



CASPIAN ENERGY UPDATE

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U.S. CASPIAN PIPELINE POLICY: SUBSTANCE OR SPIN?

Even as the Clinton era draws to an end, the Special Advisor to the President and the Secretary of State for Caspian Basin Energy Diplomacy, John Wolf, continues to make his rounds. On August 24, the Administration's "pipeline czar" began a trip to Turkey and the Caspian region in yet another effort to jumpstart the Eurasian Energy Corridor project. There is little doubt that the Special Advisor will, as always, find silver linings to every cloud on the pipeline horizon. With the end of the Administration imminent, however, a critical review of American efforts to bring Caspian oil and gas resources to Western markets through Turkey is in order.

RHETORICAL EXCESSES

Since January 1995, the U.S. government has given unlimited rhetorical support to the effort to promote "the Turkish route" for Caspian oil and gas, arguing that it was essential for regional security, economic independence, and commercial development, as well as Turco-American relations in the post-Cold War era. In 1998, the Clinton Administration's growing engagement was underlined by the unveiling of its Caspian Basin Initiative, featuring an Ankara-based Caspian Finance Center to coordinate efforts by its export finance agencies in the region, along with the creation of the post of Special Advisor.

The Administration then helped choreograph the October 1998 Ankara Declaration of support for the Baku-Ceyhan pipeline project by the Turkish president and the other regional leaders. This was followed in November 1999 by an even more high-profile ceremony involving the signing of the Istanbul Protocols by Turkey and the interested Caspian states on the sidelines of the OSCE summit in the presence of President Clinton. Despite such "diplomatic victories," however, the establishment of the envisioned Eurasian Energy Corridor by the declared target date of 2004 seems highly unlikely, as the necessary volumes, private-sector financing, and security guarantees for any pipeline transiting the turbulent Transcaucasus remain elusive.

The Caspian post was first held by a businessman and prominent Clinton fund-raiser, Richard Morningstar. Throughout his tenure, Morningstar touted with limited effect what he claimed was the "win-win situation" that would be created for producers, transit states, and energy companies by the creation of the Eurasian Energy Corridor. When Morningstar's efforts were "rewarded" in July 1999 through his appointment as U.S. ambassador to the European Union, he was replaced by Wolf. Morningstar's successor was a career Foreign Service officer and former ambassador to Malaysia and the Asia Pacific Economic Council (APEC), who had reportedly failed to get the coveted post of

ambassador to Indonesia. Wolf's extensive experiences in commercial diplomacy in both Kuala Lumpur and APEC, it was suggested, would herald smoother relations with energy companies active in the region. Instead, if anything, the oil companies became even more critical of what they perceived as undue and unwelcome pressure in the name of a geopolitical agenda.

As "point men" for Caspian pipelines, the Special Advisors undertook innumerable costly trips to Turkey, Georgia, Azerbaijan, Turkmenistan, and Kazakhstan. They have been particularly active in efforts to facilitate a multilateral legal framework between Turkey, Georgia, and Azerbaijan that would provide the foundation for the Baku-Ceyhan pipeline. The Intergovernmental and Host Government Agreements are of little value, however, in the absence of sufficient volumes and financing from the oil companies active in the region. Moreover, the unrealistically and unfailingly optimistic rhetoric of the Special Advisors have apparently convinced Turkish officials that the United States would somehow "deliver" Baku-Ceyhan, thus setting the stage for great disappointment and serious negative consequences for U.S.-Turkish relations in the likely event that the pipeline does not materialize on schedule. In addition, it has also been rightly argued that the Special Advisors has raised exaggerated expectations in the entire Caspian region about the political and military benefits of closer ties to the United States on this issue, as well as the mistaken belief that the United States would downplay concerns on corruption, human rights abuses and other undemocratic behavior.

CASPIAN GAS: RUSSIAN MANEUVERS

The widest credibility gap in the administration's policy has been in the projected gas pipeline leg of the Eurasian Energy Corridor. In February 1999, the Pipeline Solutions Group (PSG) – a joint venture of Bechtel and General Electric, subsequently joined by an upstream partner, Royal Dutch/ Shell — was given a one-year mandate by Turkmen president Saparmurat Niyazov to assemble a package for the construction of the Trans-Caspian Pipeline (TCP). Estimated at around \$2 billion, the 1,250-mile TCP would carry up to 30 billion cubic meters (bcm) per year from Turkmenistan to Azerbaijan, along the Caspian seabed, and then through Georgia to Turkey.

But a bitter dispute between Turkmen officials and their Azeri counterparts, who wanted to export their own gas from Shah Deniz to Turkey, effectively prevented progress on the TCP. The project was also hampered by opposition from Russia and Iran, which have "take or pay" gas agreements with Turkey, as well as existing pipeline connections to re-export Turkmen gas. In February 2000, Niyazov publicly castigated Wolf for delays in resolving the dispute, blaming him for the failure of Turkmen and Azeri negotiators to arrive at an amicable settlement. Unabashed, Wolf continued to argue that the TCP project was still "alive," even after PSG shut down its regional offices in June and then pulled out of the project.

Meanwhile, Russia's new leader, Vladimir Putin, was pushing ahead with an aggressive policy designed to recover Moscow's regional hegemony. Soon after Putin's March 26 election, Russia's National Security Council declared the Caspian region to be one of Russia's key foreign policy interests. On May 31, former energy minister Victor Kalyuzhny was appointed to a newly designated deputy foreign minister post, serving as special coordinator of Russia's Caspian policy. The creation of the post underlined a significant shift from Moscow's ad hoc and disorganized approach seen during the Yeltsin era to more efficient approach to the region. The ominous implications of Russia's new policy were underlined by Andrei Urnov, Russia's ambassador at large and chief of the Foreign

Ministry's Working Group on the Caspian Sea, in a May 2000 appearance on Capitol Hill. Soon after Russia had forcibly "pacified" the Northern Caucasus, Urnov told the Washington audience, "it hasn't been left unnoticed in Russia that certain outside forces are trying to weaken our positions in the Caspian Basin, to drive a wedge between us and other Caspian states."

Russian leaders focused in particular on the need to compensate for their flagging natural gas production by concluding purchase agreements for Caspian gas in order to maintain the domestic and export obligations of Russia's state-owned Gazprom, which contributes over one-third of the Russian government's revenues. As Baku and Ashkabad continued to bicker on the TCP and Wolf assured everyone that the TCP was on track, Gazprom's president, Rem Vyakhirev, visited Kazakhstan in May en route to Turkmenistan. His visit came soon after Kazakhstan canceled agreements with the Belgian firm Tractebel in favor of Gazprom for the export of Kazakh gas. Vyakhirev then joined Putin in Ashkabad where they obtained a commitment by Niyazov to increase Gazprom's 20 bcm purchase of Turkmen gas by an additional 10 bcm a year. This followed the agreement to buy 5 bcm of Uzbek gas struck during Putin's stopover in Tashkent, underlining the return of Russian dominance in the export of Caspian region gas to markets.

BLUE STREAM GATHERS MOMENTUM

The Russian powerplay in the Caspian was greatly assisted by fundamental ambivalence in Turkish energy policy. February 10 witnessed the groundbreaking ceremony for the \$3.2 billion Russian-Italian-Turkish joint venture dubbed "Blue Stream" — a 750-mile-long gas pipeline from Russia to Turkey beneath the Black Sea. Serious concern has been raised over the technical feasibility of Blue Stream and the lack of safeguards in the event of an undersea rupture in a pipeline descending to record-setting depths of over 2,000 feet. Nevertheless, Blue Stream has managed to secure \$1.7 billion, over half of the financing required for the project. Banca Commerciale Italiana, Mediocredito Centrale, and West LB have extended \$1.1 billion in credits, while an additional \$660 million will be provided by the Japan Bank for International Cooperation (JBIC) and Japan's Ministry of International Trade and Industry (MITI).

With construction under way and financing apparently secured, Blue Stream has steamed ahead of its faltering competitor, the U.S.-backed TCP. While American policy priorities may very belatedly be shifting from Turkmen gas to Azeri gas in order to keep the gas portion of the Eurasian Energy Corridor project alive, rapid progress seems doubtful. What the Special Advisors consistently failed to recognize, or, more charitably, to publicly address — not least because of the Clinton Administration's indulgent policy toward Moscow — was the commitment of the Motherland Party-controlled Energy Ministry, which directs Turkish pipeline policy, to Blue Stream. While going along with the Special Advisors on TCP, the Turkish energy officials quietly ensured that priority was always given to Blue Stream. The Turkish officials now have every incentive to slow progress on the Azeri track. They realize that the provision of cheaper Azeri gas is likely to raise further doubts in the minds of Turkish consumers about the advisability of even greater dependence on Russia, which primarily benefits certain Turkish companies close to the Motherland Party as well as their Russian partners. However, one problem they may have to confront is that British Petroleum (BP), which leads the Shah Deniz consortium as well as the Azerbaijan International Operating Company (AIOC), is implicitly linking its possible support for the Baku-Ceyhan pipeline to Turkish willingness to buy Azeri gas.

BAKU-CEYHAN: COMMERCIAL REALITIES

The picture on the other leg of the projected Eurasian Energy Corridor is only slightly less gloomy. Despite recent excitement generated by the announcement of a large oil discovery off the coast of Kazakhstan at Kashagan — prompting one unnamed U.S. official to declare that the Caspian was “back on the map in a big way” — the projected volumes are simply not there for a commercially viable Baku-Ceyhan oil pipeline by 2004. As Terry Koonce of Exxon-Mobil which is involved in Kashagan development noted in May, all estimates were provisional, and cautioned that the landlocked Caspian made efficient development fiscally problematic. Chevron vice chairman Richard Matzke, who spoke at the same conference, concurred, saying that the pipeline projects required an incremental approach grounded in commercial realities, not perceived geopolitical imperatives. With Wolf listening, Matzke continued, “Oil cannot be pulled through a pipeline, but can only be pushed” when adequate volumes of oil exist and commercial realities allow for reasonable export costs.

The reality is that Kashagan is not expected to produce until 2005 at the earliest. It is worth remembering that it took six years for the Chevron-led Tengiz consortium to reach its current production level of approximately 215,000 barrels per day (bpd), up from 60,000 in 1993. An offshore field, Kashagan has yet to be completely explored and, when extraction finally begins, will probably take even longer than Tengiz to reach peak production, making any estimate of Kashagan’s impact on the current pipeline policy debate patently premature. Moreover, when Kashagan does begin producing in significant volumes, export through Novorossisk via the Caspian Pipeline Consortium (CPC) pipeline from Tengiz may make far more commercial sense than early commitment to Baku-Ceyhan. Scheduled for completion next summer, the CPC pipeline has ample excess export capacity even when it accommodates the projected peak production of 750,000 bpd expected from Tengiz by 2010.

In the absence of Kazakh oil within the next few years, the commercial viability of the projected Baku-Ceyhan pipeline will continue to rest on the availability of Azeri oil. The BP-led AIOC is currently producing 115,000 bpd, which is directed to markets through the Baku-Supsa pipeline. The AIOC has yet to proceed to Phase 1 of its development plan, which is designed to gradually boost production to around 800,000 bpd by 2010. Theoretically, such volumes would make Baku-Ceyhan commercially viable in a decade. The major practical problem, however, of how the additional incremental oil will be sent to markets pending the completion of Baku-Ceyhan remains to be solved. Since 1995, the AIOC has not hidden its preference for an expansion of the Baku-Supsa pipeline, through which all AIOC production is currently transported, to markets, to handle a major portion of future additional volumes. Expansion has been fiercely resisted by the Special Advisors and Turkish officials, however, reportedly for fear of damaging prospects for Baku-Ceyhan. The AIOC has, therefore, been looking seriously at the alternative of resuming use of the Baku-Novorossisk pipeline, which now has an expanded capacity, as well as a newly-completed detour away from troubled Chechnya. Given the aggressive Russian policies in the region, it is obvious that any interim arrangement relating to the use of the Russian option cannot easily be reversed later in favor of Baku-Ceyhan.

The AIOC has also been looking at an offer by the Iran National Oil Company to accommodate up to 800,000 bpd in northern Iran’s as part of a swap arrangement. While current U.S. policy effectively prevents U.S. oil companies from taking advantage of this commercially attractive alternative at the

moment, it is clear that the AIOC would not mind keeping all its options open for as long as possible, instead of committing irrevocably to the expensive Baku-Ceyhan pipeline. Given this preference, it is not surprising that the U.S.-sponsored conference of prospective investors in late May in Baku failed to produce the predicted concrete movement on Baku-Ceyhan.

TIME FOR A REVIEW

The reality is that the U.S. policy promoted by the Caspian Special Advisors has succeeded mainly in arranging high-profile ceremonies and agreements that have yet to be implemented. The agreements say, in essence, that if sufficient volumes of oil are available and the companies decide to commit financial resources, the countries involved would be willing to host the Baku-Ceyhan pipeline. Furthermore, the commercial incentives by U.S. export finance agencies touted by the Special Advisors hinge upon the creditworthiness of the projects and officials in these agencies have always cautioned that such funds will only be forthcoming when commercial conditions permit. In other words, despite all the rhetoric, the U.S. was never willing to provide any of the direct financing necessary to permit the implementation of the Baku-Ceyhan project as U.S. officials confirmed during testimonies on Capitol Hill. At the same time, US support for the Eurasian Energy Corridor, independent of Russia, was always constrained by the apparently higher requirements of the Administration's policy of accommodation with Moscow. The Special Advisors, who lacked the clout to challenge this policy, were inevitably forced to repeatedly confirm Washington's desire for Russia to participate in Baku-Ceyhan, thus further undermining their credibility in the Caspian region. Nevertheless, the current Special Advisor remains unfazed and continues to argue not only that Baku-Ceyhan remains on schedule, but also that TCP's travails are only a minor setback.

Examination of the various rationalizations put forward for the unrealistic and overoptimistic policy articulated by both Special Advisors would be futile. What is, in fact, required is a thorough review of all aspects of U.S. Caspian pipeline policy, beginning with an evaluation of the efficacy of having a Special Advisor, which will hopefully lead to the realignment of strategy to conform with commercial, as well as geopolitical realities, for implementation by the next administration.

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