The Caspian Dilemma: Prosperity or Conflict?

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Abstract

Caspian oil&gas were, until the recent oil price decline, seen as the next Kuwait. We are unlikely to see another "Gulf", but the crux of the matter is transit and political risk. Caspian oil & gas is disadvantaged because its natural markets in the region and in Eastern Europe have low demand, which cannot be paid in US $. All other markets are far away, adding to transit cost. Moreover, all pipeline routes go through problematic areas. The East-West Baku-Ceyhan corridor is uncompetitive. The Russian route, through already existing Russian pipelines, is most easily available. But the Chechen situation, pipeline quality and the monopoly power of Gazprom and Transneft are obstacles. China needs oil and gas but it may be unable to absorb the additional cost of pipeline imports/transit from the Caspian. Finally, all current transit options have the "Iranian option" overhanging them: If US sanctions against Iran abate, which is possible, would then all planned heavy-investment projects in other pipelines become uncompetitive? Experience shows that pipelines in political waters - e.g. the Middle East - do not do well. The Caspian governments have not learnt to manage well their relations. The political risks involved imply that it would take a brave investor and banker who is ready to absorb the multiplication of the many political risks in the region. The legal status of the Caspian Sea remains unsettled, and experience shows that an unsettled legal status discourages investment in disputed areas. The dispute is as yet unsettled, though Russia (and Iran) seem to be moving closer to some division of at least the subsoil oil&gas areas. What is at issue is a contest between two modes of thinking: The geopolitical philosophy versus the logic of global markets. Companies, subject more to capital markets pressure than to stateâs grand designs, prefer that the logic of the market prevails. Russia may benefit the most from the market logic. If it exercises its power, it will do so at its own great cost. If it accepts the logic of global markets, it will benefit from prosperity in the Caspian. The issue for all these countries is if they are ready to focus on how to become prosperous, rather than how to maximise their respective influence. Prosperity requires recognition, penetration and acceptance of the rule of law in internal relationships, with the oil companies and with each other. The EU is perhaps best positioned for this. It has no major geopolitical ambition nor real muscle, but it seeks the stability on its Eastern border, in commerce and energy supply. This led to the 1994 Energy Charter Treaty with its Art. 7 guaranteeing transit of energy. Its technical assistance programmes are large; it has developed a tight network of economic treaties with all participants and it has no serious problem with anybody. It should now support all actors to move from the field of war to the arena of lawyers, procedures and negotiations. We need to help the Caspian region to develop good governance, both internally and in their international relations.

Geopolitics of the Caspian

The oil and gas resources in and around the Caspian Sea are viewed by most of the Caspian states as the foundation for future wealth, influence and power. These views are shared by many international oil companies which have invested heavily, by states keen on exploiting their geographical position to obtain oil and gas transit income, by consumer states including the EU, and by geopolitical players such as the US, Russia, Iran, and Turkey. Often exaggerated views on the oil and gas potential inform national and international politics in the region and have concentrated the attention of the main producer countries almost exclusively on the goal of obtaining prosperity through petroleum development. Similarly, such perceptions influence the foreign policy of the main players, with traditional geopolitical power politics complemented by economic objectives, e.g. investment opportunities for national companies. Interstate (Azerbaijan/Armenia) and intrastate (Georgia, Tajikistan, Turkey, Russia) conflicts combined with the intervention of outside players, interact with the oil and gas interests. Insecurity increases investment and transit risks, and oil and gas income is hoped, or feared, to boost the strategic position of the owner states in such conflicts.

The Caspian as an Oil Province: A Realistic View

Some over-optimistic assessments of both the oil and gas reserves and the financial benefit from production/export have increased the expectations of producing countries and their populations, the anxieties of non-producing neighbours, interest of potential transit states and the competitive sentiment of countries with interested companies. In fact, the Caspian is unlikely to become, as sometimes hoped, a new "Gulf". Its resources are comparable to those of the North Sea, with perhaps 2-3 % of the worldâs production. In addition, the production costs are much higher than in the Gulf and most OPEC countries, although lower than in the North Sea and new competing projects in Russia. The transportation costs (even the pure technical ones) are higher than for most competitors. The markets for Caspian oil and gas should be mainly in the region - but these most likely consumers at this time show depressed demand and can not pay; in the next circle are the markets in Eastern and Western Europe.

These conditions make Caspian oil and gas vulnerable to the fluctuations in oil prices. In 1998/1999 the oil price moved to very low levels (US$ 10 per barrel), with a subsequent recovery to around US$ 20. Companies, at present, base their investment decisions on prices around 15 US$. Low levels (i.e. below US$ 15) are likely to have the following impacts:

- The massive investments anticipated, in particular by the Caspian governments, are not likely to materialise. Companies will drive down and stretch their investment programmes, shift from expansion to "harvesting". Under "normal" conditions with oil prices at US$ 15 and political and transit risk not higher than in the major competing regions, one should expect an annual investment of 2-3 billion US$. This reflects pro-rata the ratio of Caspian/world reserves to world oil and gas investment. Much of the high investment figures in circulation are not unconditional or irrevocable investment commitments that are legally binding as of now, but rather estimates of investment that might be made over decades in case positive assumptions materialise. If included in an agreement, they are as a rule hedged by many conditions stretching over a long period of time. Many such conditions are, as all parties realise but do not say, unlikely to ever be met. They are in many cases a political and commercial make-believe for the political convenience of governments.
- A low oil price discourages frontier and high-risk investment, makes financing difficult and imposes a slower and more incremental investment rhythm. With the prospect of high profitability reduced, and market risks being added, projects can not sustain significant exploration.
- An oil price that is lower than assumed in original studies and contracts leads inevitably to corporate tactics to gain time while maintaining control over acreage: protracted studies, long negotiations, reference to never-ending governmental and intergovernmental discussions, but without actually committing investment.

To sum up, it is extremely difficult to ascertain or predict what reserves there are in reality. Only continued exploration, itself dependent on geological and economic assessment, can do this. Nor can we predict the oil prices of the future. The most recent experience ö with extreme downward volatility of oil prices÷casts a shadow over expectations of large and rapid exploration and development. But such development is burdened by political and transit problems - a higher oil price can help to surmount them more easily, a lower price creates a check on greed and geopolitical ambition, and sharpens the profile of the economic and technical logic.

Legal Status and Division of the Caspian Oil and Gas

There is no clear rule for defining the legal status of the Caspian sea and dividing the underlying oil and gas resources among the coastal states. Neither previous (USSR-Iran) treaty practice (binding upon the successor states of the USSR) nor international law of the sea (which is not directly applicable to this situation) provide an unequivocal answer. No generally accepted rules on the status and partition of international lakes currently exist. In this situation, one needs to appreciate that the various legal strategies and concepts used express foreign policy and petroleum strategy objectives. Russia, which relies on the idea of the Caspian as an international lake and on interpretation of the earlier agreements between the USSR and Iran, has used the "common resource" concept to oppose the unilateral division of the Sea by the principal oil and gas countries (Azerbaijan and Kazakhstan). The latter invoke the analogies from the law of the sea (the "zones of national jurisdiction", method of "equidistance," and so forth) to divide the Caspian among the coastal states by creating their national sectors.

Oil and gas development requires or is at least much facilitated by certainty in the issues of jurisdiction. Investment is discouraged if severe jurisdictional disputes, in particular involving powerful countries, undermine the security of title issued by one of the state parties to such disputes. Russian legal argument aims at both reinforcing its involvement in the development of Caspian oil and gas, and at precluding the US, its present geopolitical competitor in the area, to establish its dominance in the region.

The intensity of the legal (and thereby political and commercial) controversy has somewhat abated. There is obvious Russian interest in exploiting the apparently emerging oil and gas potential in the northern part of the Caspian. Some Russian oil companies have been won over by participation in Azeri offshore production-sharing contracts in consortia with Western oil companies. Similarly, the Russian interest in maintaining its political influence in the "near abroad" is now challenged by more modern economic interest. Impoverished neighbour countries kept on some form of post-colonial leash provide little economic benefit by trade and investment. Economic development in the Caspian states at least opens an opportunity for trade - due to reasons of language, culture and proximity, and possibly also for investment by Russian oil and gas companies. The 1998 Russian-Kazakh Agreement, under which the seabed is divided between the states concerned while the waters remain the common property, demonstrates the shift in the Russian position.

The most likely solution will be the mutual recognition of extended territorial waters, or other similar zones, under full coastal state jurisdiction, and the division of the Caspian seabed and its subsoil oil and gas resources between the riparian states. The Sea itself, in particular its marine living resources and other environmental concerns, may lend itself more easily to joint approaches and regional co-operation. However, jurisdictional disputes between the coastal states are likely to remain for a while. These new states are not accustomed to peaceful settlement of such disputes by negotiation. They can not afford to be seen to be giving in on territorial matters. International customary law, as manifested in the decisions of International Court of Justice, is not precise and specific enough to provide an easy and clear indication of where and how borders should be drawn. Existing (for example between Azerbaijan and Turkmenistan over the Kyapaz/Serdar deposit) and potential jurisdictional disputes are bound to undermine the security of any title granted by governments in a disputed area.

One solution to be considered is the use of "joint development" regimes as already practised in the North Sea (unitization of the Frigg field) and in disputed areas between Indonesia and Australia, Malaysia and Thailand, and Japan and South Korea. There are two types of regimes that are relevant. The first deals with a petroleum field straddling the agreed and undisputed delimitation line ("Frigg-Agreement" between Great Britain and Norway), which is designed to facilitate its efficient exploitation. Licensing and rules are established jointly, and revenues are usually shared in some ratio reflecting the estimates of oil reserves contained in the parts of the field belonging to the two countries respectively. The second is mainly a device to allow development of oil and gas resources in disputed areas without the political cost of settling the border definitively. Here, a joint regime for licensing, regulation and taxation is set up, and revenues and control are shared - sometimes with variations such as granting each country a predominant role in one part of the disputed area. It is therefore a very pragmatic way of avoiding protracted boundary negotiations and allowing the development to go ahead.

To sum up, the not yet resolved legal status of the Caspian is a serious obstacle to full development of its oil and gas resources (and development of an effective environmental regime) under "normal" circumstances. International law does not have a clear and specific solution at hand, but it provides a full range of concepts, precedents and procedures, which have not yet been fully utilised by the Caspian states. Such avenues as the submission of disputes to the International Court of Justice or international arbitration, and legal methods such as a Joint Petroleum Development Agreement are available and tested sufficiently elsewhere.

Transit

Oil and gas development in the Caspian region is presently largely pointless without long-distance transit. Local and regional markets are all affected by the economic collapse following the demise of the Soviet Union and can contribute neither sufficient demand nor ability to pay to finance the large-scale investment. Access to markets - mainly in Central and Western Europe and Turkey - is therefore the key to development. These transit requirements raise two issues:

- First, long-distance transit adds appreciably to the final costs of hydrocarbons. The lower the expectations about future oil prices, the more the transit requirements will obstruct the commercial viability of investment. Transit infrastructure also requires massive front-end investments. Transit costs include both "technical" costs (construction and operation of pipelines and loading facilities) and "transit fees" charged by transit countries. Transit fee or rather transit rent is another project risk. The limited ability of countries in the region to negotiate and maintain stable reciprocal arrangements raises another hurdle for setting up effective transit arrangements.

- Second, transit into most of the available directions is fraught with substantial political risk. The East-West corridor solution (over the Caucasus, through Georgia and across the Caspian and Black Seas) raises serious legal, political and environmental problems. Interstate and intrastate conflicts in the Caucasus and in Turkey pose a serious threat to secure and unimpeded transport of hydrocarbons. Pipelines through Iran - technically and economically perhaps the best option - confront the US policy of sanctions, whereas pipelines to China with its large market and a relatively risk-free transit area are too long and therefore possibly prohibitive.

The history of Middle East pipelines illustrates that few pipelines have survived and prospered in politically volatile areas. Successful pipelines ö Trans-Mediterranean (Algeria-Tunis-Italy) and Maghreb-Europe (Algeria-Morocco-Spain) seem to be based on a depoliticised environment, private law models and limited state involvement. Pipeline projects can, under favourable economic circumstances, accommodate, deal with and manage the political risk of an individual country. However, the pipelines from the Caspian will have to deal with multiple interstate and intrastate risks. It seems as the least expensive and least risky pipeline projects will be completed over the next ten years, possibly with considerable delay along with equally slow oil and gas development.

Considerable US and Turkish pressure for the longest and most expensive transit route - to Ceyhan in the Turkish Mediterranean - implies that it may not commercially feasible. A reasonable assumption is that the higher the political pressure, the greater the economic deficit of such projects. It is therefore hard to see how companies operating in a now very competitive environment can accept ö without a facility to re-allocate such risks - the alleged imperatives of home state foreign policy rather than the commercial logic of the global markets.

It is conventional wisdom (and so argues Thomas Stauffer in the July 1996 issue of the OPEC Bulletin) that Russia is likely to exploit its geographical position as the most important transportation route at the moment as well as its remaining post-imperial leverage. Perhaps this is too simplistic. There seems to be a major dilemma in the Russian oil&gas and foreign policy communities, with forces adhering to traditional influence-seeking foreign policy vying for supremacy with the more modern forces oriented rather towards economic logic. The psychological challenges of digesting decolonisation for Russia may be similar to those faced by the UK and France ö where it took decades to start to accept former colonies as truly independent countries. The more open policies of the Russian petroleum pipeline monopoly "Transneft" and some Russian petroleum companies, efforts to achieve at least some success of the Caspian Pipeline Consortium project to bring Kazakh oil to the Black Sea, progress with the gradual resolution of the property regime of the Caspian Sea and severe competition with Turkey for the main pipeline route for Azeri oil illustrate the weight of the commercial forces . In fact, Russia is as dependent on the good will and economic sense of other transit states, for example Ukraine and Latvia, as the Caspian states are on Russia.

The crucial importance of transit has encouraged the search for stronger legal instruments to facilitate transit and reinforce the security of pipelines and transit arrangements. The key legal instrument is the 1994 Energy Charter Treaty. First, it provides for extensive protection of property and contractual rights of foreign investors, bolstered by a possibility of direct investor-state arbitration. Second, it includes a novel obligation of member states to facilitate transit, abstain from politically motivated disruption and, within capacity, provide access to pipelines. This multilateral treaty provides assurance beyond traditional guarantees by bilateral agreements. Currently, there are negotiations to expand transit provisions of the ECT into a special multilateral binding instrument.

Legal arrangements alone are not sufficient to ensure that states will respect transit or that security of pipelines will be guaranteed in all circumstances. However, with the expanding availability of legal precedent, frameworks and procedures, there is the prospect that the rule of law in relations among the Caspian states and between these states and private companies will gain ground and improve the legal and political environment in the region.

The Future of the Caspian Oil and gas ö Signals to Watch

The future development path of the Caspian region is so clouded with uncertainties that no simple forecast seems possible. The way to deal with this is to identify a number of "signals" which indicate and support either a positive path ö towards investment, contribution to economic development and prosperity ö or a negative path, towards stagnation and economically destructive political intrastate or interstate conflicts. Each and every signal may not necessarily determine which path is taken, but taken together they point toward a likely direction.

Positive signals for Caspian oil and gas development are:

- Oil and gas prices at high levels. This would provide a profit margin to counter the additional risk premium required. Apart from their role in technical and financial calculations, high oil prices have a way of making investors forget or disregard high political and transit risks ö an element of mass psychology is always inherent in investor behaviour.

- Shifting Russian policy from the "Great Power" syndrome to commercial common sense. This would help the new states of the Caspian to move as well from instincts of self-preservation to prosperity.

- Significant discoveries of reasonably low-cost oil and gas fields. This would make the Caspian attractive for investors again, in particular if it coincides with a high or reasonably high oil price.

- Willingness of China, the US and Turkey to pay for their well known "strategic" interests by assuming cost risks of pipeline infrastructure, cost overruns and external and internal security risk. This would diminish the risk premium required for Caspian projects.

- A clear transition towards "legal" and civilised behaviour among the states concerned. This would include acceptance and practical implementation of the rules of the game established by the Energy Charter Treaty, investment protection treaties and GATT/WTO. In this case long-term investment and trade opportunities in the Caspian region will increase and become practically exploitable.

On the other hand, "warning signals" include:

- Political instability and insecurity in the main producer and transit countries. Inability to manage the political succession and neighbourly wars will enhance the risk and thereby cut-off investment projects except in high-profit situations.

- Resumption of a "Great Power" game with intervention in producer and transit countries. This will inevitably lead to "dead pipelines", large losses and the unwillingness of investors and banks to re-engage themselves financially. If a major pipeline project goes definitively sour for reasons of competing politics and insecurity ö we have many cases of this in the Middle East ö then new project investment is unlikely to become available for quite some time again.

The oil price is a permanent and decisive factor in these calculations. While it is wrong to always look at todayâs price as the indicator of what investors do or should do, it is a potent signal, and basically out of the hands of the Caspian states. Such unrelated events as the fluctuation of energy demand in Asia, the opening up of Kuwait and Saudi Arabia to foreign investment, a full-fledged rehabilitation of Iraqâs oil potential, ability of OPEC and other producer countries to agree on and stick to quota restrictions can make or break Caspian projects.

Can the Caspian Region Move towards Good Governance

The perception that a large resource endowment is available has always fuelled political tensions over distribution of property and benefit from resource development. It could even be argued that the absence of a large resource endowment is more conducive to peace and prosperity than its presence in the contested political environment. But the oil and gas resources are there. Their exact dimension is not yet known, but there is a wide perception that they are quite substantial, with the need to assess their possible impact. The first requirement is that the property rights to such resources must be unambiguous, determined by agreement. The second requirement is that the development and transport/transit of such resources needs an equally clear legal framework to make them work.

The new Caspian states are currently struggling for preservation internally and externally. There is little tradition of national or international law or culture of contractual commitment. The states and their political and cultural elites are beginning to learn how to understand, formulate and utilise the legal procedures implicit in modern statehood both to deal with internal and external conflict. If there is something the international community ö i.e. the at present prosperous and peaceful Western states ö can do it is to support, persuade and pressure these states and their societies toward the habits of living under the rules of civil society both in internal and international relations. Such a transition can not take place overnight. It requires a slow process of nurturing and habituation, informed by example, developed in the end internally and reinforced by success. There is little future for big projects if they are built on the sand of instability.

The oil and gas endowment of the Caspian, whatever its contribution to tension in the first place, lends itself to the deployment of the instruments of law. It requires agreements between states on demarcation, distribution and legitimisation of property rights. The method of joint petroleum development ö postponing the definitive border delimitation by a joint system for collaborative licensing of disputed areas and distribution of the revenues ö is particularly suitable for developing technical and legal collaboration.

An oil and gas development contract also forces the country to understand the logic of technology, finance and markets, and to import the standards of the oil industry, including on safety and environmental protection. Similarly, the oil and gas agreements between investors and a host state teaches it the need to respect contractual commitments and be seen as respecting them. In short, while oil and gas reserves can incite regional tensions, the logic of their development also has a powerful effect in teaching the virtues of law and contract. Similarly, the imperatives of oil and gas development can have a civilising effect on neighbourly relationship. The impact of disputed borders and unresolved transit, of closed markets and transportation routes, of military threats and externally fomented internal subversion usually leads to a lose-lose situation. Resolving such disputes means that the oil and gas industry can pay a peace premium. So international good governance and economic development through the petroleum industry usually go hand in hand.