Iraq's Power Problem (Part 2): Implications of the New Oil-for-Gas Deal with Iran

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Brief Analysis

Baghdad hopes to avoid power cuts, political turmoil, and U.S. sanctions by striking a barter agreement with Tehran, but the deal raises many questions.

On July 11, Baghdad and Tehran signed a deal that will allow Iraq to pay for the natural gas it imports from Iran with oil transfers. The deal is seemingly intended to keep Baghdad from running afoul of U.S. sanctions as it secures its electricity sector, which is still very fragile and dependent on Iran (for more on the sector's problems, see Part 1 of this PolicyWatch **(https://www.washingtoninstitute.org/policy-analysis/iraqs-power-problem-part-1-persistent-financial-and-technical-challenges)**). Yet it is unclear if the parties have worked out the many commercial and logistical complications that come with implementing such a plan.

Why Strike a Deal Now?

During peak summer season, Iraq imports 70 million cubic meters of gas per day from Iran to feed its power plants, generating around 5,000 megawatts of electricity with these supplies. This flow, coupled with direct purchases of Iranian electricity, means that Tehran accounts for 40 percent of Iraq's power needs at a cost of $4 billion per year.

Yet Iran often reduces Iraq's gas supply, contributing to power shortages, public discontent, and political problems. Some of these cuts are driven by Iranian domestic demand, but other instances stem from Tehran's desire to exert leverage and Baghdad's payment delays. Iraq currently owes $12 billion for gas and power imports, and payments toward that balance have been deposited in an account at the Trade Bank of Iraq (TBI). Yet Tehran cannot access this money without waivers on the various U.S. sanctions against Iranian government entities. The new barter deal enables Baghdad to sidestep this difficulty and pay with oil.

One reason for seeking this deal is because Iraq has had trouble meeting Washington's requirements for waiving sanctions. As described **in Part 1 (https://www.washingtoninstitute.org/policy-analysis/iraqs-power-problem-part-1-persistent-financial-and-technical-challenges)**, the waivers related to gas imports are partly conditioned on Baghdad showing progress toward two key goals: achieving energy independence from Iran and reducing the amount of gas it wastes through flaring associated with oil production. The Trump administration emphasized the former goal, while the Biden administration has placed additional focus on emissions from gas flaring.

Baghdad is taking some steps to meet these conditions, such as signing a recent gas capture and solar power deal with TotalEnergies, developing the Basra Gas Company with Shell and Mitsubishi, and expanding the Khor Mor gas field in the Kurdistan Region of Iraq (KRI), a project that involves $250 million of U.S. funding and cooperation with the Emirati-led consortium Pearl Petroleum. Iraq also launched a sixth licensing round for gas fields, changed its contract model for oil companies, initiated plans to connect its power grid with Jordan and the Gulf Cooperation Council states, and tapped Siemens to squeeze more wattage from its existing turbines when Iran cut the gas supply earlier this month.

Despite these laudable steps, however, Prime Minister Mohammed al-Sudani **acknowledged (https://apnews.com/article/iraq-iran-electricity-sanctions-oil-gas-e0bd5674c5b70020eb564fe7c9ff1446)** on July 11 that Iraq has more to do on these fronts and will still need at least three more years to become independent of Iranian gas. Indeed, Baghdad has failed to invest substantially in exploiting its own expansive gas reserves, capturing gas wasted during oil production, developing gas pipelines, or exploring liquefaction. The sundry reasons behind this failure—from insufficient infrastructure to chronic mismanagement and corruption—have given rise to a new barter deal that has ample question marks of its own.

Devil in the Details

One of the most immediate questions about the oil-for-gas deal is how will the prices be set? An Iraqi official has privately indicated that the oil will be given to Iran at international prices. Yet Iran sells gas to Iraq above market prices and sells oil to China below market. In the latter case, it is willing to pay these **steep transaction costs (https://www.washingtoninstitute.org/policy-analysis/irans-oil-exports-are-vulnerable-sanctions)** in order to facilitate its illicit oil exports. Yet it may lose even more money if it tries to reexport Iraqi oil or use it at home. The deal also includes fuel oil, however, so Tehran could make up some of the potential losses by using these supplies for domestic industrial purposes.

Other questions are just as pressing: where will Iraq get the oil, and how will it be transported? One option is to truck it from the KRI, where the bulk of the region's production of 450,000 barrels per day has been unavailable for export for months. In March, a legal dispute led Turkey **to close the pipeline (https://www.washingtoninstitute.org/policy-analysis/israel-may-lose-oil-access-baghdad-kurdish-deal)** that brings KRI oil to the Mediterranean port of Ceyhan (mostly for re-shipment to Israel). Transferring this oil to Iran could help the KRI ease some of its internal problems, solidify its connections with Baghdad, and assuage Erbil's fears of an Iranian military incursion. In the past, a similar **swap deal (https://www.washingtoninstitute.org/policy-analysis/putting-iraq-krg-oil-relations-solid-legal-ground)** saw Iraq truck oil to Iranian refineries near the border.

Assuming the parties can work these issues out, will the bartering arrangement prove stable? If Tehran comes to believe that Iraq is genuinely trying to wean itself off Iranian gas and power, the regime may try to sabotage that plan through a tactic it has used before: influencing Iraq's parliament to divert budget allocations from energy projects. Periodically attacking the assets of foreign oil companies has likewise enabled Iran to deter investment and slow progress when it deems fit—a threat that Baghdad will take seriously given that its own mismanagement has already hindered investments from oil majors such as Shell and Exxon. Iraqi corruption could rear its head again as well, since transporting oil to Iran will likely involve individuals and companies tied to militias and organized crime groups.

In short, Baghdad has lots of problems it must solve to make this work, and even then there is no guarantee the Biden administration will simply accept the arrangement and waive sanctions. The Iraqi government may be able to sidestep direct sanctions, but foreign oil companies will not automatically be immune—an especially worrisome prospect if Iraq aims to barter oil from the KRI, where several foreign companies operate. Alternatively, the deal may be intended as a joint Iraqi-Iranian tactic to pressure Washington on allowing Tehran to access its blocked funds.

A Surprise for Washington?

The oil-for-gas agreement may have caught Washington off guard—thus, even if the Biden administration is initially inclined to be supportive, it may still want (and should definitely seek) answers from Prime Minister Sudani before fully accepting the deal. This could mean striking a familiar balance between sometimes-conflicting objectives. For instance, Washington is focused on its longstanding goals of stabilizing Iraq, maximizing Baghdad's autonomy from Iran, and closing loopholes to make it harder for Tehran to evade sanctions. In the immediate context of a summer power crisis, however, stability may require moving closer to Iran, not further away.

Sudani faces a similar balancing act between conflicting realities and pressures. Although he seemingly wants to increase his political space for taking action independent of Iran, he understands that if he pushes the boundaries too far, Tehran can use its proxies inside Iraq's armed forces **(https://www.washingtoninstitute.org/policy-analysis/extraordinary-popular-mobilization-force-expansion-numbers)** and government **(https://www.foreignaffairs.com/iran/iraq-quietly-falling-apart)** to undermine him. More to the point, he has a genuinely urgent need for more Iranian gas, and he cannot get it for free.

This may be why he apparently acted without asking Washington—he either feared a "no" answer or believed the administration would be too slow to act. Going forward, he will presumably try to use the TotalEnergies deal to show he is making a real effort to wean Iraq off Iranian gas—and simultaneously signal Washington that going cold turkey is not an option unless the Biden administration wants to see the country unravel.

Sudani may also point out that he is under pressure from Iran to pay the overdue gas bill; and since Washington will not allow Tehran to draw these payments from the TBI, he had little choice but to seek a barter deal. Such arguments are credible given Iran's previous behavior—after the Biden administration allowed Baghdad to release $2.7 billion of Iranian funds for humanitarian trade, Tehran still cut Iraq's gas supply. Despite this proven Iranian leverage, administration officials remain reluctant to grant any more waivers for withdrawals from the TBI (earlier today, the State Department announced a new 120-day waiver allowing Baghdad to pay Tehran for electricity via non-Iraqi banks, though various restrictions may limit that route as well). Hence, the White House will likely accept the barter deal in the end, if only to avoid increased instability in Iraq during summer electricity shortages.

But U.S. officials should still use their leverage to work out an agreed game plan for weaning Iraq off Iranian gas, including clear milestones and, perhaps, shorter waiver periods (e.g., back to the 60- or 30-day periods granted under the Trump administration). Yes, figuring out this timeline will be difficult. But unless the new barter arrangements are aligned with a larger strategy for increasing the Iraqi government's freedom of action from Iran, Baghdad and its international partners will repeatedly find themselves in a crisis footing that benefits Tehran.

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