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COMMENTARY

An Oil Crossroad in the Cross Hairs

Edward C. Chow

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The current fighting in Georgia brings out many ghosts of the past. Gori, an obscure town on the major east-west highway across Georgia that came under Russian attack this week, was previously known mostly as the birthplace of one Joseph Stalin. And it is Stalin's deliberately complex borders for the republics of the Soviet Union that is the putative cause of this conflict.

A little-known fact is that Stalin started his political career by organizing the oil workers of Baku in Azerbaijan on the Caspian, which supplied half of the world's oil at the turn of the twentieth century, and in the Georgian Black Sea oil port of Batumi, through which the oil was transited to Europe. This history, however, was not lost on two wily veterans of Soviet politics: Georgian Eduard Shevardnadze, a former foreign minister of the Soviet Union, and the Azerbaijan leader, Heydar Aliyev, a Soviet-era deputy prime minister and Politburo member.

When their native lands had independence thrust on them with the collapse of the Soviet Union, they ended up as presidents of newly independent Georgia and Azerbaijan after rather circuitous routes. Oil is the one means by which these two countries can hope to establish and maintain their political and economic independence.

The Soviets woefully mismanaged and exhausted Azerbaijan's oil resources. When world-class offshore oilfields were discovered, they were left unexploited because the Soviets lacked technical expertise and capital. Western oil companies were eager to develop these fields for production. But Azerbaijan is landlocked on an inland sea, and all existing pipelines pointed north to Russia. This is where Georgia, Azerbaijan's Caucasus neighbor, came in. In order for the Caspian region to again become a source of oil supply to world markets, Georgia had to resume its traditional role as a transit corridor.

Aliyev and Shevardnadze—joined by Turkish president Suleyman Demirel—called their project the "new silk road," which was launched in earnest in the mid-1990s and reached an important milestone with the signing of an intergovernmental agreement for building the Baku-Tbilisi Ceyhan (BTC) pipeline from Azerbaijan through Georgia to eastern Turkey and the Mediterranean.

Their efforts were actively supported by Western governments, particularly Washington, as a way to solidify the independence of the new republics and to deliver major new oil supply from the Caspian to market without depending on Russian pipelines. The BTC signing took place on the sideline of the Organization for Security and Cooperation in Europe (OSCE) summit in Istanbul in November 1999. A month later, Vladimir Putin replaced Boris Yeltsin as president of Russia.

The fighting in Georgia, which started on August 7, and the coincidental August 4 blast on the Turkish segment of the BTC pipeline (which the separatist group the Kurdish Worker's Party [PKK] claims it attacked) showed that pipelines can be reached and breached without much difficulty. In addition, Russian forces entered the main Georgian container port of Poti, and its Black Sea fleet demonstrated its ability to blockade all Georgian ports. The transit route through Georgia previously thought to be relatively secure and reliable is now seen as vulnerable and threatened by regional hostilities.

Georgian routes have been moving over 1 million barrels of oil per day. More important, expansion of various facilities is projected to increase oil volume to around 2 million barrels per day and to transport new natural gas supply from additional oil and gas developments in Azerbaijan and across the Caspian in Kazakhstan and Turkmenistan. At current world oil demand of 85 million barrels per day, with forecasted demand growth and tight supply, these additional volumes out of the Caspian through Georgia will make an important contribution to the global supply balance.

Geologic potential exists to increase oil production along the Caspian in Azerbaijan, Kazakhstan, and Turkmenistan from currently around 2 million barrels to 3 to 5 million barrels per day—as high as major members of the Organization of the Petroleum Exporting Countries (OPEC), except for Saudi Arabia. Some of this flow will continue to be carried on existing routes via Russia or the south Caucasus, but where will incremental volumes be directed?

Diversity of supply routes has become even more important, but it comes at a premium. Each major pipeline project costs multiple billion dollars, in addition to large field development costing tens of billions. How will investors, lenders, and insurers evaluate numerous options? What role should government policy play in facilitating these mega-investments going forward?

Chinese companies are building long-haul oil and gas pipelines from Central Asia to China with the financial support of their government. Once completed, should Western oil companies be encouraged to use them as export routes that are not controlled or threatened by Russia because this route will benefit the economic autonomy of the region and contribute to overall global supply even though these supplies will not reach Western markets? Should a route from the Caspian south via Iran be reconsidered, assuming current political and security concerns will pass over time?

These are critical questions that oil executives and governments will be reevaluating in light of recent events, and they will be calibrating their future strategies accordingly. Expecting status quo ante to return is probably not prudent for business or government. It may well be wise to remember that the original Silk Road from China to Europe was not one road at all but a series of separate routes whose use depended on shifting regional alliances, rivalries, and hostilities, and Georgia was but one stop on one of those routes.

Here is a list of 10 Caspian oil and gas projects and related facilities, including those in Georgia.

Azerbaijan International Operating Company (AIOC) is the consortium of companies that operates the major offshore fields in Azerbaijan. Partners are British Petroleum, Chevron, Azerbaijani state oil company SOCAR, StatoilHydro, ExxonMobil, Turkish state oil company TPAO, Japanese companies Inpex and Itochu, Devon, and Hess.

Azeri-Chirag-Gunashli (ACG) is the main complex of offshore fields in Azerbaijan operated by AIOC. It is estimated to contain recoverable reserves of more than 5.4 billion barrels, and production is expected to reach 1 million barrels per day after planned expansion.

The **Baku-Supsa pipeline** started operating in 1998 to transport early production from offshore Azerbaijan to a new Georgian Black Sea oil terminal at Supsa for export. After the startup of BTC, this pipeline was shut down for an overhaul that has been completed and was in the midst of restarting until the current combat in Georgia. It has a capacity of 150,000 barrels per day and is owned by the AIOC.

Baku-Tbilisi-Ceyhan (BTC) is a 1,100-mile long pipeline that has a nameplate operating capacity of 1 million barrels per day and carries crude oil from the main fields offshore Azerbaijan through Georgia to a terminal on the Mediterranean in eastern Turkey. Commercial operations started in 2006 and have reached a level of 850,000 barrels per day, or 1 percent of total world oil demand. Operation was temporarily halted after the August 4 blast fire on the Turkish segment. Repair is estimated to take another two weeks or so. Plans were being pursued to increase capacity by 50 percent in order to accommodate additional flows from new field development in Kazakhstan that will initially be shipped by tankers across the Caspian. BTC owners are British Petroleum, the Azerbaijan government, Chevron, StatoilHydro, TPAO, ENI, Total, Itochu, Inpex, ConocoPhillips, and Hess.

Batumi, the old Georgian oil port on the Black Sea, has been back in operation exporting crude oil and products from the Caspian region delivered by rail. Export levels in recent years have averaged around 200,000 barrels per day, and the terminal is supposed to have a capacity of 300,000 barrels per day. Ownership was taken over completely this year by the Kazakhstan state oil company KazMunaiGas.

Kulevi is a newly inaugurated oil terminal, owned by SOCAR, on the Georgian Black Sea coast, which is supposed to have a capacity to handle 200,000 barrels per day of mainly petroleum products and some crude oil, all delivered by rail. It may be particularly vulnerable because of its proximity to the Russian-supported, separatist territory of Abkhazia.

Shah-Deniz is a large field offshore Azerbaijan that is estimated to contain 22 trillion cubic feet of gas and 750 million barrels of condensate. Its owners are British Petroleum, SOCAR, StatoilHydro, LUKOIL, Total, TPAO, and an Iranian company.

The **South Caucasus Gas Pipeline** parallels the BTC oil pipeline and was built to move natural gas from Shah Deniz to markets in Georgia and Turkey. It has an ultimate annual capacity of 16 billion cubic meters, a volume that would allow gas to reach European markets in Greece and beyond. It is currently operating at around half that capacity and was shut down temporarily after damage to BTC and fighting in Georgia. It is owned by the Shah Deniz partners.

Tengiz is a super-giant onshore oilfield in Kazakhstan, operated by Chevron, which is estimated to contain 6 to 9 billion barrels of recoverable oil. Current production is around 540,000 barrels per day, but exports are stymied by Russian obstacles to expanding its main export route through the Caspian Pipeline Consortium (CPC) to the Russian Black Sea coast. Chevron has been using rail transport to ports, including those in Georgia, and actively exploring feeding into BTC in order to reach Tengiz's ultimate production potential of around 1 million barrels per day

Kashagan, offshore Caspian in Kazakhstan, is the largest oil discovery in the world in the past 40 years. It is estimated to contain 13 billion barrels of recoverable oil. The complex and expensive field development has been much delayed, and one of its many challenges is how to move its export level above 1.5 million barrels per day to market. The south Caucasus route, including via Georgia, is one of the routes actively examined.

Edward C. Chow is a senior fellow in the Energy and National Security Program at the Center for Strategic and International Studies in Washington, D.C.