
The Bush Administration and the Caspian Oil Pipeline

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Among the major issues where the Bush Administration will have to copewith the Clinton legacy, is the Caspian pipeline project. The State Department invested heavily in a grandiose strategy that has been 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-Ceyhan oil pipeline and the Trans-Caspian gas pipeline from Turkmenistan, never made obvious economic sense.

Recent studies by two independent research groups in Washington, the CATO Institute and the Carnegie Endowment for International Peace, have criticized the economic justification for the Baku-Ceyhan pipeline, urging consideration of Russian and Iranian alternatives. That said, the Bush Administration is likely to take a different view of the projects.

Both President Bush and Vice President 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. Now the Vice President can encourage American 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.

Of course there has been a long-standing American embargo against Iran. Cheney began challenging the logic of the Iranian embargo several years ago. As chief executive of Halliburton, a giant oil-services company, he believed that the Clinton strategy was wrong. 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 digging of many dry holes by several oil companies in the Caspian, the region that had been pushed by Washington as an alternative to the Persian Gulf has been dismissed as a product of the State Department propaganda.

Instead of the politically bloated appraisal of 200 billion barrels of Caspian oil reserves (compared with Saudi Arabia's 250 billion) valued at 4 trillion dollars, exuberantly cultivated for years by the State Department to allure American investors into the region and justify its own strategy there, we are talking now about 15 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 U.S. government says tends to be taken much more seriously outside the United States than within. Oil industry analysts react with scepticism to claims made by U.S. officials concerning the Caspian Sea potential. Unfortunately, local leaders in the region take such claims at face value, concluding that the U.S. government knows something that they do not. Similarly, when Washington tells them that the Baku-Ceyhan project is commercially viable, the governments conclude, wrongly, that the State Department knows more about oil export pipelines than oil companies.

Clinton promoted a role for Turkey through the pipeline that would carry Caspian oil from Baku in Azerbaijan to Turkey's Mediterranean part of Ceyhan via Georgia, thus bypassing Russia and Iran. He also backed the proposed gas route running across the Caspian seabed from Turkmenistan to Turkey via Azerbaijan.

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

There was a degree of logic to this. Both Russia and Iran are competitors in the oil and gas markets of Caspian Sea exporters -- Azerbaijan, Kazakhstan and Turkmenistan. Russia and Iran would probably not hesitate to restrict Azeri, Kazakh or Turkmen oil and gas exports, if they felt that these upcoming Caspian rivals were eating into their markets. On paper the proposal looks credible: it avoids Russia and Iran, and ends in Turkey, a NATO ally and energy importer with no reason to restrict Caspian Sea energy exports.

However the State Department's proposals promoting any oil or gas export pipeline that would avoid crossing Russia or Iran were based more on international politics than economics, and acted as a source of tension among governments in the Caspian region and western oil companies. The problem has long been that few in the oil industry believed that the Baku-Ceyhan pipeline was commercially viable. They have repeatedly pointed out that if this pipeline were commercially viable, then it would already have been built. The Trans-Caspian gas pipeline from Turkmenistan, for instance, has already been abandoned.

Although the plan is several years old and all agreements have been concluded, it remains only a project. The projected pipeline would cost from \$2.4 billion to \$4 billion. Major oil companies think it would not be financially feasible. 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.

Nevertheless, under the pressure from Washington, a Baku-Ceyhan sponsor group of eight oil companies has been formed, agreements between the sponsor group and Azerbaijan, Turkey and Georgia signed, and engineering studies for the Turkish sector of the pipeline have just begun.

Despite the U.S. support, the project still faces difficulties. A close look at developments behind the upbeat headlines reveals disturbing signs. Investment is the main outstanding issue, especially now as a result of Turkey's present economic upsets. The sponsor group is committed to funding only the basic engineering 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 the engineering study are positive, the group is to carry out a more detailed, \$100-million examination of the line, then a 32-month period of land acquisition and construction.

The U.S. Overseas Private Investment Corporation (OPIC) and EximBank have declared their readiness to support the project. Representatives of these agencies and the sponsor group met in Washington last December to discuss financing of the project. The meeting was also a setback for the pipeline because the debate caused a split in the ranks of the Azerbaijan International Oil Consortium (AIOC) producing Caspian oil and exacerbated the perceived reserves and throughput volume uncertainty. The lingering doubts regarding the project cost came again to surface. Lower costs and higher profit margins associated with the competing alternatives, such as the existing pipelines from Baku to the Black Sea marine terminals at Supsa (Georgia) and Novorossiysk (Russia), and a shorter route to the Persian Gulf terminals across Iran, were the factor that the negotiators found hard to ignore.

Alternative routes were not eliminated even during the signing of protocols between the sponsor group and Turkey. The sponsors insisted on a provision that the group will continue evaluating alternatives to Baku-Ceyhan. 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 BP-Amoco's chief John Browne sent recently to President Aliiev 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.

Troubling cost concerns and possible opening of the Iranian option as a result of lifting of American trade embargo may tilt the balance against Baku-Ceyhan. A conclusion seems inescapable that the competing alternatives, namely the Supsa, Novorossiysk and Iranian routes, are not, as yet, off the shelf. It should be recalled, in this context, that of the eight oil companies composing the sponsor group, only Azerbaijan's SOCAR and Turkish Petroleum Corporation (TPAO) unequivocally backed the Baku-Ceyhan project while the support of the other members had been halfhearted at best.

Furthermore, three members of the AIOC opted lately out of the sponsor group: Lukoil of Russia, Exxon-Mobil and Pennzoil of the USA. With their combined 23 per cent share in the consortium, that has adversely affected investment confidence, especially for international credit agencies that are already skittish about Caspian oil reserves and the throughput sufficiency of the project. The Baku-Ceyhan pipeline needs a daily throughput of 1 million barrels to be economically justified. Azerbaijan will be able to produce only 250,000 barrels a day when all its consortia reach their peak. (For a comparison: Kuwait is producing 2.14 million barrels a day, its quota from the OPEC, and has enough oil to pump about 2 million barrels a day for 132 years.)

Since Azerbaijan's reserves are insufficient, supporters of the project are hoping that Kazakhstan's new Kashagan oil field under the northeastern Caspian Sea 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-Ceyhan pipeline extended eastward to Aktau, his Caspian seaport. At present, however, it is premature to count that Kazakh oil will make up the gap. 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-Ceyhan. Only then will it be possible to judge the extent to which Kashagan could contribute to Baku-Ceyhan pipeline.

Meanwhile, Russia has completed a 748-kilometre section of its North Caspian pipeline linking Kazakhstan's Tengiz oil field to Novorossiysk. Tengiz is the world's sixth-largest land oil field with a conservatively estimated 9 billion barrels of recoverable reserves. The entire length of the 1,580-kilometre line, which could also transport the Kashagan output to the Russian Black Sea port, is due to be opened this month, forming the largest new export route from the Caspian region since the Soviet collapse. (The length of Baku-Ceyhan is projected at 1,730 kilometres.)

Rather than building the expensive Baku-Ceyhan pipeline, oil companies in Azerbaijan now appear to favour 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.

Another motivation for an Iranian route is the growing recognition that the increased tanker traffic through the Bosphorus should be avoided on safety and environmental grounds. But directing the flow of energy from the Caspian via Iran would necessitate the normalization of relations between Washington and Tehran. Since this cannot be done easily or quickly, the Baku-Ceyhan plan still has a chance.

Recently Chevron of USA (the major developer of Tengiz oil field) announced that it wants to join other sponsors for the project. The news appears to be a sign that oil companies want to keep the route as an option for their Caspian exports. Turkish 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

Tengiz oil to flow through the Baku-Ceyhan pipeline. It is already scheduled to be pumped through the new Novorossiysk pipeline. Instead, Chevron is interested in Baku-Ceyhan 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 the intention to open talks on joining a group to sponsor engineering studies for the project. Participation in the construction itself would depend on whether oil is found at Chevron's Apsheron oil field.

The Chicago-based Amoco oil company, before its merger with British Petroleum, calculated that Baku-Ceyhan would need \$200 million per year in subsidies from the U.S. government to be viable. Rather than engage with the oil companies and take account of the independent studies which 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, the U.S. government preaches the virtues of the free market and privatization to former Communist countries, yet the same U.S. government is trying to force privately-owned western oil companies to build a pipeline that suits its own geopolitical convenience more than the interests of these companies and their shareholders.

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