

Pipelines in the Caspian

Catalyst or Cure-all?

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With questions over future prospects for Iraqi oil—the world’s second largest reserves after Saudi Arabia—at the forefront of attention, along with widespread instability in the Middle East, the Caspian Basin and its oil and natural gas resources are back on the agenda. The Caspian, along with Russia, West Africa, and Canada, where new discoveries in the tar sands have been made, are the great new potential sources of world energy. These regions are increasingly vital to addressing the need for new energy suppliers and bypassing OPEC members and Persian Gulf states. Although these regions pose significant difficulties in terms of production and export possibilities and would not necessarily be competitive with the Persian Gulf under a low oil price regime, current high crude oil prices combined with the fact that Iraq’s production potential will not be restored any time soon make them major commercial contenders.

In the Caspian Basin, the difficulty has never been one of supply—the region contains 17 to 33 billion barrels of proven oil reserves and around 232 trillion cubic feet of natural gas.¹ It has always been one of overcoming the fact that the Caspian is a landlocked sea and of transporting energy resources to world markets. With the collapse of the Soviet Union, the region’s limited energy pipeline infrastructure extended only

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across Russia. The new independent states of the Caucasus and Central Asia were locked into a single set of transportation options to the Black Sea and Europe. Oil and gas exports from Azerbaijan, Kazakhstan, and Turkmenistan required building new pipelines. The Caspian

positions through their involvement in energy and pipeline negotiations. Regional elites have enriched themselves through related business deals. Local populations have viewed BTC as a potential panacea for all the ills that ail the region. And international NGOs have

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region therefore became a focal point in the 1990s, when the first international oil contracts were signed. Because of the sheer size of Caspian energy reserves, and the evident importance of export revenues for the future development of faltering regional economies, Caspian governments transformed pipelines from merely transportation projects into means to achieve political and social objectives. In public debates about Caspian pipelines at both regional and international levels, the commercial interests of companies investing in the actual energy production were sidelined and often seemed strangely secondary or marginal to other considerations.

The Baku-Tbilisi-Ceyhan pipeline project (BTC) provides the best example of this transformation. The goal of this project is to transport crude oil from Azerbaijan's Caspian fields through Georgian territory to Turkey's port on the Mediterranean. The Azeri and Georgian governments have seen BTC as their lifeline to Turkey and Europe rather than simply a pipeline. Politicians from both countries have tried to enhance their

pushed governments and international investors to address a host of issues including government responsibility and accountability for energy revenues, democratization, human rights, and environmental protection as part of the pipeline project.² Since the conclusion of the final host government agreements for the pipeline's construction in 1999, many hopes and aspirations have been invested in BTC along with many millions of dollars from companies like British Petroleum (BP).

BTC is not the only regional pipeline project to have such high stakes beyond its commercial viability. Pipelines from Kazakhstan overland to China, from Turkmenistan across the Caspian Sea to Azerbaijan, and from Turkmenistan through Afghanistan and onward to Pakistan and India, have been seen as means for reorienting regional export routes toward new markets, or—even more loftily—for reconstructing Afghanistan and fostering peace between Pakistan and India. In its early stages of development, the Baku-Tbilisi-Ceyhan project itself was portrayed as a prospective "pipeline

for peace,” with initial plans to cut through Armenian territory and thereby improve relations between Armenia and Azerbaijan and Turkey, its two regional enemies.³ Although the Armenian option was quickly rejected for a longer route through Georgia, the idea that the pipeline can eventually promote peace and prosperity across the whole region has not quite been abandoned. And while other pipelines remain lines on the map, BTC is rapidly becoming a reality on the ground in the Caucasus.

The Geopolitics of Caspian Pipelines.

That BTC has been endowed with so many purposes is not surprising. It began, in many respects, more as a geopolitical project than a commercial one. Due to their isolation during the Soviet period and their fear of forced reintegration with Russia, Caspian states like Azerbaijan and Georgia sought to reorient themselves strategically by creating new security and economic ties to the United States and Europe. Turkey was seen by both countries (although not by neighboring

Armenia) as a window to the West by virtue of its geographic location, NATO membership, and strategic partnership with the United States. Contracts with international oil companies and the process of negotiating agreements for energy pipelines with the Turkish and U.S. governments immediately became

ways to build new political and physical linkages with the West. Likewise, for the United States, the BTC project became a three-pronged tool in its regional policy. It was a means of creating an East-West—rather than a North-South—transportation corridor from the Caspian to the Black Sea that would avoid Iran to the south, cement the position of Turkey as the new bridge between the Caspian and Europe, and break dependence on Russia to the north.

BTC addressed several policy imperatives for Washington in the 1990s. First, it would help to isolate Iran in the Caspian as well as in the Persian Gulf as punishment for its continued sponsorship of international terrorist groups perpetrating attacks against American and allied interests. This was especially important after the August 1996 adoption of the



Iran Libya Sanctions Act (ILSA) by the U.S. Congress. ILSA imposed penalties on major international investors in Iran’s oil and gas industry. Second, it would reward Turkey for its support of the United States during the first Gulf War and its willingness to forego transit revenues from Iraqi oil. Turkey’s

Mediterranean port of Ceyhan was the terminal for Iraqi oil and its economy was hard-hit by the loss of Iraqi crude. Ceyhan's infrastructure, relative proximity to the Caspian, and access to world seaways made it an ideal destination for a new pipeline from Azerbaijan. Third, BTC would increase export options beyond Russia and promote the development of multiple pipelines for oil and gas in the region. Although there was no specific policy to isolate or even avoid Russia as there was for Iran, relations between the United States and Russia soured in the late 1990s. Russia was increasingly viewed in Washington as a spoiler in international affairs and as something other than an honest broker in regional conflicts. And Russian state-run companies made life difficult for exporters forced to deal with Soviet-era pipelines, volatile tariff agreements, and precarious access during disputes. International oil companies became increasingly anxious about Russia's potential stranglehold over oil and gas exports.

As a corollary to these geopolitical considerations, BTC and other pipelines became the central part of a framework for economic development and conflict resolution in the Caucasus—the scene of violent ethnic conflicts and civil wars in the late 1980s and 1990s. BTC and peace were two important elements of a virtuous circle. Energy revenues and transit fees were essential in boosting the coffers and legitimacy of cash-starved and weak central governments in states like Azerbaijan and Georgia to help them entice back secessionist regions like Nagorno-Karabakh and Abkhazia. Trickle-down economic benefits for local communities from energy and related service sector jobs and overall foreign investment were presented as eventually outweighing fac-

tors for conflict. In turn, conflict resolution and political and economic stability in the Caucasus region were crucial for the long-term success of international investment in Caspian oil production.

Zero-Sum Games and Commercial Concerns. This range of geopolitical considerations and the U.S. policy of isolating Iran fed popular perceptions of a zero-sum game in Caspian energy development. In the late 1990s, the United States was depicted in discussions of energy politics as pitted against both Russia and Iran in the Caspian. Russian and Iranian analysts frequently criticized U.S. efforts to push the countries out of Caspian projects and both governments adopted tit-for-tat strategies in response to any U.S. policy innovation. When, for example, the Clinton Administration created a new position in the State Department to coordinate U.S. executive branch programs for Caspian oil and gas, Russia responded by appointing not one but two high-level officials with special responsibility for the Caspian. Russia and Iran also concluded agreements on strategic energy cooperation in the region, and together tried to block the exploitation of Caspian resources by demanding a new division of the Caspian Sea's resources. Russia later softened its stance on this issue after discovering substantial oil deposits in its own sector of the Caspian.

The geopolitical noise around Caspian energy development and talk of a new "Great Game" among the United States, Russia, Iran, and the other Caspian states were good media fodder in the 1990s, but they detracted attention from the overarching commercial issues. For international oil companies

investing in Caspian energy projects, there was a great deal at stake in the machinations over pipelines. The costs of operating without them were high. Under a low oil price regime, overheads made Caspian energy less competitive on global markets when oil and gas had to be transported over thousands of kilometers across land and sea. When oil production began in the mid-1990s, it was transported by ship and rail across Russia or the Caucasus, first to the Black Sea, and then from there through Turkey's Bosphorous straits out to the Mediterranean. The cost of the rail transportation alone was around \$34

Russia to the port of Novorossiysk that could be constructed relatively quickly. This was a shorter route than other options proposed—including a project to build a pipeline from Kazakhstan across the Caspian to Azerbaijan. This pipeline started to function in October 2001. Trans-Caspian pipelines, on the other hand, were technically difficult to build and potentially expensive in the absence of high oil production volumes. Some international oil companies also considered Iranian transportation options in defiance of U.S. sanctions. With its highly developed energy sector and existing domestic network of pipelines, Iran was

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per ton, or about \$4.60 per barrel, which became a serious issue when oil prices dropped to around \$10 per barrel in 1998.⁴ Companies were often forced to suspend oil production when overland transportation options were not available. Pipelines were essential to cutting costs and avoiding the inherent problems of having to constantly offload oil from tanker to rail and back again.

The Push for BTC. Commercial concerns drove feasibility studies and Caspian pipeline projects forward, but the BTC project was not always the preferred option in companies' calculations. For example, Chevron, which operated the onshore Tengiz oilfield in Kazakhstan, pushed for a pipeline from Kazakhstan overland around the northern tip of the Caspian and then across southern

considered by many investors the cheapest and most secure export route. In 1998, for example, Total, a French company, conducted a feasibility study for a pipeline from the Caspian to Iran's ports on the Persian Gulf. Two American companies, Mobil (now subsumed under ExxonMobil) and Conoco, lobbied the U.S. government to ease ILSA restrictions and allow oil swaps with Iran. This would have allowed them to ship Caspian oil to northern Iranian refineries in exchange for an equivalent amount of Iranian crude that could be shipped from Persian Gulf ports to world markets. The U.S. government resisted these pipeline and oil swap projects.

Two other oil pipelines in the Caucasus were also used before BTC to transport the first batches of new oil production from Azerbaijan to the Black Sea—a Sovi

et-era pipeline from Azerbaijan to Russia's Black Sea port Novorossiysk, and a new pipeline from Azerbaijan to Supsa, a Georgian port on the Black Sea. These pipeline routes were fully operational by 1999, and both the Azeri government and the Azerbaijan International Operating Company (AIOC), an international

David Woodward also announced that the consortium did not anticipate sufficient volumes of oil production to warrant BTC's construction before 2005.⁶

The position of BP and the AIOC changed quite dramatically after BP's merger with Amoco, an American energy company. BP's chairman, Lord John

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consortium of ten major oil companies exploiting Azerbaijan's Caspian fields, considered expanding them to export main oil production. The U.S. government played the decisive role in modifying this plan, fearing that its sanctions regime would soon be breached and that Iran would become a viable option for Caspian oil exports.

While intense U.S. diplomacy succeeded in convincing the governments of Azerbaijan, Georgia, and Turkey to conclude the host government framework agreements necessary for the construction of BTC, the oil companies proved more difficult to persuade. The AIOC and its lead company, BP resisted 'geopoliticking' and remained focused on business considerations—whether BTC was commercially viable or not. Early cost estimates for the construction of the pipeline varied from \$2.4 to \$3.8 billion and, after oil prices hit a major low of around \$10 per barrel in 1998, the AIOC was understandably cautious. Reports suggested that the consortium could lose as much as \$3 billion in profit over thirty years by using BTC as its main export pipeline if oil prices were low.⁵ In March 1999, AIOC Chairman

Browne, took the strategic decision to make the Caspian one of the centerpieces of the company's global portfolio and endorsed BTC. Some analysts saw this decision as directly related to BP's merger and its desire to cooperate with the U.S. government now that it had new interests in the United States. But BP also had to factor other considerations into its decision-making. The Turkish government, international environmental groups, and even oil companies had pointed to the dangers of straining the already limited capacity of Turkey's narrow Bosphorous straits with increased tanker traffic from the Caspian. U.S.-Iranian relations showed little sign of improvement and it was clear that the United States would continue to block Iranian transportation options for the foreseeable future. The considerable financial considerations related to the construction of BTC were also somewhat eased by a dramatic rise in world oil prices (up to almost \$40 a barrel and a ten-year high by 2000), and by Turkey's decision, under U.S. guidance, to offer a maximum cost or completion guarantee to the AIOC for pipeline construction. The U.S. government also offered

financial assistance through its trade agencies.⁷ BP's decision to endorse BTC was crucial in pushing the project forward.

In November 1999, a new framework agreement was signed during the OSCE summit in Istanbul between BP, on behalf of the AIOC, and the Turkish, Azeri, and Georgian presidents. In this agreement, BP/AIOC pledged to secure the financing for the construction of the pipeline, and the Turkish government agreed to pay for cost overruns in excess of \$1.4 billion on its portion of the pipeline.⁸ In addition, the three governments reached an agreement to build a gas pipeline from Shah Deniz, the newly discovered Azeri natural gas field, that would run parallel to BTC up to the Turkish border. It would then continue to the Turkish city of Ezerum, where it would connect with an existing gas pipeline network and supply Turkish consumers. On its way through the Caucasus, this new pipeline would also provide natural gas to Georgia to address the country's chronic energy shortage. The new parallel oil and gas pipelines added to the overall geopolitical and economic importance of the BTC project.

A Pipeline for Regional Prosperity?

The BTC pipeline project broke ground in September 2002 in Baku and was billed as the largest private sector construction and investment project in the Caucasus. When completed, it will extend 1,760 kilometers across three countries. At its maximum capacity in about 2010, it will carry a through-flow of one million barrels of oil a day, and will be the central element of a projected \$20 billion investment package that includes up and down-stream projects.⁹ Most analysts inside and outside the region recognize that the scale and extent

of BTC and its related projects will be unique. No other private sector projects of this magnitude are likely to materialize. The success of BTC and the overall profitability of Caspian oil production will also certainly determine the extent to which other foreign investment investments are made in other regional sectors in the future.

In many respects, the very prosperity of Azerbaijan and other Caucasus states is at stake in the construction of BTC. The collapse of the region's centrally planned economies after the dissolution of the USSR was compounded by the effects of the regional conflicts of the 1990s. Hundreds of thousands of people were displaced in the region and many more left for Russia. The loss of human resources through emigration, the contraction of domestic markets, and the few opportunities for international trade limit the Caspian states' potential for development outside the energy and related service sectors. Furthermore, even though there is an abundance of energy available for export, the Caspian region suffers from a domestic energy deficit. Regional consumers lack the ability to pay utility bills and the energy distribution infrastructure for households and industry is in extremely poor condition. All the states, including Azerbaijan, still depend on Russia for power and gas supplies.

These concerns preoccupy governments, local populations, and NGOs. Since 2000, international NGOs like Human Rights Watch, Friends of the Earth, Transparency International, and many others have launched a major public advocacy and outreach campaign to press BP, the AIOC, the BTC management company, the Azeri and Georgian governments, and international financial institutions involved in building the

pipeline, to address myriad issues related to the pipeline's construction and other regional issues. Indeed, the allocation by governments of export revenues and transit fees is still to be determined. Other issues have been raised, including the environmental impact of the pipeline, the preservation of important cultural sites along the route, land purchases for the construction of the pipeline, employment for communities along the pipeline, community oversight of the construction process, and the central and local governments' response to public protest and the concerns of communities at different phases of the project. As of the end of September 2003, one year after the groundbreaking ceremony, 200 kilometers of pipeline had been laid along the BTC route and a 400-kilometer construction corridor had been prepared through Azerbaijan, Georgia, and Turkey. Of the 10,000-strong workforce on the project, 7,000 local nationals had been employed. The BTC operating company had also deployed teams of archaeologists to excavate and record data at ancient sites uncovered during construction in Georgia.¹⁰

Conclusion—Catalyst or Cure-all?

Regardless of the geopolitical and other considerations behind the decision to build BTC, the pipeline is primarily a commercial venture to transport oil from the Caspian to world markets. The companies involved in the project will move ahead regardless of the complexities if their negative impacts do not outweigh the commercial benefits. The pipeline's ultimate success also depends on issues detached from the Caspian region such as the long-term fluctuation of world oil prices. While BTC can link Azerbaijan,

Georgia, and Turkey, the construction of one pipeline to the Mediterranean cannot overcome the otherwise disadvantageous location of the Caspian. The series of legal and political agreements that made BTC's construction possible have created a complex set of relations among the three countries, the United States, and international energy companies, but the pipeline cannot be substituted for other economic, political, and security relations with the West. Nor can it tie fractured countries like Azerbaijan and Georgia back together again or replace regional cooperation in the Caucasus—especially given the fact that it bypasses Armenia.

And there are few examples of pipelines promoting peace. Instead, there are plenty of examples of pipelines traversing areas of considerable instability in Latin America, West Africa, and elsewhere. The higher costs of operating in conflict zones, and of protecting and repairing pipelines, are factored into companies' calculations. Most existing and proposed energy pipelines in the Caspian region run through conflict zones. In 1999, oil exports were suspended when the pipeline from Baku to Novorossiysk was ruptured due to the war in Chechnya. Restoring service required building a route bypassing Chechnya through the neighboring republic of Dagestan. In the future, the Baku-Novorossiysk pipeline is unlikely to play any significant role in a peace settlement in Chechnya, just as BTC is not likely to be the deciding element in resolving the conflict between Armenia and Azerbaijan over Nagorno-Karabakh.

Although they cannot ensure peace, pipeline projects—especially on the scale of BTC—can provide an important economic boost through infusions of invest

ment and creation of jobs at the national and local level. But pipeline projects cannot solve the overall under-development of regional economies. Large-scale economic development projects are the purview of international institutions like

the World Bank, not of oil companies like BP. Pipelines are a catalyst for development but not a cure-all for the political, economic, and social problems of regions like the Caucasus and the broader Caspian Basin.

NOTES

1 See figures provided by the U.S. Department of Energy's Energy Information Agency (EIA), August 2003, available online at: <http://www.eia.doe.gov/emeu/cabs/caspstats.html>. These figures would put the Caspian's oil reserves on par, at the lower end, with Qatar and with the United States on the upper end; and its natural gas resources at the same level as Saudi Arabia.

2 See, for example, Svetlana Tsalik, *Caspian Oil Windfalls: Who Will Benefit?* (New York: Open Society Institute, Caspian Revenue Watch, 2003).

3 See Jack Maresca, "A 'Peace Pipeline' to End the Nagorno-Karabakh Conflict," *Caspian Crossroads* 1 (Winter 1995).

4 Cited from Russian pipeline company Transneft's figures in *Neft i Kapital* (January 1999), 51.

5 Reported in "Pipelines: Azerbaijan," *Caspian Investor* (January 1999), 28. As outlined in the article, with estimated construction costs of \$3.8 billion and low crude oil prices, Baku-Tbilisi-Ceyhan would generate \$14.5 billion in profit, in contrast to an expanded

version of the pipeline from Baku to Supsa, which would offer \$17.5 billion in profit.

6 See "Turkey, AIOC Begin New Round of Discussions on Baku-Ceyhan," Newsbase, *FSU Oil and Gas Monitor* (30 March 1999), 5; and "AIOC Head Says MEP Will Only Be Profitable under Certain Conditions," Newsbase, *FSU Oil and Gas Monitor* (27 April 1999), 17.

7 Haitham Haddadin, "United States, Turkey Try to Speed Baku-Ceyhan Pipeline," *Journal of Commerce* (23 April 1999).

8 Jane Perlez, "Strategic Issues Aside, Focus on Oil Pipeline Turns to Money," *New York Times* (21 November 1999).

9 For this and other information see BTC, Co. "Regional Review: Economic, Social and Environmental Overview of the Southern Caspian Oil and Gas Projects" (February 2003).

10 BTC, Co., "Construction gathers momentum, passes milestone," *BTC Bulletin* (25 September 2003), available online at: <http://www.caspiandevelopmentandexport.com/ASP/LatestNews.asp?ArticleID=14>.