

Caspian Hydrocarbons, the Politicisation of Regional Pipelines, and the Destabilisation of the Caucasus

Terry Adams, former president of AIOC

Abstract

Caspian Oil and Gas Reserves are both commercially and competitively viable for long term strategic supply to Southern Europe and the Black Sea. Critical pipeline capacity for regional export to these markets is already evolving to meet capacity demand. However recent politicisation of pipeline routes in the South Caucasus has seriously interfered with the ongoing investment process. The fundamental need for the private sector to underpin development and the political evolution of the region is emphasised. The strategic role and self interest of the EU is reinforced.

Introduction

Since the collapse of the Soviet Union there has been widespread comment and speculation as to the realities of Caspian Oil and Gas. It is questioned whether or not these resources can truly form the basis for future economic and political stability in the Caucasus. Much of the debate has focussed on the effectiveness of regional pipeline systems, both old and new; and the manipulation of these systems for regional advantage and political ends. Consequently, in this paper, we will look at the New Geography of Russiaâs Near Abroad; within the context of independence being driven and maintained by the award of Oil Contracts. These inexorably tie to the cementation of international political alliances and national foreign policy. The paper will assess the material threats we see to regional oil development; and whether or not these will deflect the positive economic changes that have already occurred over the past five years.

Caspian Oil Reserves

There has been continued public speculation as to the realities surrounding Caspian Oil Reserves. Nevertheless the enthusiasm with which Western Oil Companies have competed for new Contract Areas in both the South and North Caspian, reflects their firm belief that these Caspian basins held substantial and accessible upstream reserve potential. This was done not with emotion, but after considerable technical due diligence.

The attraction of the Caspian focussed on Proven Oil Fairways; Plio-Pleistocene palaeodelta systems to the South, and Palaeozoic reef complexes to the North. Both oil provinces had extensive databases, developed over a considerable period of time. The petroleum geology of the Caspian is particularly well understood. The area includes many proven super giant fields; and there are a large number of known untested virgin structures, of similar dimension. These were favourably located within the hydrocarbon fairways, and were available for licensing. This fact drove the early Caspian oil boom.

But the question must be asked, how did this investment opportunity arise? Up to the collapse of the FSU, the Caspian was inaccessible to Western investors; so the answer to the question is two fold. Firstly, Soviet technology imposed operating water depth constraints, that had already been breached in the West. For conventional field development the Sovietâs could not access structures in deeper water. Hence the 1994 AIOC investment in the Azeri Chirag Deepwater Gunashli Field in offshore Azerbaijan. Secondly, in the mid 70âs, a strategic policy decision was taken in Moscow to redirect Russian oil investments from the Caspian to West Siberia. Oil development in the Caspian declined, and consequently many world class prospects remained untested.

Detailed analysis of available databases confirmed that some 17.5 billion barrels of recoverable oil had already been found within the South Caspian. That a further 20 billion barrels should be found in Azerbaijan and Turkmenistan, in already well defined untested traps, is still a realistic expectation. To put this into context, this YTF (yet to find) is an equivalent reserve level to the North Sea. This is replicated for similar geological

reasons, in the North Caspian Basin. Here numerous untested Palaeozoic reefs have been identified on seismic; as Tengiz Oil Field look alike. Tengiz itself holds a proven oil reserve in excess of 8 billion barrels. So again it would be surprising, if a further 20 billion barrels YTF would not be found along this prolific oil trend. Two critical exploration wells were scheduled for 1999 to test these fairways. In the South Caspian Shah Deniz found a megagiant gas field with condensate, in offshore Azerbaijan. The results from Kashegan now drilling in offshore Kazakhstan are not yet known. But Caspian exploration still carries Geological Risk, and exploration drilling more generally fails than succeeds. Nevertheless, there is technical confidence that the Caspian should deliver a further YTF of 40 billion barrels; with an upside of perhaps 65 billion barrels recoverable. This projection is geologically sound, and reflects current common understanding in the Industry.

But these numbers are modest in comparison to much of what has been published in the press. There a YTF reserve of 200 billion barrels plus is still persistent as a projected number. This would place the Caspian on a par with much of the Middle East. It is equivalent to the reserve potential of Kuwait and the United Arab Emirates combined; and close to Saudi Arabia itself. Clearly this YTF prediction is flawed. Essentially, it arose in early 1995, from a Reserves Review commissioned by the US State Department, now held by the Department of Energy. It was compiled at a time of considerable geopolitical re-positioning by the United States within the Transcaucasus. The number so derived, primarily for political purposes, reflects the concept of an Ultimate Reserve, in which oil would fill every conceivable trap, with no exploration risk. This is commercially meaningless.

More realistic reserves projections have been promoted since inception of the Baku Oil Boom in 1995, of which the CIA were fully aware. Therefore with a Caspian reserve potential of some 40 billion barrels, by 2010 a cumulative Caspian oil production of between 3 to 5 mmbd can be projected with some confidence. Cumulative production most probably will fall closer to the low end, even if there are no serious political dislocations in the development process. The Caspian will be an important player in international Oil Supply, but it will never be a future Global Swing Producer. That privilege remains safely entrenched within the Middle East. At best the Caspian in total will deliver no more than 3% to 5% of Global Oil in the coming decades.

Equally there has been much negative speculation regarding two failed exploration ventures in offshore Azerbaijan. The Karabakh Contract Area (CIPCO) of Pennzoil, and the Ashrafi Dan Ulduzu Contract Area (NACO) of BP Amoco, were both priority targets in an early drilling campaign. Located close to, but not on trend with AIOC, how could they have failed? The geology and geophysics of the Apsheron Sill is well understood. Plio-Pleistocene Oil Fields trend along the flank of this emerging basement ridge. Giant structural traps are ideally located to entrap oil migrating northwards from a deep basin centre to the south. However SOCAR geologists already knew too well that explorers should beware, if they went too far north of this critical edge. So a likely exploration failure was predicted, well in advance of any new drilling. This was the common view held by Azeri experts; which was shared by many Western experts too. But the structures were large and needed to be tested. Operationally they were simple to access. Consequently, the drilling of these two prospects has in fact reinforced the understanding of the South Caspian Geological Model, not undermined it. Rather than diminishing the offshore oil potential of Azerbaijan, these results have reconfirmed the exploration understanding that underpins South Caspian Reserve prediction.

But there are some hard facts to be faced. Offshore Exploration in the Caspian is commercially expensive. Oil reservoirs are complex and deeply buried. The Caspian seabed is active and unstable; and much of the prospective areas lie within very deepwater. Also within the geological section to be drilled above these reservoirs, zones of severe formation overpressure are frequently present, which challenge current drilling technology. Add to these the absence of effective infrastructure in the region, this then presents the risk investor with a considerable front end cost burden. Exploration well costs in excess of \$50 million are common. Consequently Exploration Failure Cost is high; typically \$150 million to \$200 million or more for an offshore Production Sharing Contract in Azerbaijan.

But correspondingly Finding Costs in the success case are low. This reflects the nature of giant oil field

exploration, with mega-reserve potential. For the Caspian this translates into a Finding Cost of US 50 to 75 cents a barrel, which puts offshore Caspian oil potential to the forefront of international exploration. But this remains essentially an opportunity for Big Oil only, who have the financial clout to tolerate the failure cost exposure involved.

Regional Oil Transportation

The risk of not being able to transport Caspian Oil to market was, and still is, perceived to be the most significant business challenge for oil investment in the region. The extended delays experienced by Chevron in the evacuation of oil from Tengiz through Russia to the Black Sea, is a prime example. The creation of an effective regional pipeline by CPC from Tengiz to Novorosysk, was pending since 1992. It is now under construction, and should become operational in 2001. In the meantime Chevron maintains short term export routes for some 200000 b/d; using existing Russian rail transport; and by barge across the Caspian Sea to Baku, and then by rail through Georgia to Batumi on the Black Sea (60000 b/d). The new CPC line to Novorosysk when fully commissioned will have an eventual export capacity of 1.3 million b/d. This should then capture the bulk of North Caspian export; and serve Russian long term commercial and political interests in a material way.

As a result of the Chevron experience, in the South Caspian AIOC made export capacity to the Black Sea the strategic priority for its foreign investors, before offshore investments were made. Consequently in early 1996 pipeline transportation agreements and inter-governmental treaties were signed, firstly with Russia, and subsequently with Georgia. These allowed for the transportation of Azerbaijan Oil northwards to Novorosysk, and westwards through Georgia to Supsa; both oil ports on the eastern margin of the Black Sea. Azerbaijan oil was successfully transported through Russia in late 1997. But as a consequence of events leading to the Second Chechen War deliveries were interrupted, and eventually cut by mid 1999. The Georgian Supsa Line became operational in early 1999. This now provides the full 120000 b/d capacity needed for the initial tranche of AIOC oil from the first Chirag platform.

For the last three years some 60 to 100000 b/d of East Caspian crude has been successfully trans-shipped by rail from Baku to Batumi by Caspian Transco. Incremental Turkmen oil produced by LASMO and others from the Burun Field has been successfully transferred to the Tehran Refinery via the Iranian Neka Pipeline for Oil Swaps in the Gulf. The Neka pipeline has a current operational capacity of some 40000 b/d. Additional export capacity for South Caspian crude is available through the Volga Don Canal system which can take up to 60000 b/d (for summer operations); and by rail from Makhachkala to Novorosysk, also for some 60000 b/d.

Currently there is sufficient export capacity available to third parties for South Caspian oil. For the longer term, there are emerging plans for major regional export pipelines, which are the subject of heated debate. To the North Baku-Novorosysk via a Chechen by-pass, with a capacity of 1 million b/d; to the West (Baku Supsa to Baku Ceyhan) with an initial capacity of 1 million b/d, and to the South (NIOC) with a capacity of 350000 b/d. It is no longer a matter of if but when these pipelines will be built. The clear message is that once new oil is found and capacity is needed, expansion plans and new pipelines will follow. For the South Caspian herein lies the rub. The politicisation of pipeline routes are now in conflict with commercial realities.

South Caspian Transportation Tariffs

For existing Caspian export systems, market competition to capture export crude has already resulted in reducing transportation costs. Turkmen crude export can be used as an example as it employs multiple export options. Turkmen crude moves westwards across the Caspian to Dubendi (Baku), and then by rail with Caspian Transco to Batumi. For summer operations it moves north through the Volga Don system. Southwards oil moves to Neka for year round pipeline transfer to the Tehran Refinery; for a corresponding swap of equivalent NIOC export crude at Kharg. It should be noted that the following tariffs represent an inclusive transportation cost, involving both marine and land transits for a delivery in the Mediterranean. The Iranian Swap fee is for a Kharg FOB.

In 1998, the Iranian swap option gave the best tariff (\$4.9/bl). In 1999, rail transportation costs were materially reduced from Dubendi to Batumi and tariffs fell (from \$8.3/bl to \$ 6.50/bl); in response to market competition. Once export capacity is restored for the AIOC-SOCAR pipeline from Baku to Novorosysk; further downward market pressure should result (\$6/bl). Tariffs for Volga Don summer operations are also competitive (\$5.9/bl). All existing tariffs are clearly set above true cost, at a level which the market will currently bear. They can all accommodate price reductions.

To summarise; an average transportation cost for crude from the South Caspian to a Mediterranean Refinery can be set at around \$6.00 - \$6.50/bl. This as we shall see contributes to around half of the Caspian Development Cost of \$12.50 per barrel. Likewise transportation also represents a major charge against Cost Recovery (Cost Oil) within Production Sharing Contracts. This creates a major conflict of interest between the Producer and Transit Countries involved. The producer country makes its profit upstream (Profit Oil) and aims for minimal transportation costs. The transit country makes its profit downstream (Tariff), so wishes to maximise transportation cost. This was the challenge faced by Azerbaijan, Turkey and Georgia, during recent and procrastinated negotiations over future tariffs for the Baku-Ceyhan Pipeline. These have been set in principle at \$2.58/bl for land transportation to Ceyhan. This with a further 40 cents/bl for marine transit to the Mediterranean, gives an inclusive transportation cost for Baku oil of \$2.98/bl (i.e. roughly half of current average transportation cost). But these land transit costs include an interest charge for pipeline CAPEX. Once liquidated, land transit cost drop to \$1.15/bl; which should then deliver an inclusive transportation cost of \$1.55/bl from Baku to the Mediterranean. If achieved this would be dramatic. Nevertheless directionally South Caspian transportation costs should half in the coming decade.

But why should a Western export route for the South Caspian remain the predominant option, when there is an available alternative South through Iran? We have already seen that crude swaps with Iran is the cheapest Caspian transportation option to maximise net backs. The inherent cost saving that Iran itself obtains when Caspian crude is used to service their northern refineries, eliminates their own internal crude transportation costs, by not having to bring equivalent oil from Kharg. There is significant potential for Iran to reduce their swap fees further, and still maintain competitive advantage. But the crude volumes needed by Iran for swaps are strategically capped. It is significant that NIOC in an international tender for a new pipeline from Nekka to Tehran, confined pipeline design capacity to 350000b/d. Such volumes of Caspian crude would service approximately 50% of their own northern market needs. To become 100% fully dependent on Caspian crude would be strategically imprudent; and this is clearly demonstrated.

But to take far greater volumes of Caspian crude by pipeline to the Gulf for onward marine transfer to E Asia or to US West Coast would be commercially impracticable. This would introduce a transportation cost burden that could not compete commercially with far cheaper oil transportation of Caspian crude to markets in the South Mediterranean and Black Sea. Also Iran and other OPEC Gulf producers would not wish to see large volumes of Caspian crude enter their already congested seaway. But more importantly Iran would not wish to see their Asian markets undermined by Caspian crude. Swap volumes are not material, and have the advantage of falling outside of OPEC accounting. Therefore for sound commercial reasons Iran is unlikely to access more than 10 % of future Caspian production needed for swaps. Arguments for a main export pipeline through Iran to the Gulf shows that it is not a viable option. The heated political opposition to an Iranian MEP under ILSA and Iran Containment, is in fact irrelevant.

Detailed studies have already confirmed that the Mediterranean and Black Sea markets should have the capacity to absorb up to 3 million barrels a day of Caspian crude. Inherent Caspian crude chemistry is environmentally attractive to Mediterranean and Turkish refineries. It will displace supplies of less environmentally friendly crudes from the Middle East and West Africa, on a fully competitive basis. The Caspian is essentially a global niche producer strategically positioned to service Southern Europe. This fact is not generally reflected in the current export debate, which still promotes the Caspian as a global Middle East alternative.

Oil Price and Commerciality of Caspian Crude

With the serious collapse of oil price in late 1998 and early 1999 there was considerable speculation that Caspian exploration and development would stop. At that time the Brent crude benchmark hovered around the \$10/bl level. There were dire predictions that \$5/bl oil was near. For a variety of reasons for the past six months oil price has remained within a \$24-26/bl envelope.

Nevertheless comparisons of Caspian Operating, Development, and Transportation Costs with the North Sea and Middle East are revealing. Currently the built up cost per barrel for North Sea and Caspian oil are roughly equal (\$12.50/bl). Both compare unfavourably with the Gulf (\$2/bl). But the cost structure for the Caspian is fundamentally different from the North Sea. Two costs dominate the Caspian barrel; transportation (6.50/bl) and development drilling (\$3/bl). In the mature North Sea, costs are more evenly spread across the spectrum.

However given a reasonable degree of long term stability, Caspian transportation costs are likely to halve in the coming decade. Equally technology improvement should have a dramatic impact on reducing Caspian development drilling and well completion costs. The Industry is still low on these learning curves. With the development of common infrastructure there will be further cost savings. By 2010 the built up cost per barrel for Caspian crude should fall to around \$8/bl real. The mature North Sea in comparison has already creamed these benefits; and costs there are likely to remain static or increase. Therefore as long as the oil price maintains a sustainable level of around \$15/bl or more, the Caspian will be profitable. It can support long term sustainable investment as a niche producer for the European market. Although Caspian Failure Costs are high; with giant field potential Finding and Development Costs are low, and it is this that will drive development forward.

South Caspian Oil Investment

So what does this mean for continuing short term investment in Baku and Ashgabad? Of the 19 Contract Areas that have now been ratified in Azerbaijan, all but one (AIOC) are Exploration Production Sharing Agreements (PSA). AIOC is a Development PSA for existing reserves, under a committed \$10bn development plan. To date AIOC have already pumped some \$870mm directly into the Azerbaijan economy.

For the remaining 18 Exploration Contracts some 29 investing exploration companies have made contractually binding work commitments, to be completed within the next three to five years. This work will not be abandoned. Most, if not all of these contracts carry the requirement for 3D seismic and a minimum of two exploration wells. Several carry far greater commitments. Consequently, drilling, oil field services, logistics and social infrastructure etc will continue to be needed in Baku, and the current work momentum will not go away. With only a modest success from what is an extensive Exploration Programme in Azerbaijan, some contracts will inevitably result in new Oil Developments. If only half of the \$30bn plus development plans envisaged in existing contracts mature, this should ensure the longevity of Baku Oil investment, with all the economic change that this should bring to the stability to the Caucasus.

Turkmenistan has come relatively late to the upstream game. But already, they too have some \$400mm of work commitments in place for oil contracts in their Western Region. But more importantly, if short term gas sales agreements with Turkey become reality, it will be the enormous gas deposits already found in East Turkmenistan that will have a far greater impact on their future economic growth.

Politicisation of Export Pipelines in the South Caucasus

Context:

Five years have seen dramatic political change within the Transcaucasus. This is particularly true for Azerbaijan who pursued a singular Oil Policy that transformed its sense of destiny and independence, and its role on the international stage. It has been a period in which there has been a complete rebalancing of regional geopolitical influence and the weakening if not undermining of traditional regional ties.

In 1994 Azerbaijan was a country in economic collapse, enduring serious political chaos. It had a weak central government, an unstable and rapidly devaluing currency, hyperinflation, and seriously negative economic

growth. It suffered from regional confrontation, and an unresolved war in Nagorno Karabakh. With the burden of almost one million IDPs (internally displaced persons) in a total population of just over seven million, the situation was unmanageable. It was also a country that was isolated internationally, without apparent influence. It was politically dominated by the traditional regional power players of Russia, Turkey and Iran. Its long suffering literate skilled and sophisticated people were totally demoralised. They had no sense of future expectation, or relief from the oppressive, and hostile environment under which they attempted to survive. By 1999, four years later, we see the emergence of strong central government, a developing democratic process, a vocal press and a viable political Opposition. There is an emerging free market, the country has stabilised, and inflation reduced to low single figures. Internal budgeting, finance, and fiscal reforms have effectively maintained national debt at low levels (despite the collapse in oil price a year ago); and central budgeting has attracted the positive approval of the IMF. An effective (but not yet perfect) western business environment has been created, with a proven track record. But more dramatically the country has achieved true international status, which is exceptional for a small nation with a population of less than say the city of London. However the Karabakh War remains unresolved, the IDPs remain disenfranchised, and their conditions have worsened. But the long suffering population as a whole now have raised expectations, with a taste for the democratic process. They have demands that must be met. The political challenge facing regional stability is now internal as well as external. The people want jobs and stability for the many, and not wealth for the few. Herein lies the challenge.

Azerbaijan and the new oil strategy.

It was the formation in Baku of the AIOC international oil consortium in 1994 that saw the beginning of the strategic alignment, between the investing foreign oil companies and the government of Azerbaijan. The company became the vehicle through which Heyder Aliyev created not only the opportunity for internal national stability through economic change; but new international geopolitical alliances that were to be so critical for independence in the longer term. A far-sighted oil strategy was to re-balance the geopolitics of the Caucasus as a whole.

So what drove the foreign investors of AIOC in 1994 to take on what was so clearly a substantial investment risk? Very simply, access to an undeveloped giant offshore oil field, with some 4 billion barrels of existing oil reserves; to be developed by conventional technology. Geology and low technical risk were the critical factors to move investment forward. Political risk was the overwhelming challenge, for both the government and the foreign investors. The oil investment maxim that "When politics are hostile, keep your geology simple" applies.

What in turn drove the Azerbaijan leadership forward? Simply put, international political support. Baku saw that \hat{I} Flag would surely follow Trade \hat{a} . AIOC became a microcosm of regional and international politics, whereby investor governments supported the political needs of their major companies; and oil investment in Baku became synonymous with national self-interest.

When formed in September 1994, AIOC comprised ten companies with seven national interests. It brought Washington and London to the negotiating table; but at the same time regional interests in Moscow and Ankara were to be well served. The arrival of Japan in 1996 to a large extent set the seal of political approval on what had been achieved, and reflected the political stability and economic optimism of the new ownership.

Unlike comparable oil contracts initiatives in Russia, Azerbaijan recognised immediately that the critical requirement for any secure oil strategy would have to be based on well-defined oil Production Sharing Contracts, that clearly recognised and protected investor needs. The government decided that each oil contract would incorporate four essential elements:

- Fair but tough commercial terms that were well balanced between investors and government. There should be no in-built temptations for early contract re-negotiation.
- All oil contracts would be spelled out in great detail, so that both parties were in no doubt with regard to their contractual obligations.

- Each contract would be ratified by Parliament, and would enjoy the force of Azerbaijani Law.
- Each contract would include significant financial and work commitments, that would become the basis for economic renewal in the Republic as a whole.

Azerbaijan's oil strategy as a basis for geopolitical influence was well considered from the start. AIOC became the catalyst for change. It is instructive to recall the 1995 decision making behind this first Oil Project in , and the commercial and political drivers that were needed for its success. The immediate challenge was to resolve the issue of obtaining stable and secure export capacity for AIOC "early oil" to the Black Sea. Initially it was determined that one export route would be chosen. This resulted in a competitive choice between Russian infrastructure from Baku to Novorossiysk, or Georgian infrastructure from Baku to Supsa. Both options proved to be technically and commercially viable. However, after some considerable internal debate it was decided for both operational and commercial security that a multiple pipeline solution was to be preferred. Both pipelines would be used, and a multiple pipeline policy was accepted by both the US and the EU for their political support.

Consequently in February/March 1996 contractual agreements were signed with both Russia and Georgia, which involved the highest levels of political lobbying on behalf of AIOC, by both host and investor governments. Truly a Flag followed Trade. It should be noted that both Russia and Turkey were positive in their support of Azerbaijan's commercial ambitions. Dialogue was free between all the players. It should also be recorded that during the reconstruction of these early pipelines design capacity allowed for later expansion to accommodate the next major phase of oil development that the AIOC investors were already planning. The aim was to maintain a continuous investment with no dislocations. It was recognised by AIOC that for each year delay, they exposed the Project to a value loss of some \$100 million NPV. The economic effect on Azerbaijan arising from delay was potentially far worse. The first AIOC export oil successfully reached the Black Sea in December 1997.

Simultaneously with this AIOC development activity, Azerbaijan also promoted an aggressive award of new Production Sharing Contracts not only to enhance its plans for internal economic renewal, but to expand its base of international geopolitical alliances. Commercial and political ties were fully and firmly cemented with Georgia; and the two leading statesmen (Aliyev and Schevernadze) embarked on a high profile international geopolitical offensive, during a period which by historical chance coincided with serious ongoing internal political distractions in Moscow, Ankara and Tehran.

In 1994 AIOC brought Washington, London, Moscow, Ankara, Oslo, Riyadh, Tokyo to the political table. In 1996 and 1997 further contracts followed, with the arrival of Paris, Brussels, Rome, Bonn and Tehran. By end 1998 some 13 offshore and 2 onshore contracts had been agreed, which added Madrid to the geopolitical pot. But throughout the period Washington, London and Moscow consistently maintained pole positions. By 1998 President Aliyev declared his geopolitical plan was in place, and further contract awards would be driven by commercial considerations alone. Canada arrived in 1999. With 15 offshore contracts and 4 onshore contracts, involving 30 investing companies in total; Phase I (1994-1997) of Azerbaijan's oil development was truly a period of regional and international cooperation with increasing optimism for the future. It saw investment decisions being taken on purely commercial grounds, and it created a sound basis for significant internal economic renewal.

South Caspian Regional Pipelines and National Interest

Under the terms of the AIOC Production Sharing Contract, the consortium had the obligation to prepare for a future Main Export Pipeline to accommodate the large volumes of export crude that were being projected for the South Caspian. Consequently from as early as 1994 AIOC began detailed feasibility studies for competitive long term major pipeline route options. One was to be eventually selected, essentially on competitive commercial grounds. A variety of route options were to be considered; Baku-Novorossiysk (RF), Baku-Supsa (Georgia) and Baku-Ceyhan (Turkey). Supplementary reviews of Bosphorous by-pass options were also to be done in recognition of the seriousness of this marine logistical bottleneck. A southern route option through Iran was soon eliminated by the commercial realities involved.

However by late 1997 the fact that main export pipeline selection was to be a "zero sum game" with a single winner, caused a seachange in regional political opinion. For the South Caspian, Turkey took an entrenched position in favour of Baku-Ceyhan. This became a central plank in foreign policy. For them it was the only option to be considered, even though Baku-Ceyhan could never be the lowest cost option. Politics began to override commercial considerations. Moscow (Nemtsov) was equally convinced that their northern route to Novorossiysk would have the commercial edge; but recognised that the route carried inherent problems for security through the North Caucasus. A Chechen by-pass was proposed. At the same time AIOC and its investor shareholders saw the Main Export Pipeline as being required for long term export only, when cumulative offshore production levels would commercially support investment in a 1 million barrel a day pipeline. AIOC were still engaged with the commercial concept of expansion of their "Early Oil" pipelines, perhaps as a first phase of future MEP development. This would ensure continuity of ongoing investment, and would accommodate the next tranche of oil to be evacuated from Chirag-Azeri (350000 b/d). Thus for a variety of reasons polarisation of regional political interests became focussed on the Main Export Pipeline issue. The regional cooperation enjoyed by AIOC for its Phase I Early Oil Project was dissipated. "Trade was now being forced to follow Flag". The result was delayed investment (1997-); when non-economic pipeline options were being promoted by governments, against the commercial interests of the foreign investors.

Three Geopolitical Blocs emerged from this South Caspian debate:

Bloc 1. "Proactive Challenge" (for Baku-Ceyhan only); led by the USA and Turkey, but including Azerbaijan and Georgia. These now aligned their broader foreign policy interests with Washington in direct conflict with Moscow. At the same time but with some reluctance, Azerbaijan tacitly supported US Containment policy against Iran.

Bloc 2. "Frozen Instability" (with no new pipeline activity); led by Russia together with Armenia and Iran. Their primary aim was to maintain a regional "status quo", with no rebalancing of regional interests, until such time it was in the interest of the Bloc so to do. The collective aim was to resist all further expansion of US interest in the region.

Bloc 3. "Measured Neutrality (for multiple private sector pipelines); led by the European Union but with the full support of the Foreign Oil Companies. All saw the even handed balance of regional interest as being critical to long term stability and security. They supported a pipeline policy of "multiple options" which meant what it said.

This polarisation into self interest blocs now worked against long term stability and security. It represents the Second Phase (1997-) of Foreign Policy Development in the Caucasus; putting at risk much of the positive change that was achieved in Phase One (1994-1997). It has undermined the need for compromise between Armenia and Azerbaijan over Nagorno-Karabakh, (which itself impacts on the long term security of any pipeline system to Turkey); whilst more importantly promoting global consequences as well. Recent events in Kosovo, the second Chechen war, and the sensitivities of Russia to the new global order are all intimately tied up within the Caucasian regional paradigm.

But for Azerbaijan and Georgia this regional power play has had a more immediate effect. There has been a material slow down in internal investment, delayed income for government, and the absence of work (new jobs) for the population at large. Two years of ongoing investment in new infrastructure by AIOC has been lost during procrastinated MEP negotiations. A decision for a \$3 billion development project on the Azeri structure remains in abeyance. Internally this has created a developing crisis of confidence. There is a growing internal belief that Azerbaijan's Oil Policy could be potentially flawed; against the long term interest of the State. Many service contractors left Baku, as they could not tolerate delays, and major new hotel and office complexes remain under utilised. Initially US foreign policy in the region was focussed very much on the moral high ground. They aimed to support the long term independence of the countries of the South Caucasus and Central Asia through economic renewal; to be based on the rule of law, respect for human rights, the promotion of the democratic process, a free press, and the fostering of free market economies. This policy remains in place and is shared in full by the European Union. But the support of any national

independence, by definition, engages the external player in the broader geopolitical arena. For the US this meant constraining Russian and Iranian influence in the region; whilst simultaneously requiring an increased presence in the region by the US itself. This inevitably led to regional diplomatic and commercial conflict which almost by default became focussed on the pipeline issue. All was largely based on an untested perception that enforced selection of pipeline routes for petroleum export from the Caspian would determine long term geopolitical outcomes.

For the US this invoked as a first priority their direct support for Turkish ambitions in the Caucasus and Central Asia. It reflected long term regional security obligations (particularly for the Middle East), as well as for Turkey's regional economic interests. Firstly by supporting Turkish pipeline ambitions in the Caspian without any financial obligations, it provided a low cost option for the US to strengthen its alignment with Turkey. Secondly it provided a direct vehicle to promote ILSA and Iran Containment. From this in 1997 the US Office of the Caspian Coordinator was born. Regional geopolitical conflict became inevitable; as both Russia and Iran saw Baku-Ceyhan as the centre piece of an American strategy to dominate the Caspian region, with their own exclusion. But with the EU remaining passively in the background, by default it encouraged this belief.

But Baku-Ceyhan as a geopolitical symbol to cement the members of Bloc 1 into a coherent long term stable alliance was one thing. What the US was not prepared to do was to provide the private sector with direct economic incentives (subsidies) to see that the line became a physical reality. Despite the Baku-Ceyhan Accords of October 1999; no public sector external finance has emerged.

There is still insufficient Caspian oil available to fill the proposed Baku Ceyhan design capacity, and justify short term construction. New South Caspian oil discoveries will be made; but to bring this oil to market will involve long term development lead times (seven years or more). AIOC already has potential moveable oil, but no existing export capacity. In the absence of financial subsidy for Baku-Ceyhan, they are forced to look at more prudent and pragmatic solutions. Expansion of their existing infrastructure remains their immediate alternative. With current insecurity in the North Caucasus, Baku-Supsa expansion would be technically and commercially their first choice. This could even be part of a Phase I development of a future main oil line from Baku to Ceyhan. However the situation is now at impasse; and urgently needed ongoing investment by AIOC in Baku remains suspended. Already two years delay on this investment decision have cost the foreign investors lost value; and pushed out material cashflow to Azerbaijan under the AIOC Contract to 2005 and beyond.

The Present

Today a very fragile political and economic "status quo" pertains within the Caucasus, which is unlikely to survive unless strategic change occurs. Major expectations were raised by the latest OSCE Summit in Istanbul (10/99), at which Presidents Clinton and Yeltsin were present. A degree of political rapprochement between Russia and America was expected; with at least a resolution of the Karabakh Conflict as one positive outcome. In the event the meeting was overshadowed by the deepening Chechen crisis, and the threats by Russia against non-interference by those present in their internal affairs. In particular Russia demanded respect from the international community, concomitant with their leadership position in the World. The language of the Cold War returned.

So where does this leave Baku-Ceyhan and the politicisation of Caucasian pipeline routes? Given the symbolic profile promoted by the US for Baku-Ceyhan with all its associated geopolitical rhetoric, to retreat from its position would be a serious blow to US prestige and credibility within the region. For Azerbaijan and Georgia, who also firmly nailed their flags to the Baku-Ceyhan mast, in the absence of success for Abkhazia and Karabakh they now need to accept a political U-turn if they are to allow AIOC to go ahead with existing pipeline expansion. Likewise because the US were unwilling to subsidise Baku-Ceyhan itself, they encouraged Turkey to take on substantial financial risk (a low bid turnkey contract on the Turkish sector of Baku Ceyhan) at a time when the country is already experiencing considerable economic problems and other pressing needs for internal capital investment. When there are already doubts over the timing of such export capacity needs,

and in the absence of foreseeable investment from the private sector, it should be in Turkey's own economic interest to delay this premature pipeline expenditure. Turkey could obtain all necessary South Caspian commitments to Baku-Ceyhan through a phased approach, with Baku-Supsa expansion first, followed by an extension to Ceyhan. By encouraging Georgia and Turkey to see pipelines in political rather than economic terms, the US not only raised expectations that other perhaps more critical issues would be removed to compensate for potential economic loss (Karabakh and Abkhazia), it inevitably led to serious souring of political relations with their immediate neighbours (Russia and Iran).

The Future

So how does one rise above such complexity to overcome a dangerous stalemate? Herein must lie a visionary role for the European Union to facilitate long term stability for its own strategic self interest. With Turkey's long term initiative to join the EU becoming a reality; with the geopolitical realities surrounding EU-Russian relationships and the security of common borders; and with rapidly improving relations between EU and Iran; all combine to suggest that the leadership role previously enjoyed by the US should realistically now pass to the EU. This would not only help defuse current pipeline conflicts of interest; it would also allow the US to back off gracefully from where it currently finds itself; without resort to financial penalty (subsidies), or loss of political prestige.

Such change would make particular strategic sense within the context of a common European Union Energy Policy. As we have seen, Southern Europe (together with the Black Sea) must become the market destination for Caspian crude, at a time when European North Sea supplies are in terminal decline. Caspian crude is vital for European long term strategic interests. As the lead foreign investors in Caspian Energy Development are now predominantly European, this enhances this position. Commercial self interest will continue to maintain UE alignment with the US investment sector.

Similar comments can be made for the transportation of Central Asian Gas, with Turkey as the entrepot. This is a broader issue that cannot be covered here. But it is an undoubted certainty that the enormous proven gas reserves of Central Asia, the South Caspian and Iran, are more than sufficient to provide an economically viable and sustainable gas supply into Southern Europe for the 21st Century as a whole. This gas is certainly the key alternative to a Russian monopolistic gas supply long term. This is reflected in the current race to capture the existing Turkish Gas Market; between Russia's Blue Stream Project on the one hand and the Turkmen-Azerbaijan Transcaspian Gas Pipeline Project on the other. This too is a "zero sum game", as only one project will win. The Turkish Gas Market is unable to absorb both gas supplies. If the Transcaspian project loses, the South Caspian will not only lose an immediate investment of \$2.5 billion, but Caspian Turkmen gas reserves could well become stranded assets for the foreseeable future or longer. It should be in the EU interest to see that this does not occur.

Existing EU initiatives in Central Asia and the Caucasus (TRACECA, INOGATE, Energy Charter) for the rehabilitation of regional logistics and infrastructure for East-West trade have already raised a profile for EU in regional political leadership. Clearly for the EU to promote successful long term regional renewal in the Caucasus, the issues surrounding existing conflicts (Karabakh, Abkhazia) must be resolved with some immediacy. Demography and energy resources must play a major role in policy formation. However freemarket private sector investment will inevitably be needed to underpin the process. Coordination will be complex between the Private and Public Sectors, but broad based analogies with the economic renewal of post WWII Europe immediately spring to mind. Time is of the essence, as despite success to date the region is fragile and could still revert to chaos.

Conclusions

To summarise:

- Caspian Oil Reserves (30nb/d proven, 40nb/d YTF) are material within a global context; but compare more closely to North Sea projections than inflated comparisons with the Persian Gulf.

- Caspian Production should average some 3 million barrels per day by 2010, if no long term dislocations in the development process occur.
- Caspian oil will never be a global swing producer, as its production will be strategically tied to Southern Europe and the Black Sea. However 10% of Caspian Oil will move south to the markets of North Iran.
- Caspian Exploration Failure Cost is high; but Finding Costs are low. Offshore oil developments in the Caspian are commercially viable long term, but for the major oil companies only.
- Fully built up Caspian Development Cost is currently approximately \$12.50/bl; which is predicted to fall to \$8.0/bl within the coming decade.
- Caspian crude is commercially competitive on a global basis, in all scenarios which involve an Oil Price of \$15/bl (Real) or more.
- In the first Phase of Baku Oil Development (1994-1997) ÆFlag followed TradeÆ. For the second Phase of Baku Oil Development (1977-) ÆFlag has attempted to Lead TradeÆ. The consequences have been negative.
- The politicisation of regional pipeline routes from the South Caspian over the past two years has reopened regional conflicts. It has suspended economic renewal of the Caucasus, without compensatory resolution of internal conflicts (Karabakh, Abkhazia).
- Unless there is an immediate return to politics of regional cooperation, current instabilities within the Caucasus will become exacerbated.
- It is in the urgent economic and political self interest of both Azerbaijan and Georgia to cooperate with AIOC and the Transcaspian Pipeline Project; to sanction these two projects this year; to attract an immediate \$4 to 5 billion of new investment into the South Caucasus.
- Long term Caspian Energy Supplies are strategically critical for Southern Europe and the European Union. EU leadership in their development together with the security of the region is politically prudent and expedient.
- In terms of Large State-Small State Relations in the Caucasus; "Better a Good Neighbour than a Distant Relative" ö Old Georgian Saying.