?

END TO THE STALEMATE?

“WE ARE NOT ASKING FOR ANYTHING OUTSIDE THE CONSTITUTION.”

BIG EXCITEMENT: Kurdistan’s oil minister Ashti Hawrami, pictured in November 2010. “Basically, we have an agreement.” REUTERS/AZAD LASHKARI

IN THE COMPOUND ringed by blast walls that houses the Kurdish parliament and other government buildings, the Kurdish regional government’s natural resources minister Ashti Hawrami sits in his office, dimmed by heavy drapes. The four-year-old building is clad in brick and boasts a grand entrance hall with an inlaid marble floor and curved staircase. That gives way to more modest decorations inside: inexpensive photographs of oil installations, mass-produced prints of flowers, faux-leather sofas.

Hawrami says there is “big excitement” in the oil industry. He expects the existing contracts agreed by the Kurdistani government will soon be recognised by Baghdad. But push him and even he cannot point to a fundamental change in Baghdad’s position on the contracts. Put simply, Kurdistan says its contracts are in line with the constitution, while officials in Baghdad insist on central control over oil contracts. “In principle, it has been agreed that everything will be done according to the constitution, and we are not asking for anything outside the constitution, so therefore basically we have an agreement,” Hawrami said in November.

Not quite. If Baghdad forces the Kurdistani government to redraft the contracts, explorers’ returns could be hit hard. Kurdistan’s deals with foreign oil companies are production sharing contracts (PSCs). But Baghdad wants the contracts to be rewritten along the lines of the service deals it has signed with BP and Exxon in the south. PSCs usually offer better returns and more control than service contracts. Analysts at Deutsche Bank calculate the internal rate of return allowed under DNO’s contract will be 50 percent. In comparison, Baghdad’s $2/barrel service contracts with Royal Dutch Shell yield only 17 percent.

Iraqi Oil Minister Abdul Kareem Luaibi has said the 2011 federal budget will include the expectation of shipments of 150,000 barrels per day from Kurdistan -- more than the Kurds say they can produce.

So even though exports resumed a few weeks ago, with no clarity on the revenue model companies like DNO are yet to be paid. That’s not a problem for diversified investors like Marathon Oil and OMV who can afford to sit and wait. But smaller Kurdistan-focused companies will struggle.

Gulf Keystone, for instance, says it has enough cash to last until the second quarter of 2012. By then, it hopes to have a steady cash flow from exports, which will open up the option of debt financing. But if that doesn’t happen, it will face a crunch. Analysts at
Bernstein calculated that a two-year delay in an oil project’s start up could halve its economic value.

There have already been casualties.

U.S.-based Calibre Energy’s plans for a $100 million flotation failed to materialize, ending its hopes of being a major force in the region. Sterling Energy’s shares soared to over 220 pence in late 2009, when it raised $103 million to start drilling, only to fall to under 50 pence a year later, as it encountered drilling problems. The shares now trade around 66 pence.

News of a final deal on exports will please people like Norway-based private investor Eirik Amundsen, who holds 79,000 shares in DNO. “It’s been some very tough years, but I have always firmly believed that common sense sooner or later will prevail, and thus give DNO the opportunity to fully develop the potential of its Iraqi assets,” he says. “I have to admit, though, it has taken much longer than I anticipated.” And while optimism is high, there’s no guarantee the wait is over yet.

(Additional reporting by Andrew Quinn in Washington, Rania El Gamal in Baghdad and Shamal Aqrawi in Arbil; Editing by Sara Ledwith and Simon Robinson)