

The Mythology of the Munificent Caspian Bonanza

and Its Concomitant Pipeline Geopolitics

Alec Rasizade

When I first ventured into Caspian petroleum economics and geopolitics in the early 1990s, there was a great deal of ground to speculate on future developments. Of late, Caspian scholarship is getting increasingly difficult and unrewarding because what needs to be said has been over and again repeated in various international workshops and conferences, academic and industry journals, mass media and intelligence reports. Yet, at the expense of being repetitive at times and in the light of recent developments around Afghanistan, there is still some room to articulate the issues that are likely to determine the future geopolitical landscape of the region and have a direct bearing on major powers' strategic interests.

The Foggy Bottom's Old Caspian Tale and the Bush Administration's New Approach

Among the major issues where the Bush administration has to cope with the Clinton legacy are the Caspian area energy policy and the concomitant pipeline projects. The State Department has invested heavily in a grandiose strategy to press the Caspian countries and international consortia operating in the region to export their oil and gas westward through

pipelines that would terminate in Turkey. These costly projects, the Baku-Jeyhan oil pipeline and the Trans-Caspian gas pipeline from Turkmenistan, never made obvious economic sense.

The State Department, nonetheless, has been a staunch advocate of both projects and pressed the leaders of Turkey, Georgia, Azerbaijan, Kazakhstan and Turkmenistan to sign a package of legal framework agreements in Istanbul in 1999 under American auspices. The plan's strategic objective was twofold: to reduce Russia's political influence in the Caucasus by pushing it out of the Caspian Sea, and further isolate Iran in the region.

However, instead of the politically bloated appraisal of 200 billion barrels in ostensible Caspian oil reserves (compared with Saudi Arabia's 250 billion) valued at four trillion dollars, exuberantly cultivated for years by the State Department¹ to attract American investors into the region and justify its own strategy there, we are talking today about only 20 billion to 30 billion barrels of proven reserves, most of which are confirmed under the Kazakhstan section of the sea.

Part of the problem is that what the US government says tends to be taken much more seriously

outside the United States than within. Oil industry analysts reacted with skepticism to claims made by US officials concerning the Caspian Sea potential. Unfortunately, local leaders in the region take such claims at face value, concluding that the US government knows something that they do not. Similarly, when Washington tells them that the Baku-Jeyhan project is commercially viable, the local governments conclude, wrongly, that the State Department knows more about oil export pipelines than the oil companies operating in their region.

But the proposals promoting any oil or gas export pipeline that would avoid crossing Russia and Iran are based more on politics than economics, and effectively act as a source of tension between the Caspian governments and the western oil companies that are reluctant to build the new expensive pipelines mapped at the Foggy Bottom.² The problem has long been that few in the oil industry believed that the Baku-Jeyhan pipeline was commercially viable. They have repeatedly pointed out that if these pipelines were commercially feasible, then they would already have been built. The Trans-Caspian gas pipeline from Turkmenistan, for instance, has already been abandoned.

Recent studies by two independent research groups in Washington — the Cato Institute and the Carnegie Endowment for International Peace — have also criticized the economic justification for the Baku-Jeyhan project, urging consideration of Russian and Iranian alternatives.³ They calculated that the Baku-Jeyhan pipeline would need \$200 million per year in subsidies from the US government to remain viable.

Rather than engage with the oil companies and take account of the independent studies that have criticized the project, the State Department has instead tried to pressure them into paying for a pipeline they do not want. There is an irony here. On the one hand, Washington preaches the virtues of the free market and privatization to former Communist coun-

tries, yet the Clinton government was trying to force privately owned western companies to build a pipeline that would suit its geopolitical convenience more than the interests of those companies' shareholders.

That said, the new Republican administration is likely to take a different view of the Caspian projects, especially in the wake of the war in Afghanistan. Both Bush and Cheney have direct links to American oil corporations, and would therefore be expected to promote their interests. Richard Cheney has been an outspoken advocate of ending economic sanctions against Iran. He began challenging the logic of the Iranian embargo several years ago as chief executive of Halliburton, a giant oil-services company.

Now that he is a vice president, Cheney is giving cover to our oilmen overseas who were convinced several years ago that transporting the oil via Iran would be more reasonable than building a proposed Azerbaijan-Georgia-Turkey pipeline at a cost of some \$4 billion. His comments reflected a broad skepticism within the oil industry about the wisdom of that policy. Many analysts say now that projections of the Caspian oil potential rest on a number of questionable assumptions while the actual amount is much less. After the digging of many dry holes by several oil companies in the Caspian, the area that had been pushed by the State Department as an alternative to the Persian Gulf has been dismissed as a product of Washington's geopolitical propaganda.

Caspian Oil and Global Energy Needs

Western preoccupation with the Caspian reflects a growing interest in its energy resources, a recognition of its geopolitical significance, a desire to balance Russian influence, to stem the growth of drug trafficking, and also to create a bulwark against Islamic fundamentalism. On the side of the local elites, in addition to the economic benefits expected to be accrued from natural resource exploitation, their leaders per-

ceived the engagement of the West as a way to balance the otherwise overpowering Russian influence in the region.

At the outset, the Caspian oil rush was akin to a high-stakes game of cards. There was a lot of bluffing. It was complicated further by the fact that the cards were being played within another strategic game of chess, with other rules, played at a large geopolitical chessboard. With a relative consolidation of the chessboard into patterns, at least temporarily, the Caspian oil game is now more or less settled. Though the bluffing survives from the old days of card game, strategy as opposed to tactics has become the conditioning environment in the region, as in a chess game.⁴

The Caspian developments have a significant bearing on the world's current and future energy security. The industrial world is now looking for oil beyond the Middle East, and to an emerging slate of sources: West Africa, the Caspian Basin, and Southeast Asia. But it is also understood that the petroleum demand will likely increase sharply and that oil import dependence will rise too. The resources found in these areas will be critical components to ensuring the global energy stability.

Indeed, with a continued growth of the world economy by three percent per annum, world energy demand will increase at the rate of two percent annually, meaning that the world will need 65 percent more energy in 2020 than in 1995. Ninety-five percent of this additional energy demand will be met by fossil fuels — coal, oil and gas. In absolute terms, some 92 percent of the total primary energy demand in 2020 will be based on fossil fuel.⁵

What sort of volumes under the Caspian are we talking about? Certainly not another Persian Gulf, but perhaps a new North Sea. There has been substantial downgrading recently of Caspian reserves because of unsatisfactory drilling results in the Azerbaijan sector,

which has been depleted over the past 100 years of industrial oil production. Conservative estimates of proven total Caspian oil reserves yield figures between 15 to 40 billion barrels.⁶ That is nearly twice the size of North Sea reserves and three times the size of Alaska's Prudhoe Bay.

This represents between two and five percent of world reserves. Because much of the northern part of the Caspian remains to be explored, it is more likely that estimates of the reserve base will increase rather than decrease. However, the most optimistic reserve estimates for Caspian oil still pale in comparison with those for the Middle East, which holds over 650 billion barrels or some 65 percent of the world's proven reserves.

Today, the oil production in Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan combined is less than one million barrels per day (mbd), of which about two-thirds is used domestically and less than ten percent is moved through Russia to export markets. If investments in the Caspian region continue at the current pace, and if sufficient export outlets are developed, the annual oil production could reach three mbd by 2010, of which about two mbd would be available for export. (Domestic consumption is also expected to grow). Russia currently exports about two mbd.

These figures mean that at best the Caspian Basin will account for about four to five percent of world oil supply in 2010. For comparison, in recent years the Middle East OPEC countries have supplied over 40 percent, and would supply over 52 percent of world consumption by 2010. In a low case scenario, Caspian oil production by 2010 would reach 2.5 mbd, comparable to Venezuela, of which about 1.3 mbd would be available for export.

One of the differences that set the land-locked Caspian apart from the North Sea and other important marginal suppliers is the difficulty of getting the oil and gas production to world markets. The energy transpor-

tation systems of the Caspian region were originally designed and built to serve the strategic needs of the Soviet Union. All oil and gas export pipelines inherited from the Soviet period pass through Russia. Russia's pipeline operators, citing capacity constraints and various tariff problems, have effectively capped exports from the region.

The lack of adequate export infrastructure is probably the most difficult problem facing investors in the region. Construction of new export pipelines has become a priority. However, most routing options are fraught with technical, financial, legal and political difficulties. The proposed pipelines must pass through — or take expensive detours to avoid — politically troubled areas. There is reason to expect that some pipelines could become targets for ethnic terrorism. Multiple routes would increase energy security by making exports less subject to technical or political disruptions on a single route.

Baku-Tbilisi-Jeyhan Project

Although this plan is several years old and all agreements have been concluded, it remains moot. Major oil companies think the projected pipeline would not be financially feasible. Nevertheless, under pressure from Washington, a Baku-Jeyhan sponsor group of eight companies has been formed, agreements between the sponsor group and Azerbaijan, Turkey and Georgia signed in October 2000, and engineering studies just completed. 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-Jeyhan pipeline.

Despite the American support, the project still faces difficulties. A close look at developments behind the upbeat headlines reveals disturbing signs. Investment is the main outstanding issue. The sponsor group is committed to funding only the basic engineer-

ing studies on the pipeline (\$26 million). There is no commitment to fund the main construction phase, which may run up to \$4 billion. If the results of engineering study are found positive, the group is to carry out a more detailed, \$150-million examination of the line for the next 12 months, and then a 32-month period of land acquisition and construction.

Alternative routes were not eliminated even after the signing of protocols between the sponsor group and Azerbaijan, Georgia, and Turkey. The sponsors insisted on a provision that the group will continue evaluating alternatives to the Baku-Jeyhan project. Some partners are not comfortable with the \$2.4 billion project cost estimate obtained from the 1998 feasibility study. Cost concerns were again mentioned in the letter, which the BP-Amoco's chief J. Browne sent to president H. Aliev of Azerbaijan. He noted that the engineering studies would define the "project's technical and economic viability" and the sponsor group wants to see the \$2.4 billion cost estimate confirmed.⁷

The cost estimates of the Baku-Jeyhan pipeline vary between \$2.4 billion and \$4 billion. That compares to about \$2.5 billion for a new pipeline to Novorossiysk, \$1.8 billion to Supsa (Georgia), and \$1 billion to the Persian Gulf through Iran.⁸ Financing a large new pipeline would mean lower initial revenues for the Azeri government too, as the Azerbaijan International Oil Consortium (AIOC) has to recoup the construction costs.

In order to accelerate a decision on the pipeline to Jeyhan, the onus seems to be on Turkey to provide incentives to lower the effective price of its preferred route, including tax breaks and attractive transit fees. But such hopes were dashed by Turkey's recent financial and economic collapse. So far, the American-Turkish project has succeeded mainly in arranging high-profile ceremonies and agreements that have yet to be implemented.

Rather than building the expensive Baku-Jeyhan

pipeline, oil companies in Azerbaijan now appear to favor a cheaper alternative that would use existing facilities. They would send an extra 100,000 barrels per day from Baku to Supsa, an extra 100,000 barrels a day north, through Russia to Novorossiysk, and at least 50,000 barrels south to Iran, to be swapped for export shipments from its Persian Gulf terminals. This combination could handle all the extra oil Azerbaijan hopes to export over the next five years, and if additional pipelines are needed later, there will be time and money then.

This diversification has been fiercely resisted by the US and Turkey for fear of damaging prospects for the Baku-Jeyhan project. The US EximBank and Overseas Private Investment Corporation (OPIC) declared their readiness to support the project. Representatives of these agencies and the sponsor group met in Washington in December 2000 to discuss the financing of the project.

The meeting was also a setback for the project because the debate caused a split in the ranks of the AIOC and exacerbated the perceived reserves and throughput volume uncertainty. The lingering doubts regarding the project cost again came to the surface. Lower costs and higher profit margins associated with the competing alternatives, such as the existing pipelines from Baku to Black Sea marine terminals at Supsa and Novorossiysk, and a shorter route to Persian Gulf terminals across Iran, were the factors that the negotiators found hard to ignore.

It should be recalled, in this context, that of the eight oil companies composing the sponsor group, only Azerbaijan's SOCAR (State Oil Company of Azerbaijan Republic) and Turkish Petroleum Corporation (TPAO) unequivocally backed the Baku-Jeyhan project while support of the other members had been halfhearted at best. Furthermore, after the Washington meeting, three members of the AIOC opted out of the sponsor group: Lukoil of Russia, Exxon-Mobil and

Pennzoil of the USA. With their combined 23 percent share in the consortium, that has adversely affected investment confidence, especially for international credit agencies that were already skittish about Caspian oil reserves and the throughput sufficiency of the project.

The Baku-Jeyhan pipeline needs a daily throughput of one million barrels to be economically justifiable. Azerbaijan will be able to produce only about 750,000 barrels a day when all its consortia reach their peak. (For comparison, Kuwait is producing 2.14 million barrels a day, its quota from the OPEC, and has enough oil to pump about two million barrels daily for 132 years).

Commercial incentives by US export finance agencies hinge upon the creditworthiness of the project 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 and support for the "Eurasian energy corridor" (Silk Road Strategy Act), independent of Russia, the US government has never been willing to provide any of the direct financing necessary to permit the implementation of the Baku-Jeyhan project. It remains to be seen what attitude the Bush administration would adopt concerning the Baku-Jeyhan line and other energy projects in the Caspian region.⁹

Tenghiz-Novorossiysk Pipeline and the Kashagan Prospects

Meanwhile, Russia has completed its North-Caspian pipeline linking Kazakhstan's Tenghiz oil field to Novorossiysk. Tenghiz is the world's sixth largest land oil field with a conservatively estimated nine billion barrels of recoverable reserves. The entire length of the 1,580-kilometer line was opened this year, forming the largest new export route from the Caspian since the demise of the USSR. (The length of Baku-Tbilisi-Jeyhan line is projected at 1,730 kilometers).

The recent announcement of a large oil discovery off the coast of Kazakhstan at Kashagan has generated some excitement. Since Azerbaijan's reserves are insufficient, supporters of the Baku-Jeyhan project are hoping the new Kashagan oil could provide the needed volumes of oil for the pipeline that Azerbaijan lacks. President Nazarbaev of Kazakhstan has stated recently that he would like to see the Baku-Jeyhan line extended eastward to Aktau, his Caspian seaport.

At present, however, it is premature to count on the Kazakh oil making up the gap. All appraisals are provisional, making any assessment of Kashagan's impact on the current pipeline policy debate premature. An accurate estimate of reserves in Kazakhstan's offshore sector will not be available until the end of 2002. Even then, an additional pipeline would have to be built from Aktau to Baku, costing yet more money on top of the \$4 billion estimated for Baku-Jeyhan. Only then will it be possible to judge the extent to which Kashagan could contribute. Pipeline projects require an incremental approach grounded in commercial realities, not perceived geopolitical imperatives. Oil can only be pumped when adequate volumes exist, allowing for reasonable export costs.

When Kashagan does begin producing oil in earnest, its export via Novorossiysk through the northern pipeline from Tenghiz may make far more commercial sense than Nazarbaev's early commitment to Baku-Jeyhan project. The Russian Caspian Pipeline Consortium (CPC) has ample excess export capacity even when it accommodates the projected peak production of 750,000 bpd anticipated from Tenghiz by 2010.

Chevron, the principal producer of Tenghiz oil, announced recently that it wants to join other sponsors for the Baku-Jeyhan project. American, Turkish and Azeri officials were quick to publicize the news, declaring it a vote of confidence in the plan. But there are currently no plans for any of Chevron's Tenghiz oil to flow through the Baku-Jeyhan line. It is already

scheduled to be pumped through the Novorossiysk line. Instead, Chevron is interested in the Baku-Jeyhan as a potential outlet for the Apsheron oil field, which it is exploring off the coast of Azerbaijan. Chevron's level of participation is limited only to its intention to join the engineering studies for the project. Participation in the construction itself would depend on whether oil is found at Chevron's Apsheron concession.

In the absence of Kazakh oil within the next few years, the commercial viability of the projected Baku-Jeyhan pipeline will continue to rest on the availability of additional Azeri oil. The AIOC is currently producing 115,000 bpd, which is directed to markets through the Baku-Supsa pipeline. The consortium has yet to proceed on its development plan, which is designed to gradually boost production to 600,000 bpd by 2010. Even theoretically, such volumes would not make the Baku-Jeyhan project commercially viable.

A Role for Iran

Iran is considered by some to be the most attractive export route for both Caspian oil and gas. It already has a well-developed oil and gas transportation infrastructure, including portions of pipelines that could be used on various routes. Most companies argue that an export pipeline to the Persian Gulf could be significantly cheaper than the proposed east-west corridor. They would prefer to transport Caspian oil and gas to world markets via Iran, where it would cost no more than \$1 billion to complete the existing pipelines and related infrastructure. The National Petroleum Corporation of China, Total of France, and even several American majors have all separately studied the feasibility of building a main pipeline from the Caspian to the Persian Gulf.

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 as part of a swap ar-

rangement. While current US policy effectively prevents American 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 Baku-Jeyhan project.

In the meantime, the sanctions imposed by the USA and Iran's unreliability in times of crises raise important barriers to pipeline projects through this country. American sanctions have been imposed on Iran as a result of accusations that the Iranian government is supporting international terrorism and developing weapons of mass destruction. Such sanctions could make it difficult for any pipeline project involving Iran to obtain international financing.

Nevertheless, a number of companies are already involved in limited oil swaps with Iran. These involve delivery to Iranian Caspian ports in exchange for Iranian oil at its Persian Gulf export terminals. For example, Kazakhstan sends crude oil to the Iranian port of Neka on the Caspian Sea in exchange for Iranian exports of equal value from Kharg Island in the Persian Gulf. Iran has organized a tender for a new pipeline to further facilitate swaps by enhancing links with Iranian refineries in Tehran and Tabriz. Iran claims it could absorb up to 1.6 mbd of Caspian crude oil for existing and planned refineries in the north of the country.¹⁰ However, its plans in this area are not necessarily related to swaps, but seem to focus on straight purchases of oil for use in northern Iran.

Caspian oil producers may be reluctant to base their export plans on the market of a country that is also a supply competitor. There are similar concerns related to oil transported via Iran to the Gulf. Caspian oil would not represent as much of a diversification of global supplies if, by transiting Iran to the Persian Gulf, it becomes subject to the same constraints as much Middle Eastern oil if flows were disrupted through the Strait of Hormuz. This would obviously

undermine the value of Caspian oil as an alternative to oil from the Gulf.

Turkey's Thirst for Natural Gas and the Race among Suppliers

In contrast to the oil pipeline projects, Turkey does not need to worry about being bypassed by gas pipelines. Turkey's economic growth already is being constrained by a shortage of gas supply, and the potential suppliers are just as eager to supply their gas to Turkey as Turkey is to receive it. Turkey urgently needs ten billion cubic meters (bcm) of additional gas annually. Its gas consumption is expected to reach 55 bcm by 2010 and 80 bcm by 2020.¹¹ Agreements signed so far guarantee only 45 bcm of natural gas a year.

Consequently, the two giant gas projects, "Blue Stream" from Russia and the Trans-Caspian gas pipeline from Turkmenistan, plus the new line from Azerbaijan, are racing to get to the Turkish market first. Competition between these projects has become part of the strategic "great game" over the future of the region.

The importance of gas supply for Turkey has caused it to pursue a policy toward gas pipelines that is driven more by economics than by geopolitics (in contrast to its approach toward oil pipelines). Turkey has signed new agreements with varying degrees of firmness to purchase gas from Russia (currently its primary supplier), Turkmenistan, Azerbaijan, Iran and even Iraq, all of which would be delivered primarily through a new pipeline infrastructure.

The gas business differs from the oil business. For sources of natural gas supply and areas of demand need to be connected directly by pipelines, because shipping gas by tanker is a technically complex and expensive process. Pipelines for gas are typically more difficult to finance than oil pipelines, as they require credible guarantees of payment.

Azerbaijan's aggressive play for the Turkish gas

market in the wake of its 1999 discovery of a major gas field under the Caspian has caused a variety of problems, which have called into question the American plan to build a pipeline across the Caspian Sea to supply Turkmen gas to Turkey. Russia's competing "Blue Stream" project, which would pump gas to Turkey across the Black Sea, also appears to be nearing the moment of truth when construction begins in earnest.

Meanwhile the completion of the infrastructure required to bring gas into Turkey from Iran appears within reach. Under a contract between the two countries, Iran is to export three bcm of natural gas to Turkey annually beginning from July 2001 if the Turkish part of the pipeline is completed as planned. The volume of Iranian natural gas exports to Turkey is to reach ten bcm in 2007. Iran is currently busy laying a 550-km gas pipeline from Qazvin in central Iran to Bazargan on the border with Turkey.

Turkmenistan is keen to create new export routes for its natural gas wealth. Under the 1999 agreement with Ankara, Turkey will buy 16 bcm of Turkmen gas per year for a period of 30 years, beginning in 2003. Turkmenistan hopes eventually to transport 30 bcm of gas per year, with 16 bcm to Turkish market and 14 bcm going through Turkey to Europe.¹² The Trans-Caspian pipeline linking Turkmenistan with Turkey, if constructed, would follow an underwater route across the Caspian Sea and then pass overland through Azerbaijan and Georgia. Turkey's state pipeline concern Botash has already begun work on some sections of the pipeline and expects to finish laying it between the Anatolian city of Erzurum and the Georgian border by the end of 2001. The Turkish section of the line will also carry the Iranian gas.

In February 1999, the Pipeline Solutions Group, a joint venture of American companies Bechtel and General Electric, subsequently joined by Royal Dutch Shell, was given a one-year mandate by Turkmeni-

stan president S. Niazov to assemble a package for the construction of the Trans-Caspian pipeline. But a bitter dispute between Turkmenistan and Azerbaijan, who wanted to export its own gas to Turkey, effectively prevented progress on the project. The project was also hampered by opposition from Russia and Iran, who have gas supply agreements with Turkey, as well as existing pipeline connections to re-export the Turkmen gas. In February 2000, Niazov publicly castigated the US special envoy for delays in resolving the dispute, blaming him for the failure of Turkmen and Azeri negotiators to arrive at an amicable settlement.¹³

After the discovery of the offshore Shah Deniz gas field, Azerbaijan wants to explore and develop the deposits that may contain over one trillion cubic meters of natural gas. At present, SOCAR produces only about five bcm of gas a year, all of which is consumed domestically, and hopes to push its gas output up to eight bcm by 2002, and to 15 bcm by 2010. However, much work will have to be done to achieve those targets, including the construction of a gas export pipeline to Turkey, which alone requires investment totaling \$2.6 billion.¹⁴ Azerbaijan itself presently imports Russian gas and would not need to draw up a major export scheme unless it could push its gas production above the domestic consumption level of 16 bcm per year. The agreement signed by president Aliev in Ankara in March 2001 to supply Azeri gas to Turkey beginning with two bcm in 2004 and increasing it to five bcm by 2006 was a disappointment because the amount of gas involved was below expectations.

The Blue Stream Project versus the Trans-Caspian Gas Pipeline

Turkey has been purchasing Russian natural gas via an overland pipeline through Ukraine, Romania and Bulgaria since 1987. The official origin of Blue Stream goes back to 1997 when Turkish prime minister M. Yilmaz signed a gas purchase agreement with

Russia. Under the agreement, Russia's Gazprom would supply up to 16 bcm of gas a year over a period of 25 years. Gas would be delivered through a pipeline consisting of two land sections, one in each country, and a third, 376 km-long undersea line in between. The last-named would run between Jugba on the Russian side and Samsun on the Turkish side. Gazprom would be responsible for the construction of the pipeline up to Samsun. The land section in Turkey, between Samsun and Ankara, would be the responsibility of Turkey's gas monopoly Botash.

Subsequently, Gazprom formed a 50:50 percent partnership with Italy's giant energy concern ENI, to assist with financing and laying of the subsea section of the line. The project is environmentally challenging, as a rupture in the pipeline would release a highly dangerous hydrogen-sulfite gas to the detriment of coastal life. The Blue Stream pipeline, reaching depths of up to 2150 meters in the Black Sea, will set a record in underwater pipelines in terms of depth. The deepest pipeline to date, at a depth of 1600 meters, has been laid in the Mense field in the Gulf of Mexico. The Mense pipeline is 100 km long as opposed to Blue Stream's nearly 380 km.¹⁵

All of this translates into the risk of serious and even catastrophic damage to the undersea section of the Blue Stream line during its operation. A major accident would not only involve an expensive and protracted repair, it would necessitate cutoff of gas supply for a long period of time. An irony here is that Moscow has opposed the Trans-Caspian gas pipeline on the grounds that it would upset ecological balance of the Caspian Sea, but revealed no such concern for the Black Sea.

It is unclear why Russia and Turkey, instead of choosing an expensive and risky undertaking such as the Blue Stream, did not opt for the Izobilnoe-Batumi-Erzurum alternative to ship gas from Russia to Turkey overland. Izobilnoe is a Russian town near the Black

Sea where the Blue Stream pipeline will start. Even taking into account the transit fees payable to Georgia, this land option would have been cheaper and certainly free of the environmental risks noted above. Perhaps, the planners have considered the ethnic conflict between Abkhazia and Georgia as a greater jeopardy.

Another problem associated with Blue Stream is its threat to the Trans-Caspian project. Washington keenly supports the Turkmenistan-Turkey pipeline because it bypasses Russia and Iran. President Niazov, frustrated by the lack of progress in this US-backed project, agreed in February 2000 to supply vast volumes of Turkmen gas to Russia over 30 years. But he has already pledged in 1999 to supply the Turkish line with an eventual 30 bcm a year. Turkmenistan would be unable to meet that demand while at the same time pumping 30 bcm to Russia annually. (Turkmenistan's natural gas production in 2000 was only 24 bcm).¹⁶

Russian leaders focus on the need to compensate for their flagging natural gas production by concluding purchase agreements for Turkmen gas in order to maintain the domestic and export obligations of Gazprom, which contributes over one-third of the Russian government's revenues. President Putin visited Ashgabat where he obtained a commitment by Niazov to increase Gazprom's current 20 bcm purchase of Turkmen gas by an additional ten bcm a year. Moscow controls Turkmenistan's northern gas pipeline through Russia, which was its link to European markets in Soviet days. Russia could frustrate the American Trans-Caspian project by accelerating the Blue Stream while simultaneously opening the northern outlet for Turkmen gas.

With construction under way and financing apparently secured, the Blue Stream has steamed ahead of its faltering competitor, the Trans-Caspian project. While American policy priorities may belatedly be

shifting from Turkmen gas to Azeri gas in order to keep the gas portion of the "Eurasian energy corridor" alive, rapid progress seems doubtful.

On the other hand, the Blue Stream gas is likely to raise further doubts in the minds of Turkish consumers about the advisability of greater dependence on Russia. Taking into account the annual 14 bcm Russian gas supply across the Balkans and the 16 bcm planned through the Blue Stream, over the next decade Russian gas will comprise 70-75 percent of Turkey's domestic consumption (dropping to 60 percent in 2010). In terms of energy security, this heavy dependence on Russian gas is excessive.

The argument in favor of the Blue Stream project is that Turkey and Russia are two giant neighbors that would gain from cooperation instead of regional rivalry. The Russian leadership believes that Turkey aided the Chechens during the 1994-1996 war while Turkey has its own suspicions that Russia supported the Kurdish PKK movement. Prior to his arrest in February 1999, the PKK leader A. Ocalan sought shelter in Russia to the dismay of Turkish officials. The Blue Stream advocates have argued that certain Russian circles could revitalize the PKK unless there was strong commercial cooperation, with the Blue Stream project at the heart of the strategic partnership.

Caspian Geopolitics

A number of signs point toward the possibility that the regional political context in Central Asia and the Caucasus may undergo considerable changes. It is undeniable that Moscow's show of force in Chechnya and the images of vitality and effectiveness presented by president Putin have affected the way that Russia is perceived by Transcaucasian leaders. They continue to see Russia as a threat to their independence, but as a threat that must be dealt with subtly. Their partnership with Turkey and the USA is not immediately threatened, but both Azerbaijan and Georgia are

recognizing that more flexibility and balance will be required in their relations with the new capitalist Russia.

If Putin's government could offer not only threats but also some tangible benefits to these republics, then they would have a fair chance in seeking to rebuild Russia's influence and stature in the Caucasus. Azerbaijan has already taken a few steps away from the unrestrained anti-Russian and pro-American stance it had previously displayed, and the same may happen to a limited extent in Georgia as well. Similarly, the presidential succession which lies in Azerbaijan's future is not likely to go smoothly, and the potential succession crisis could conceivably draw in the neighboring powers, Russia, Turkey and Iran.

Meanwhile, Putin is pushing ahead with an aggressive policy designed to recover Moscow's regional hegemony. Soon after his election, Russia's National Security Council declared the Caspian region to be one of Russia's key foreign policy interests. Former energy minister V. Kaluzhny was appointed to a newly designated deputy foreign minister post, serving as a special coordinator of Russia's Caspian policy. The creation of the post underlined a significant shift from Moscow's *ad hoc* and disorganized approach during the Yeltsin era to a more efficient policy in the region.

Tehran's interests in the Caucasus revolve around Caspian oil and the concern that Azerbaijan might subvert its internal ethnic Azeri population (who began to call the part of Iran they live in "Southern Azerbaijan"). Tehran suggests that it can also act as a mediator in settling ethno-political conflicts in the Caucasus. Iran has mediated a cease-fire in the Nagorno-Karabakh conflict in May 1992, before the Organization for Security and Cooperation in Europe organized the Minsk Group to find a solution to the issue without Iranian involvement.

The possibility of a Southern Azerbaijan question

becoming an international problem should be taken very seriously. Iran's northwestern province bordering on Azerbaijan is populated mostly by Azeri Turks identical to those across the frontier. There have been semi-nationalist movements in the province during past decades and some of the Iranian Azeris seek unification with Azerbaijan. Presently, Tehran and Baku have normal relations and are in a continuous dialogue. The Azerbaijani government discourages pan-Azeri nationalism. Still, a heightening of this issue could cause considerable friction some day.

Preoccupied as it is with fighting the Kurdish separatist insurgency since 1984, Ankara is far from adventurist in its foreign policy. During his October 2000 visit to Central Asia, the new Turkish president A. Sezer gave signals of a change in Turkey's approach to its Central Asian cousins. The traditional policy adopted by Turkey towards these republics during the term of his predecessor S. Demirel was based on a rhetoric of brotherhood and personal relationships. Despite Turkey's wish to strengthen its ties with these countries, there have been few concrete results in practice.

Turkey's interest in the Caspian pipeline issue began as just one of the many strands of the late president T. Ozal's broad policy of engagement with the newly emerged Turkic states. The concept of making Turkey the main export corridor for oil from Azerbaijan and perhaps Central Asia as well was first discussed at a political level by presidents Ozal of Turkey and Elchibey of Azerbaijan in 1992. As Turkey's grander ambitions in the region began to fade and the Caspian oil rush picked up steam, the Baku-Jeyhan pipeline project increasingly became the core of Turkish policy towards the Caspian region and indeed an important priority of Turkish foreign policy overall.

But nowadays Russia has emerged as Turkey's largest trade partner, largely because of Turkish energy imports. Secondly, Turkey plans to spend some

\$150 billion on weapons during the next 25 years and Russia is keen to win some of these lucrative contracts.¹⁷ Quite apart from Russo-Turkish competition, Turkish security interests are therefore closely interwoven with developments across the Black Sea. The risk of friction with Moscow over regional policy has also encouraged a relatively conservative Turkish approach to ethnic turbulence in the Caucasus and Central Asia, where there continue to be opportunities for a more active Turkish involvement.

Over time, a wide range of forces and crosscutting relationships will work to counteract today's polarization and weaken the current regional blocs. Falling into this category is a long list of potential changes, none of which is guaranteed but all of which will become increasingly possible over time: a more constructive and less threatening Russian policy in the Caucasus; US-Iranian reconciliation; a warming of relations between Turkey and Russia driven by further growth in economic ties; a growth in the possibility of Turkish-Armenian rapprochement; a higher level of American engagement in the region after Afghanistan and greater involvement by the European Union coupled with its growing pull on Turkey.

More Graft — Less Investment

Despite the Caspian oil rush, Western firms recurrently cite corruption as the singular factor discouraging investment in the region. Transparency International's 1999 index, which ranks countries by the number of reported experiences with corrupt officials, gave Kazakhstan 84 points out of a possible 100. Armenia and Russia had 80 and 82 points respectively, while Georgia, Turkmenistan and Uzbekistan each scored 87, and Azerbaijan was awarded the highest ranking among the former Soviet republics with 96 points.

For the last three years, overall corruption level indices rendered by both Transparency International

organization based in Berlin and Control Risks Group based in London have consistently ranked Azerbaijan as the third most corrupt country in the world after Cameroon and Nigeria.¹⁸

Another recent study conducted by the European Bank for Reconstruction and Development (EBRD) confirms these findings. According to EBRD, 25 percent of foreign firms doing business in Kazakhstan reported solicitations for bribes and kickbacks. In Azerbaijan, 60 percent of companies surveyed reported frequent extortion and blackmailing, and complained of incessant delays and illicit charges requested to move business matters along. The EBRD study concluded that corruption imposes an unofficial "tax" of sorts on business ventures operating in the Caspian territories, averaging between eight and ten percent of companies' annual revenue.¹⁹

This dubious reputation prompted Western banks to think twice about funding projects in Azerbaijan, Kazakhstan and Turkmenistan. And now, a string of exploration failures has prompted the banks to adjust their expectations of the Caspian's potential. For all this, the region still has its fair share of development projects that need to be financed. For instance, the 14 biggest projects in Azerbaijan alone will require total investment of \$45 billion and that figure does not include the construction of new export pipelines.²⁰

The Caspian governments have to recognize that most petroleum companies have a choice to invest their money elsewhere. Production costs in the region may be below those of the North Sea and Russia, but they are certainly higher than those in the Middle East. Western Africa will also be a major competitor for investment. Furthermore, it is not enough to produce the oil. It must also be moved to world markets.

Governments in the Caspian region that hope to attract production and transit investments must keep in mind that they are competing with other regions for investment funds. Political considerations that become

too onerous could easily price Caspian oil out of the market. The Caucasus and Central Asia were a hotbed of corruption and nepotism during the Soviet era, a trend that has continued even as the region became the energy industry's most promising frontier.

Feud Over the Legal Status of the Caspian Sea

The decade of diplomatic efforts to define a legal status for the sea and draw aquatic boundaries between the five littoral states fixed in an international treaty to be signed at a Caspian summit has ended last year with incidents that incited anger instead of steps toward a compromise. Attempts by Azerbaijan, Iran and Turkmenistan to establish their Caspian dividing lines have ended in open conflicts. As tensions rose, chances continued to dim for a five-nation summit to decide on a division of Caspian resources.

The latest blow to negotiations on dividing the sea came from Baku, which accused Turkmenistan of "arrogance" in demanding a halt to Azerbaijan's offshore oil projects. Baku was responding to a note from the Turkmen foreign ministry, which charged Azerbaijan with acting against the norms of international maritime law by developing oil fields that are claimed by Turkmenistan.

Turkmenistan announced last March that it was close to signing \$10 billion in deals, including a contract to develop the offshore oil field known as Serdar. Azerbaijan, which calls the field Kyapaz, has claimed the area as its own. By announcing its plans for the oil field, Turkmenistan gave new life to its dispute with Baku. (But oil companies are believed to be waiting for the legal problems to be solved).

In April, presidents Aliiev and Niazov, at the annual Turkic summit in Istanbul, declared that the time had come to end their long feud over the Caspian dividing line, offering the first glimmer of hope for a settlement in several years. Teams of experts from both sides were hastily convened in Ashgabat to settle the affair.

But the expert talks ended in a diplomatic disaster. Instead of leading to compromise, the talks broke down as Turkmenistan renewed its claims not only to Kyapaz/Serdar, but also to fields that have been part of Aliev's "Deal of the Century" project since 1994. Ashgabat also charged Azerbaijan with unilaterally blocking the general treaty among the five littoral states.

Azerbaijan rejected the Turkmen demand to stop its production. The exchange leaves the Caspian argument right back where it started, but with renewed expressions of ill will. Azerbaijan has previously shown its ability to make concessions when its greater interests are at stake. H. Aliev gave up a portion of its transit fees from the projected Baku-Jeyhan pipeline to Georgia in order to strike a deal with president Shevardnadze after progress was stalled for several months in 2000.

An earlier rift between Azerbaijan and Turkmenistan over shares in the Trans-Caspian gas pipeline to Turkey has effectively scuttled the project. Neither side has been willing to give ground, while Aliev has proceeded with plans for gas sales to Turkey on his own. On his side, Aliev may have thought Niazov was ready to bargain because his plan to host a Caspian summit in Ashgabat has essentially collapsed.

The same sort of charges was brought last summer against Azerbaijan in the Iranian foreign ministry's protest citing the brazen disregard by Baku for the Soviet-Iranian agreements on division of the Caspian Sea signed in 1921 and 1940. Iranian warships opened fire and drove back a joint Azeri-British Petroleum geological survey vessel in what they claimed were the territorial waters of Iran. In response, the Turkish air force conducted a military show over Baku and the vicinity.

In the meantime, Nazarbaev invited Aliev to sign a bilateral Caspian border agreement, arguing at the Istanbul Turkic summit that "It will take additional effort

and time to reach a consensus on the legal status of the Caspian on a five-party format."²¹ Nonetheless, presidents Khatemi and Putin signed in March 2001 a joint declaration in Moscow, stating that Iran and Russia would not recognize bilateral boundary pacts on the Caspian Sea until all five littoral nations agree: "The legal status of the Caspian must be determined by all the five. Bilateral accords cannot bind other states as far as determining the legal status of the sea is concerned."²² Their joint position may raise tensions further in the Caspian dispute.

Regional Impact, Trepidation and Lessons from the Afghanistan Crisis

Recent events in Afghanistan, viewed through the prism of US energy supply interests in the Caspian region, teach us two compelling lessons. First, US national security can be dramatically affected by political chaos and state failure in places that seem remote and irrelevant. Second, in many such locales as Tajikistan, Azerbaijan, Georgia, Uzbekistan, Turkmenistan and Kazakhstan we ignore the challenge of nation-building at our own peril.

The political chaos into which Afghanistan descended in the 1990s created a fertile environment for the emergence of the Taliban. The same may easily happen in any of the aforementioned "stans" given their present political and social situation. An international stabilization effort would be key to preventing the recurrence of a terrorist threat from the region.

The effect of the military campaign in Afghanistan on public opinion in the Caspian Basin is difficult to gauge. Yet this public opinion is already in general either exhausted by economic hardship or increasingly discontent with political repression. That very situation presents the danger to the USA whose rapprochement with Central Asian regimes may negatively affect its long-term energy interests.

The implications of the current events are greatest

on Uzbekistan, where 1,000 American soldiers have been sent to provide security at an airport to be used for delivering humanitarian aid. The Uzbek government certainly hopes that military cooperation will lead Washington to downplay its traditional concern with human rights. The risk arises if the US becomes too closely identified in the popular mind with president Karimov's regime. If that comes to pass, then not only could Washington lose the potential for influence upon any post-Karimov transition, but the more active post-Karimov public opinion in the country may orient the country's foreign policy away from the USA and Western democracies in general.

The Islamic Movement of Uzbekistan is stepping up its activity in the country, searching for cross-border sanctuaries in Kyrgyzstan and Tajikistan. Tajikistan, an energy-poor country, is the frontline with Afghanistan, where the Northern Alliance's main support base is ethnic Tajiks. Significant refugee flows from Afghanistan into Tajikistan seem unlikely, however. Because Tajikistan's border is closed, refugee flows may not pose a directly insurmountable problem to the region at large. To reach the heart of Central Asia the refugees would have to cross at least one mountain range and traverse other unpopulated areas.

The energy-rich Turkmenistan has a long but sparsely populated border with Afghanistan, and there are an estimated one million ethnic Turkmen living in Afghanistan who could possibly pose a refugee problem for Turkmenistan. Turkmenistan has had the best relations with the Taliban of any country in Central Asia, but it has not experienced significant Islamic militancy.

There is nothing in the short term that can affect access to the Caspian energy reserves. Since the brunt of any new fighting is not likely to take place to the north of Afghanistan, direct consequences seem unlikely for Western access to Caspian energy re-

sources. In the case of Kazakhstan, for example, the major oil-producing regions are a thousand miles away in the northwest of the country, and offshore in the Caspian Sea. The country has no border with Afghanistan. Its energy exports, which started this year through a new pipeline that goes through Russia to the Black Sea, will not be affected by hostilities in Afghanistan.

In the medium term, it is possible that any renewed refugee flows to Central Asia will create socio-economic resource constraints, increasing the potential for domestic instability in Turkmenistan and Uzbekistan. Concerning energy, their potential role as suppliers may be undermined by domestic political instability. This is not because the governments will come under serious threat, but rather because of the threat of sabotage to pipelines by militants, similar to what is already taking place in the Caucasus.

For instance, Uzbekistan's reserves of natural gas are important only for the Central Asian energy balance and do not have the potential to be significant on the world market. For two years it has been the subject of sporadic attacks by the Islamic Movement of Uzbekistan (IMU), which was backed by the Taliban. The IMU and like-minded organizations such as *Hizb-ut-Tahrir* seek to overthrow the secular regimes in Central Asia and replace them with an Islamic Caliphate. Government repression and populist slogans have given these movements a certain popularity. A greater danger to Central Asia than the immediate situation is thus the destabilization of the delicate social balance in the region, and particularly in the region's key country, Uzbekistan.

The Western search for active assistance against the Taliban in Central Asia has been seen by authoritarian regimes in the region as a *carte blanche* to intensify their repression of political and social dissidence. Even without the events in Afghanistan, Central Asia suffers from scarce resources and vola-

tile ethnic tensions. It would be useful if the present focus on Afghanistan were to lead international institutions to increase their attention to the whole of Central Asia. A Western-sponsored reconstruction package not only for Afghanistan but that which also includes Central Asia may be advisable to avoid longer-term instability.

Notes

¹ See the State Department's *Dispatch* magazine, October 1995, p.14; May 1997, p.12.

² The informal name "Foggy Bottom" traditionally refers to the US Department of State, whose central office building is located in this low-lying area of Washington.

³ *The Great Game, Round 2: Washington's Misguided Support for the Baku-Ceyhan Oil Pipeline*, by Stanley Kober, (Cato Institute publication No.63), Washington, October 2000, 14 pp.; *An Agenda for Renewal: US-Russian Relations*, (Report by the Russian and Eurasian Program of the Carnegie Endowment for International Peace), Washington, December 2000, 52 pp.

⁴ I have to acknowledge here that this analogy is quoted from "The changing nature of the Caspian oil game" by Robert Cutler, originally published in *Oil and Gas Newsletter* on 31 May 1999 (<http://www.gasandoil.com>).

⁵ All figures were derived from "Future trends in supply and demand in oil markets" by W.A. Ramsay, *Global Oil Report* (London), March-April 1998, pp. 24-37.

⁶ "Caspian oil potential," *Petroleum Economist* (London), July 2000, pp.25-27.

⁷ *Financial Times* (London), 21 February 2001.

⁸ "Caspian pipelines: Two steps forward, one step backwards," *Global Oil Report* (London), May-June 1999, p.8.

⁹ For a detailed analysis of changing US policy, see my recent articles: "Caspian pipeline: Difficulties lie ahead," *Review of International Affairs* (Belgrade), March 2001, No.1103, pp.21-27; "The Bush administration and the Caspian oil pipeline," *Contemporary Review* (Oxford), July 2001, No. 1626, pp.21-25.

¹⁰ *Kayhan International* (Tehran), 22 January 2001.

¹¹ Temel Iskit, "Turkey: A new actor in the field of energy," *Perceptions* (Ankara), March-May 1996, p.48.

¹² *Oil & Gas Journal* (Houston), 24 April 2000, p.23.

¹³ *The Wall Street Journal* (New York), 14 February 2000.

¹⁴ *Journal of Commerce* (New York), 28 March 2001.

¹⁵ *Oil & Gas Journal* (Houston), 6 March 2000, pp.19-20.

¹⁶ *Petroleum Economist* (London), April 2001, p.19.

¹⁷ *Turkish Daily News* (Ankara), 19 January 2000.

¹⁸ Transparency International, *Corruption Perceptions Index*, (Berlin, 1998-2000), available at [http://www.transparency.de/documents/](http://www.transparency.de/documents;); For the Control Risks Group index, see: *The Economist* (London), 30 December 2000, p.34.

¹⁹ *Financial Times* (London), 22 November 2000.

²⁰ *Petroleum Economist* (London), August 1998, p.21.

²¹ *Cumhuriyet* (Istanbul), 28 April 2001.

²² *Nezavisimaya gazeta* (Moscow), 21 March 2001.