

**RUSSIA AND CASPIAN OIL: Moscow Loses Control**

**Abraham S. Becker**

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## **PREFACE**

This paper is one in a series on the general subject of Russia's interest in and attempts at economic integration of the CIS. The author first began research in this area in 1992-93, under a joint Arroyo/Project Air Force project entitled, "The Twin Arcs of Crisis: New Strategic Challenges for the United States in Europe and the Former Soviet Union". A draft paper prepared for that project remained unpublished because of lack of funds. After his retirement and transfer to Emeritus status, the author returned to the subject in 1995. His survey of Russian policy in this area, "Russia and Economic Integration in the CIS," was published in the Winter 1996/97 issue of *Survival*. The present paper offers an examination of Russian policy and behavior in a particular regional and functional cut. It is hoped to continue with additional regional analyses.

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## SUMMARY

This paper examines Russian policy and behavior regarding the exploitation of Caspian Sea hydrocarbons in terms of three broad issues: ownership of the seabed resources; participation in the international development consortia that have been formed to exploit these resources; and the routes, construction and ownership of the pipelines linking the Caspian to world markets. Because the subject is so large, this paper focuses on oil and largely ignores natural gas development.

The policy context of the assessments in this paper is the Russian government's asserted aim of integrating the members of the CIS (Commonwealth of Independent States) into an economic and political union. Integration may be attempted at the macro level -- coordinated actions by national authorities to change the formal institutional structure of their international relations -- and at the micro level, the creation of international linkages via market processes at the enterprise or sector level. The activities examined in this paper fall into both classes and in the interaction between them.

**The Legal Status of the Caspian Sea.** For several years the Russian Ministry of Foreign Affairs (MFA) insisted that the Caspian was to be viewed as a lake, whose resources belonged jointly to the littoral states and could only be exploited by consensus decisions. Azerbaijan, forcefully, and Kazakhstan, somewhat less so, maintained that the Caspian was an inland sea; under international law of the sea, the seabed should be divided into national sectors under the exclusive control of the individual littoral states. Almost needless to say, the conflict of these views was not about legal principles but about the profits, influence and power of denial that accompany the right to dispose of valuable mineral resources. Moreover, it was well known that the most promising sectors of the Caspian were those claimed by Azerbaijan, Kazakhstan and Turkmenistan.

Between the spring of 1994 and the fall of 1996, the MFA pressed hard for a formal recognition of the Sea as a lake and protested the

unilateral development plans of Azerbaijan and Kazakstan, but without any success. Unexpectedly, the MFA announced that it would accept national sectors out to 45 miles from the shoreline but it would continue to insist on joint control of future exploitation outside the 45 mile zone. This proposal was clearly intended to split off Kazakstan and Turkmenistan, whose oil sites lie generally within 45 miles of their shores, from Azerbaijan, which is claiming sites far beyond such a line. Baku rejected the MFA's offer; Almaty (Kazakstan) offered soothing words but stopped well short of full acceptance; and Ashgabat (Turkmenistan), although contesting specific Azerbaijani claims in or near the middle of the Sea, came around to Baku's view.

In the fall of 1997, the MFA withdrew its 45-mile proposal and reluctantly acceded to the division of the seabed into national sectors. The MFA is now seeking acceptance of the principle of joint control of the waters and surface of the Sea. Kazakstan seems prepared to go along, but Azerbaijan and Turkmenistan are opposed.

De facto the Caspian has been partitioned; de jure settlement, if it can be reached at all, remains for the future.

**Participation Rights.** Another part of the Russian government pursued a quite different policy. As Azerbaijan and an international oil consortium, the AIOC (Azerbaijan International Oil Co.), were negotiating a contract for offshore development that came to be called "the deal of the century", the Russian Ministry of Fuel and Energy signed an agreement with Azerbaijan in November 1993 confirming Baku's right to the fields in dispute. The apparent quid pro quo was a 10 percent share in the AIOC for Lukoil, the largest Russian oil company, in which the energy ministry was the largest shareholder. The ministry openly approved the signing of the development contract between Baku and the AIOC in September 1994, to the chagrin of the MFA. Lukoil subsequently obtained stakes in four other development consortia which contracted with Baku to explore offshore sites in the Azerbaijan sector; in only one of these was Lukoil given a majority holding. Lukoil did not participate in five other major Azerbaijan offshore contracts; in one case Lukoil was specifically refused admission, probably because the



Russian company's participation in previously concluded deals had not altered the MFA's hard line on the legal status issue.

Lukoil sought a 20 percent share in the joint venture of Chevron and the government of Kazakhstan to develop the onshore Tengiz field, the country's richest. Because Chevron was hoping for a larger pipeline quota from Moscow, it provided Lukoil with a 5 percent share. Moscow's failure to realize Chevron's hopes is probably responsible for Lukoil's inability to enlarge its holding, despite persistent efforts. Neither Lukoil nor other Russian companies are currently slated to participate in Kazakhstan's impending development of its offshore deposits. The Russian companies do not seem to be interested so far in Turkmenistan's inaugural development projects.

**Pipelines.** The strongest leverage Moscow has held over Caspian basin development stems from geography and Soviet policy. The Caspian is landlocked, so export requires pipelines or railroads crossing national frontiers. Soviet policy left just a few pipelines in the region and almost all run north-south through Russian territory. The large volumes of Caspian oil projected to come on stream in the first decades of the next century mandate large new pipelines, requiring massive investment.

Four main routes for exports to Western markets have been under consideration:

- Through Iran to the Persian Gulf seems the shortest and cheapest, but this option is presently ruled out by U.S. government opposition.
- Moscow strongly prefers the "northern" route, which would take Azerbaijan oil to the Russian Black Sea port of Novorossiisk via Dagestan and rebellious Chechnya. Novorossiisk is also the accepted destination for Tengiz oil on a route along the northern end of the Caspian.
- Under the "western" route, oil from Baku would be piped through Azerbaijan and Georgia to the latter's Black Sea port of Supsa.
- Turkey wants a major share of Caspian oil to be piped to the Turkish Mediterranean port of Ceyhan, via Azerbaijan and Georgia.

Because substantial transit fees as well as political and economic leverage are at issue, the debate over route choice is again hardly about technical considerations but centers on political and economic advantage.

*Northern route.* The pipeline from Baku via Grozny to Novorossiisk (hereafter, BGN pipeline) has been the only complete pipeline on the western side of the Sea. As such it was the obvious candidate for transporting "early" oil, the output from the AIOC sites expected in limited quantities until 2002-2005. Moscow has pressed for shipping "later" oil, the full stream expected after 2005, through the BGN as well. The major counter-argument was the threat to the security of the BGN, particularly because of the poisoned relations between Moscow and Grozny even after the end of the war in Chechnya. Kidnappings, armed incursions, acrimonious negotiations over transit fees and operating conditions induced Moscow to announce in September 1997 a projected bypass around Chechnya. The project has experienced considerable cost escalation however, and its completion date is uncertain. In view of the instability of Dagestan, the security of a bypass through that province is questionable.

*Tengiz and the pipeline to Novorossiisk.* The Caspian Pipeline Consortium (CPC) was formed in 1992 to construct a line from Tengiz to Novorossiisk. It took almost five years to reach agreement on the allocation of shares. The Russian government plus Lukoil and Rosneft, another Russian oil major, directly and in partnership with others, own 35-40 percent, while the holdings of the Kazakstan government and one of its companies were cut to below 21 percent. The CPC is also troubled by sharply rising construction costs, and completion is not likely before the first half of 2001. In the meantime, the Tengiz development consortium has been constrained by severe limitations on the amounts that Transneft, the Russian pipeline monopoly, will accept for export through Russian territory. Transneft, it has been made clear, has no interest in increasing competition with Russian crude exports.

As a result Kazakhstan has been searching for interim expedients: by tanker across the Caspian and then by rail to Georgia's Black Sea coast; swapping Kazakhstan oil to northern Iran for shipments from Iran's Persian Gulf ports (currently on hold for technical and administrative reasons); and piping oil from Kazakhstan south across Turkmenistan to Iran (still held in reserve in the spring of 1998, most likely because of American government opposition).

*Western route.* In a compromise between unwillingness to depend completely on the BGN pipeline and concern about offending Moscow, Azerbaijan and the AIOC agreed in October 1995 to ship early oil, which came on stream after a year's delay at the end of 1997, through two pipelines -- the BGN and one from Baku to Supsa. A decision on the route for later oil was left to the future. The MFA and Transneft protested, urging exclusive reliance on the BGN. Once again the energy complex diverged from the MFA and expressed its satisfaction with the compromise.

Security and cost inflation affect the Baku-Supsa line as well. The unsettled conflict over Nagorno-Karabakh and Armenian-Azerbaijani hostility carry potential threats to pipeline segments in nearby Azerbaijan and Georgia. Tbilisi has disputes with the provinces of South Ossetia and Ajaria. Especially dangerous is the one with the breakaway province of Abkhazia on the Black Sea coast. The Baku-Supsa pipeline was supposed to be ready by the end of 1998, but the line was in worse condition than expected: projected construction costs have doubled and the completion date is uncertain.

Azerbaijan oil piped to Supsa would be shipped to Europe via the Turkish Straits. In March 1997 Azerbaijan and Ukraine proposed to send some Azerbaijan oil from Supsa to Ukraine for both local consumption and reexport to Europe. Because the project involves construction of a fleet of tankers to make the sea link to Odessa, an oil terminal there and a pipeline to the Polish border, the concept seemed prohibitively expensive. The project was revived in the spring of 1998, due partly to the delay in beginning the pipeline to Turkey, discussed below, and to Baku's proposal to double the diameter of the Baku-Supsa line. The

latter idea, itself a response to the sharply increased construction costs, would increase throughput capacity by a factor of six and provide more than enough oil to supply the Ukrainian route as well. Nevertheless, high costs and uncertain financing becloud this option too.

*Black Sea vs Mediterranean.* The sole maritime exit from the Black Sea is the Turkish Straits. Since mid-1994 Ankara has attempted to restrict oil tanker traffic through the Straits, allegedly to minimize pollution from oil spills. This raised Moscow's interest in a pipeline from the Bulgarian Black Sea port of Burgas to Greece's Mediterranean outlet of Alexandroupolis. Financing difficulties and disputes over allocation of shares however have kept this project on a back burner.

Turkey has pushed hard for a pipeline between Baku (via Azerbaijan, Georgia and Turkey) to Ceyhan on its Mediterranean coast. Russia has campaigned for the northern route with public contention and private pressure. Moscow cited the threat to the security of the Turkish route from the Kurdish regions of eastern Turkey and the high costs of a long land route through Georgia and Turkey. Russia pressed the governments of Azerbaijan and Georgia to support the northern route; Tbilisi believes that two attempts to assassinate President Shevardnadze are linked to this campaign. Moscow also offered various incentives to the same end.

Neither covert action nor blandishments however have moved Baku and Tbilisi. The former continues to affirm its preference for Baku-Ceyhan as the main export route from the Caspian; the latter would prefer a much enlarged Baku-Supsa line but will accept one to Ceyhan that still crosses Georgia.

The prospect of significant output from Kazakstan and Turkmenistan sites has given rise to a proposal to lay a pipeline across the Caspian seabed and join it to the projected Baku-Ceyhan line. The U.S. government warmly supports the proposal but Moscow rejects it, allegedly because oil spills would pollute the Sea and impair its valuable fish resources.

The Caucasus and Central Asia appear to be lining up in favor of the trans-Caspian-Baku-Ceyhan pipeline. The Russian government is

divided: the energy ministry and former Prime Minister Chernomyrdin appeared ready to accept the principle of multiple export pipelines from the Caspian, but the MFA remains unpersuaded. As usual Lukoil goes its own way, supporting the shipment of Kazakhstan oil through Azerbaijan, expressing interest in participating in the construction of a main export line through Georgia, and exploring participation in the Baku-Ceyhan line with Turkish authorities.

**What has Moscow wrought?** Russia's struggle to maintain control over the exploitation of the Caspian basin's mineral wealth has been examined in terms of three cardinal issues:

On the status of the Caspian. Russia has lost the battle for joint control of the entire seabed. Moscow has reluctantly agreed that each littoral producer has the right to develop offshore oil and gas for its own national benefit and in contract with whomever it wishes. That right may be challenged on the surface or subsurface of the Sea, as Moscow now seeks to secure agreement on the principle of joint control above the seabed.

On participation rights. The Russian energy sector overcame the MFA's opposition to Russian oil company membership in the international oil development consortia. Lukoil, to the greatest extent, another Russian oil major and the Russian government, to a much smaller extent, have footholds of varying size in Azerbaijan-sector development projects, the Caspian Pipeline Consortium and the exploitation of Tengiz oil. Lukoil had hoped to account for 20 percent of all Caspian oil output by 2005. That would hardly constitute a controlling interest, nor would it guarantee dependence by non-Russian producers on Russian resources or service. It appears unlikely however that Lukoil will come close to reaching that goal.

On pipelines. The battle is still being waged, but on less advantageous terms than seemed likely a few years ago. Despite the problems of cost and financing that beset the alternatives to the BGN pipeline, there is a good deal of political steam behind the trans-Caspian-Baku-Ceyhan project; other projects are being vigorously pursued.

How can we explain Russia's failure to secure control over the exploitation of the Caspian basin and the changes in Russian government policy that have occurred in the process? Several contributing factors suggest themselves:

1. Credit is due to the determination of the heads of the Caucasus-Central Asian states -- particularly, Azerbaijan's Heydar Aliyev, Kazakhstan's Nursultan Nazarbayev and Georgia's Eduard Shevardnadze -- who stood their ground under at times intense Russian pressure.

2. "Simple realism" eventually won out. Despite Russian threats, Azerbaijan concluded ten major deals with international consortia and Kazakhstan and Turkmenistan joined the game. As Deputy Prime Minister Nemtsov ruefully acknowledged: "We have wasted a lot of time and the Americans have taken root in the Caspian region."

3. The Russian energy complex, supported by the prime minister, opposed the MFA's policy direction and subverted its militant demands. Like the MFA, the energy complex was interested in control of the Caspian, but its instrument was the penetration of Russian oil companies into the international consortia.

4. Russia's efforts at integration in the Caspian basin failed at the macro level and made only slight progress at the micro level through development participation. Trade between Russia and the other Caspian-area Soviet successor states is becoming less rather than more important. Integration in the CIS as a whole has made little progress, due, first, to the lure of integration in the world market and the international community, against the uncertain economic benefits and possible unpleasant political costs of closer association in the CIS; and second, to Moscow's own ambivalence on the relative economic value of CIS versus world market integration, and on the costs, in terms of a renewed "burden of empire", of any possible strategic gains through CIS integration.

5. The economic and military weakness of post-Soviet Russia appears as the ultimately decisive factor. It is impossible to imagine that Soviet Moscow, even allowing for the independence of the former Soviet republics, would have tolerated such deviations from central policy as Azerbaijan and Kazakhstan managed to pull off in the last few years. Nor

is it likely that the West would have been nearly as bold in promoting the cause of the CIS littoral states -- and the commercial interests of the Western oil companies -- if the Soviet Union had held together. The MFA pursued Russian foreign policy goals, including the integration of the CIS states, with vigor and dedication, but its tenacity could not screen the decline in Russia's power. The Caucasus-Central Asian states seem to be pulling still further away from Russia in their recent international associations.

One caveat should be noted. The high costs of extraction and transportation of Caspian oil render the ambitious development projects there vulnerable to the price weakness that has been experienced recently in the world market. Continued extensive price declines could delay the higher cost projects and thus provide the basis for one of the few scenarios in which Moscow could regain a larger foothold in the disposition of Caspian resources.

Absent such a development, or a far more improbable sudden rejuvenation of Russia's economic and military power, Moscow will not regain anything like its pre-1991 hold on the region, at least in the foreseeable future





## **1. INTRODUCTION**

The oil and gas potential of the Caspian Sea basin is immense, second only, it is said, to that of the Persian Gulf. The realization of this potential however is immensely complicated. It constitutes a unique international affairs problem that cuts across economics, politics and security. It has engaged multiple actors, ranging from isolated bandit groups to national states and international consortia, whose interests and activities over the past five years span thousands of miles along the middle of Eurasia.

As long as the Soviet Union existed, there were no significant conflicts over Caspian Sea hydrocarbons. Moscow decided issues of exploration, development and distribution, with little interference from Teheran, or any other state. The regional focus of Soviet energy development moreover was not the Caspian but West Siberia. The collapse and dissolution of the USSR fundamentally transformed the Caspian equation. Instead of two Caspian states, Iran and the USSR, with the latter asymmetrically dominant, there were now five independent entities-- Iran, Russia, Kazakstan, Turkmenistan and Azerbaijan. Russia's severe economic and military decline unleashed a struggle for control of the basin's resources. The three other Soviet-successor states, striving for independence and viability, were powerfully motivated to exploit the immense wealth at their doorstep. Beyond the five littoral states were several other countries -- Armenia, Georgia and Turkey, even Ukraine -- who had sizable economic and political concerns in the disposition of the basin's mineral resources. The extraction and transportation of the prospective oil and gas reserves came to involve international commercial interests around the globe and national state interests as far flung as those of Bulgaria and Greece in the West and China and Japan in the East. In the background loomed the United States and other European powers who had an economic stake in the oil and gas resources -- in part because of the participation of their

international conglomerates in Caspian development -- and a political stake in the relations between Russia, other Soviet successor states and other regional powers, especially Iran. This radical change in the regional power alignment and the perceived size of the oil and gas bonanza were responsible for the ensuing multilateral struggle over the disposition of the Caspian basin resources.

The political economics of Caspian hydrocarbons focuses on three broad issues: ownership of the seabed resources; participation in the international development consortia that have been formed to exploit these resources; and the routes, construction and ownership of the pipelines linking the Caspian to world markets. In turn, these ramify into a network of subissues that generate or reflect competition between regional powers, centering on the efforts of the newly independent states to escape economic stagnation and on the tangled ethnic-national-religious conflicts in the Caucasus.

Much has already been written on this subject, and satisfactory treatment of all these factors would require a book. This paper restricts itself to the examination of Russian policy in the Caspian in the three issue areas outlined above. Further, the paper largely ignores natural gas developments, focusing instead on the exploitation of Caspian Sea oil.

The assessment of Russian Caspian Sea policy takes as its context the Russian government's asserted aim of integrating the members of the CIS (Commonwealth of Independent States -- the loose association of the former union republics of the defunct USSR except the three Baltic states) into an economic and political union.<sup>1</sup> Moscow's strategy toward the CIS, in the words of Yeltsin's September 1995 decree on that subject, is aimed "at the creation of an integrated political and economic community of states which can aspire to a respected position in the world". The "consistent promotion of integration processes in the CIS framework", Yeltsin later declared, is "Russia's main foreign policy

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<sup>1</sup>On Russia's overall integration policy, see Abraham S. Becker, "Russia and Economic Integration in the CIS," *Survival*, 38:4, Winter 1996-97, pp. 117-36.

priority."<sup>2</sup> Most of the CIS states suspect that the "promotion of integration processes" only barely conceals the Kremlin's drive to reestablish control of a region it regards as strategically vital. Unfortunately for Russia, it seeks integration in a new and unfavorable geopolitical environment, as already noted. Moscow's central conundrum is how to overcome Russian power weakness in the face of Western, particularly American, interest in limiting Russian imperial sway. This paper's principal finding is that Moscow has not yet hit upon a solution.

The author has previously distinguished between "macrointegration" -- coordinated actions by national authorities to change the formal, institutional structure of their international economic relations -- and "microintegration", the creation of international linkages via market processes at the enterprise or sector level.<sup>3</sup> The present paper deals with actions at both levels and the interactions between them.

The three issue areas are taken up in order in the next three sections. A final section summarizes the findings and seeks to identify the underlying causes.

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<sup>2</sup> OMRI (Open Media Research Institute), *OMRI Daily Digest*, No. 181, September 18, 1995; *Rossiiskie vesti*, June 1, 1996, in FBIS (Foreign Broadcast Information Service), *Daily Report -- Central Eurasia* (hereafter: FBIS, SOV or FBIS, USSR), SOV-96-115-S, June 13, 1996, p. 51.

<sup>3</sup>Becker, "Russia and Economic Integration...", pp. 118-120.

## 2. THE LEGAL STATUS OF THE CASPIAN SEA

Who owns the oil and gas underneath the Caspian Sea? Azerbaijan, forcefully, and Kazakstan, somewhat less so, have maintained that the Caspian is an inland sea, and that the international Convention on the Law of the Sea, which calls for dividing the seabed into national sectors, fully applies. Russia had insisted that the Caspian is a lake, all of whose resources belong jointly to the littoral states, and that these rights continued to be governed by the terms of Soviet-Iranian agreements of 1921 and 1940. Hence, Moscow contended, the oil and gas in the seabed could not be utilized except by consensus of the five states.<sup>4</sup> Azerbaijan countered that these treaties had nothing to do with the exploitation of seabed mineral reserves, which was in fact regulated by a June 1991 agreement between the USSR Ministry of the Oil Industry and the then Azerbaijan republic government.<sup>5</sup> Russia's position was, until recently, supported by Turkmenistan and especially by Iran. Ashgabat (Turkmenistan) appears to have changed its stance; Moscow is in retreat; perhaps only Tehran continues to hope for joint control.

The Soviet-Iranian treaties, inter alia, implicitly prohibited participation of third parties in the development of the Sea's resources. Neither Azerbaijan nor Russia was capable alone of handling the financial, technical and logistical problems of developing the Caspian, a fact that Moscow did not dispute. The Russian stance must therefore be understood as directed less to keeping the international

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<sup>4</sup>For a fuller statement of the Russian Ministry of Foreign Affairs' position, see Alexandre Matveev (legal department of the MFA), "Le statut de la mer Caspienne: le point de vue russe," *Le Courrier des pays de l'Est*, No. 411, August 1996, pp. 55-61. See also Vladimir Razuvaev, "Russian Interest in the Caspian Region: The Energy Dimension," *Stiftung Wissenschaft und Politik (Ebenhausen, FRG)*, May 1996. The deputy director of Rosneft, the Russian state oil company, went so far as to suggest that Moscow claim the former Soviet oil equipment now being used by the other Caspian states as Russian property. *Monitor* (Jamestown Foundation), I:59, July 25, 1995.

<sup>5</sup>See the interview with Azerbaijan's Foreign Minister, Hasan Hasanov, in *Nezavisimaya gazeta*, February 20, 1996, in *CIS Weekly Press Survey* (hereafter, *CIS WPS*), III:7, February 17-23, 1996.

conglomerates out than to restoring Moscow's supremacy over the development of the basin. Almost needless to say, the conflict was certainly not about legal principles but about the profits, influence and power of denial that accompany the right to dispose of valuable mineral resources.<sup>6</sup>

It has escaped no one's attention either that the most hydrocarbon-promising sectors of the Caspian so far are those claimed by Azerbaijan, Kazakhstan and Turkmenistan. The Russian and Iranian sectors are far less richly endowed. Whether authentic or otherwise, a purported memorandum from then Foreign Minister Kozyrev to then Premier Chernomyrdin conveyed a plausible warning: Acceptance of Azerbaijan's jurisdiction into the middle of the Caspian would lead to a division of the Sea's resources such that "Russia would end up in the most disadvantageous position because it would receive the most insignificant and unpromising section of the Caspian."<sup>7</sup>

Azerbaijan was the first of the littoral states to begin development of Caspian oil deposits with foreign help. Negotiations began in 1992 and an international consortium, the Azerbaijan International Oil Co. (AIOC), was formed in the summer of 1993 to develop three highly promising offshore sites -- Azeri, Chirag and Gyuneshli. Baku claimed all three within its jurisdiction. An important feature of the ensuing dispute is that "offshore" with respect to these deposits extends to almost 125 miles into the Sea, clearly beyond the limit of coastal waters. (At its widest point, below the fields in question, the Caspian is over 250 miles across.) The agreement reached in September 1994 between the Azerbaijan state oil corporation and AIOC was said to be worth about \$7.5 billion, earning it the journalistic sobriquet, "deal of the century".

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<sup>6</sup>Russia also expressed concerns about fishing, navigation and other issues that it charged were compromised by the "go-it-alone" stand of Azerbaijan and Kazakhstan. Razuvaev, "Russian Interest in the Caspian Region".

<sup>7</sup>Ali Naibov, citing the alleged text of the document from the Azerbaijan press, in *Kazakhstanskaya pravda*, November 5, 1994, in FBIS, USR-94-127, November 22, 1994, p. 87.

On April 28, 1994, Russia's Ministry of Foreign Affairs (hereafter, MFA) informed the British government that

the Caspian Sea is an enclosed water reservoir with a single eco-system and represents the object of joint use within whose boundaries all issues or activities including resource development have to be resolved with the participation of all the Caspian countries.

The letter concluded with the warning that "any steps by whichever Caspian state aimed at acquiring any kind of advantages with regard to the areas and resources...cannot be recognized." The admonition was evidently directed at British Petroleum, the lead company in AIOC.<sup>8</sup>

A second MFA demarche to the British government cited the possible dangers to the Caspian eco-system.<sup>9</sup> Three months later the MFA renewed its objection to the consortium deal with Azerbaijan on ecological grounds -- later, extinction of sturgeon was listed as a case in point.<sup>10</sup> The MFA also asserted however that the 1921 and 1940 treaties continued to bind all the Soviet successor states.<sup>11</sup> When the Azerbaijan

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<sup>8</sup>*Financial Times*, May 31, 1994.

<sup>9</sup>RFE/RL (Radio Free Europe/Radio Liberty), *Daily Report*, June 8, 1994.

<sup>10</sup>"What interests the American, British or Norwegian companies involved in the consortium is to pump oil, and the circumstance that the Caspian Sea may turn into a swamp as a result, with its unique sturgeon species perishing, is, naturally, of little concern to them." A "high-ranking member" of the MFA to the Interfax News Agency, November 14, 1994, in FBIS, SOV-94-220, November 15, 1994, p. 10. The threat to Caspian sturgeon, which is real, appears to derive partly from oil and gas operations but also from discharge of raw sewage and petrochemical plant wastes into the Sea as well as from poaching of immature sturgeon in the northern Caspian by Azerbaijan and Kazakhstan. *New York Times*, December 23, 1995, p. 39; Interfax News Agency (hereafter IF), *IF Business Report*, 116 (1536), June 24, 1997.

<sup>11</sup>RFE/RL *Daily Report*, September 21 and 23, 1994. According to a legal scholar: "Apart from the fact that those [treaties] only regulated the fishing and shipping rights and not the economic exploitation of the sea, it is necessary to point out, particularly to Russia, that they could not have regulated the question of the exploitation of the continental shelf because this concept did not come into being until 1944." Henn-Juri Uibopuu, "The Caspian Sea: A Tangle of Legal Problems," *The World Today*, 51:6, June 1995, p. 121. This is one of the main arguments advanced by Baku in support of its position. See, e.g., *Nezavisimaya gazeta*, January 19, 1996, in *CIS WPS*, III:3, January 20-26, 1996.

parliament defiantly ratified the consortium agreement on November 15, 1994, the MFA spokesman threatened: "Ignoring current international obligations may entail serious political and international consequences."<sup>12</sup>

The MFA reiterated its objections frequently during the next two years but without noticeable effect.<sup>13</sup> In the fall of 1996 Moscow redoubled its efforts. The then minister for cooperation with the CIS states, Aman Tuleyev, lamented that "we have already wasted time. Talks need to be held immediately. Otherwise integration [between the fuel-energy sectors of Russia and the CIS states] may not even be contemplated."<sup>14</sup> The warning was in point. Shortly thereafter, the presidents of Azerbaijan and Kazakhstan jointly declared that each littoral state had the right to develop the mineral and biological resources in its sector of the Sea.<sup>15</sup> In November Boris Berezovsky, then deputy secretary of the Russian Security Council, came to Baku apparently to caution Aliyev that if he did not agree to joint sovereignty in the Caspian, in the words of the newsletter, *Pipeline News*, "Moscow had plenty of weapons at its disposal -- halting gas deliveries, limiting pipeline access, imposing export tariffs." On his heels, however, came James Collins, then the U.S. State Department's point man for the New Independent States, to pronounce for the first time Washington's clear support of sectoral division and national sovereignty in the sectors.<sup>16</sup>

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<sup>12</sup>ITAR-TASS, November 15, 1994, in FBIS, SOV-94-222, November 17, 1994, p. 3.

<sup>13</sup>E.g., in July 1995 (when an unidentified "senior diplomat" threatened "a whole range of measures, including tough ones" if Azerbaijan did not comply -- *Monitor*, I:58, July 24, 1995; a first deputy foreign minister denied the threat on July 28 -- *Monitor*, I:64, August 1, 1995); in November 1995 (*Monitor*, I:143, November 22, 1995, and I:145, November 27, 1995); and in October 1996 (*Monitor*, II:193, October 16, 1996).

<sup>14</sup>*Pipeline News*, 28, September 7-13, 1996.

<sup>15</sup>*Monitor*, II:172, September 17, 1996 and *Pipeline News*, 30, September 21-27, 1996.

<sup>16</sup>*Pipeline News*, 38, November 16-22, 1996. The Russian newspaper *Segodnya* also speculated that Berezovsky's trip aimed to convince local leaders that "economic cooperation is profitable and an oil confrontation [with Russia] is dangerous." Cited in *ibid*.

Perhaps that tipped the balance.<sup>17</sup> Unexpectedly, the MFA announced that it would accept delimitation of national sectors out to 45 miles from the shoreline; it would be prepared to discuss the jurisdiction of sites already being drilled beyond that line; but it would continue to insist on joint control of future exploitation outside the 45 mile zone. Foreign Minister Primakov proposed a double tender system, under which littoral states would have first claim on development participation in future contracts let by any of them. Possibly because the idea of double tenders seemed patently self-serving, he also offered to recognize 10-20 mile national fishing zones.<sup>18</sup>

The MFA announcement was clearly intended to split off Kazakhstan and Turkmenistan, whose oil sites lie generally within 45 miles of their shores, from Azerbaijan, which is claiming sites far beyond such a line. It was also evident that such an agreement would give Russia a share of the resources in the rich Azerbaijan-Turkmenistan corridor of the Sea, which Moscow would otherwise have little hope of attaining, and a stronger say generally in decisionmaking on disposition of Caspian resources. Baku naturally would have nothing to do with the Russian plan. Almaty and Ashgabat did sign on in November, but in neither case did the eventual outcome please Moscow.<sup>19</sup>

Kazakhstan apparently was willing to offer soothing words but stopped short of concessions on actual property rights. It declined an invitation to join Russia, Turkmenistan and Iran in founding a company to develop the reserves in the proposed jointly-owned area of the Sea. Almaty also declared, on its own and on Baku's behalf, that the joint

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<sup>17</sup>It is also noteworthy that Russia was considering letting development contracts for the Russian offshore deposits. *Pipeline News*, 28, September 7-13 and 30, September 21-27, 1996. This implicit acceptance of the legitimacy of national sectors made the MFA's declaratory position awkward.

<sup>18</sup>*Monitor*, II:202, October 29, 1996; *OMRI Daily Digest* (successor to the RFE/RL *Daily Report*), 219, November 12, 1996; Jamestown Foundation, *Fortnight in Review*, I:10, November 15, 1996. The double tender proposal was in fact another form of demand for participation rights, an issue discussed in the next section.

<sup>19</sup>The capital of Kazakhstan was moved from Almaty to Akmola in late 1997 and renamed Astana in May 1998. To avoid confusion, Almaty alone is used in this paper to denote the Kazakhstan government.



company would not be allowed to work in the Azerbaijan and Kazakstan sectors.<sup>20</sup> It has continued to support Baku's position on national sovereignty and sectoral division.<sup>21</sup> Kazakstan also announced that despite the lack of agreement among the five littoral states on the status of the Sea, it would begin working deposits in the Kazakstan sector in 1997.<sup>22</sup>

Moscow found a way to retaliate. In mid-1997 it publicized a tender competition for development of offshore reserves in the northern part of the seabed but situated partly in an area claimed by Kazakstan. Moscow first ignored and then rejected Almaty's protests. The tender offer, an MFA official pointedly declared, "corresponds to the current legal status of the Caspian."<sup>23</sup> Kazakstan's President Nazarbayev, clearly, understood the hint:

The whole problem stems from the fact that the big oil was found on Kazakstan's, Azerbaijan's and Turkmenistan's continental shelf, and not on Russia's. Had the big oil been found on the Russian shelf, then Russia would have taken a completely different stand.<sup>24</sup>

Turkmenistan, in contrast, signed both November 1996 agreements, on the division of the Sea between commonly-owned and national sectors, as well as on the creation of a joint littoral-state company to exploit the common areas. Three months later Turkmenistan laid claim to Azeri and part of Chirag, two of the three fields being developed by the AIOC, as lying in "Turkmenistan waters".<sup>25</sup> At first the MFA rushed to applaud, fully backing Ashgabat's claim on the disputed oil sites.<sup>26</sup> Just as

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<sup>20</sup>OMRI *Daily Digest*, 219, November 12, 1996 and 220, November 13, 1996; *Pipeline News*, 39, November 23-29, 1996.

<sup>21</sup>Monitor, II:172, September 17, 1996 and II:174, September 19, 1996; IF, *Daily News Bulletin* (hereafter, *IF News*), June 25, 1997.

<sup>22</sup>OMRI *Daily Digest*, 235, December 6, 1996. .

<sup>23</sup>*If News*, September 18, 1997; John Helmer, "Central Asia: Uncertain Currents in Caspian Oil Game," RFE/RL, October 1, 1997, copied in *Johnson's Russia List*, 1248, October 2, 1997; RFE/RL *Newsline* (successor to *OMRI Daily Digest*), 142, October 20, 1997.

<sup>24</sup>Monitor, IV:15, January 23, 1998.

<sup>25</sup>*Financial Times*, January 23, 1997; Monitor, III:18, January 27, 1997; *Pipeline News*, 46, February 1-7, 1997.

<sup>26</sup>The MFA may have been misled by Ashgabat's demand that Baku compromise on the Sea's status.

hastily however it withdrew support, perhaps when it realized that the claim implied a right to sectoral division and national jurisdiction in the Sea.<sup>27</sup>

In the summer of 1997 Turkmenistan protested Azerbaijan's contract with an international consortium to develop the Kyapaz field, which lay closer to the Turkmenistan coast. Russia's oil giant Lukoil was a participant in that consortium and Ashgabat refused to engage in any further discussions of the legal status of the Sea until Lukoil withdrew from the deal.<sup>28</sup> Under pressure from Moscow, Lukoil complied.

The differences between Turkmenistan and Azerbaijan/Kazakhstan on the legal status as well as Ashgabat's particular dispute with Baku may be on the way to resolution. In February 1997 Turkmenistan's President Niyazov agreed with Kazakhstan's Nazarbayev on the temporary division of the Sea out to its middle line into national sectors, until the legal status was determined by joint agreement. Simultaneously they recognized "each other's right and that of all the littoral states to carry out work to develop mineral resources in the sea bed." Ashgabat began seeking international help in developing deposits in the Turkmen sector that summer.<sup>29</sup> At the end of 1997 Azerbaijan and Turkmenistan agreed to create a joint commission to determine their sea border on the principle of the median line. The commission was instructed to deliberate in a spirit of "consensus, reasonable compromise and mutually advantageous partnership". After all, the "partners" noted, "a large part of Caspian oil reserves is located precisely in the corridor between Azerbaijan and Turkmenistan."<sup>30</sup> The MFA was visibly unhappy.<sup>31</sup>

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<sup>27</sup>*Monitor*, III:32, February 14, 1997 and III:33, February 17, 1997. Indeed, the head of the Caspian working group in the MFA asserted that all existing (presumably, Soviet-era) maps "show that the Azeri and Chirag structures belong to the Azerbaijan sector of the Caspian Sea." His point was that "first the status of the Caspian Sea should be defined, and then rights to own concrete oil fields should be discussed." *Pipeline News*, 49, February 22-28, 1997.

<sup>28</sup>*IF News*, July 29 and August 16, 1997; *RFE/RL Newsline*, 95, August 14, 1997.

<sup>29</sup>*RFE/RL Newsline*, 115, September 11, 1997.

<sup>30</sup>*Monitor*, III:230, December 10, 1997.

<sup>31</sup>*Monitor*, III:45, March 5, 1997.

Faced with the unyielding resistance of Azerbaijan as well as the opposition of Kazakstan and Turkmenistan, and left with only one, ineffective ally, Iran, Moscow in effect threw in the towel. The MFA withdrew its proposal for 45-mile national sectors and hinted that it might no longer oppose national sectors.<sup>32</sup> The Russian government issued a tender for the development of a vast block on the North Caspian shelf during the second half of 1997, and thereby signaled that it was joining, after failing to lick, the national sector developers.

By the spring of 1998 Azerbaijan and Turkmenistan had made progress in resolving their dispute, having agreed on the principles of national sectors and division of the sea from a median line; Russia was on the way to an agreement with Kazakstan on the principle of national sectoral division of the seabed.<sup>33</sup> The Russian Foreign Ministry told Azerbaijan's President Aliyev that

Russia has decided to take a serious step towards a compromise on the delineation of the Caspian Sea.... We recognize the rights of littoral states to their zones of activity, but from the point of view of shipping and the ecology there must be a single system.<sup>34</sup>

The difference between "sea" and "seabed" may however be significant. Could joint control of the Caspian waters and surface legitimate a Russian attempt to regulate the number, size or location of drilling platforms on the surface?<sup>35</sup> Or to scuttle the projected trans-Caspian pipeline (discussed in a later section), which Russia opposes? The Russian government advanced its new principle of national sectoral division of the seabed and joint regulation of the waters of the Caspian through the first months of 1998. In April Azerbaijan rejected the principle: While it welcomed the Russian-Kazakstan agreement on national sector division of the seabed, Baku continued to believe that "not only

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<sup>32</sup>*If News*, October 17, 1997; *RFE/RL Newsline*, 160, November 14, 1997.

<sup>33</sup>*IF News*, February 5, 1998, and *Monitor*, IV:25, February 6, 1998. Iran seems to have adopted the Russian position. *IF News*, June 2, 1998.

<sup>34</sup>Lada Yevgrashina, "Focus: Russia Says Willing to Compromise on Caspian," *Reuters*, March 30, 1998, copied in *Johnson's Russia List*, 2125, March 31, 1998.

<sup>35</sup>Michael Lelyveld, "Russia: Moscow's New Caspian Policy?" *RFE/RL*, April 7, 1998.

the floor but also the water and the surface of the sea should be divided up".<sup>36</sup> Baku has convinced Ashgabat of the merits of this position,<sup>37</sup> but not Almaty: Nazarbayev seems prepared for a formal agreement with Yeltsin on the Russian position.

De facto, then, the Caspian has been partitioned. De jure settlement, if it can be reached at all, remains for the future.

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<sup>36</sup>*IF News*, April 15, 1998.

<sup>37</sup>*Monitor*, IV:74, April 17, 1998; *IF News*, May 16, 1998.

### 3. PARTICIPATION RIGHTS

The author of virtually all the Russian government statements and positions cited in the previous section is the MFA. Another part of the Russian executive, curiously, pursued a quite different policy. This was one important reason why Almaty and Baku remained relatively unperturbed by the Russian pressure for joint control.<sup>38</sup> In the fall of 1993 the Russian Minister of Fuel and Energy formally confirmed Azerbaijan's right to the main fields in dispute.<sup>39</sup> The apparent quid pro quo was a 10 percent share in the AIOC for the Russian oil giant, Lukoil, which Baku carved out of the 30 percent allocation to its state-owned company, Socar.<sup>40</sup>

Negotiations with Lukoil had been going on since the summer,<sup>41</sup> when, in October, Russia's prime minister Chernomyrdin suggested reserving a 12-mile territorial-waters zone for each littoral state and then declaring the rest of the sea a neutral zone. Baku took the hint and extended the invitation to Lukoil. As one journalist reported, "practically everyone regarded [the invitation] as Baku's payment for Moscow's obligingness."<sup>42</sup> More dramatically, Lukoil's admission to the consortium may have been linked to a military coup that overthrew pro-Turkish President Abulfaz Elchibey in May 1993 and brought Heidar Aliyev, ex-KGB general and ex-Soviet Politburo member, to power. Some observers speculated that the coup was supported by the Russian "power

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<sup>38</sup>Another, surely, was the overt American support for their claims. See *Monitor*, II:234, December 16, 1996. The fact that Terry Adams, the British president of the AIOC, was knighted in June 1997 is only one indication that Baku had the support of London as well.

<sup>39</sup>Aidyn Mekhtiev, "Who Will Get the Rights to First Oil?," *Nezavisimaya gazeta*, June 2, 1994.

<sup>40</sup>Lukoil reported that the company produced some 55-60 million tons of crude a year in 1995-96 and refined about 20-25 million tons. *Pipeline News*, 27, August 31-September 6, 1996.

<sup>41</sup>Aidyn Mekhtiev, "The Current Status of the Caspian Does Not Suit Russia," *Nezavisimaya gazeta*, June 15, 1994.

<sup>42</sup>Ali Naibov, in *Kazakhstanskaya pravda*, November 5, 1994, in FBIS, USR-94-127, November 22, 1994, p. 86.

ministries" -- the armed forces, security, police -- possibly the subsurface mass whose visible surface tip was the MFA.<sup>43</sup>

Against this background, the MFA's overt and vigorous opposition to the AIOC deal is said to have astonished and irritated the Ministry of Fuel and Energy -- incidentally, a major shareholder in Lukoil. A deputy energy minister was dispatched to Baku to witness the signing of the deal in September 1994, an obvious snub to the MFA. An energy ministry spokesman noted archly that there were various interests involved, "each of which could have a different position."<sup>44</sup>

Such agnosticism did not go down well with the MFA, whose first deputy legal advisor accused the Fuel and Energy Ministry, and the minister personally, of damaging Russian national interests by failing to coordinate positions with the MFA. "Anything like this would previously have cost a person his Party membership card," the legal advisor fumed.<sup>45</sup> In the immediate aftermath of the signing, Azerbaijan was violently shaken again by the assassination of two Azeri officials, close associates of Aliyev, and an attempted insurrection against him. Aliyev branded Russia the instigator.<sup>46</sup>

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<sup>43</sup>"Russian Pressure on Azerbaijan," *Foreign Report* (The Economist), 2311, July 14, 1994, p. 1. The "power ministries" and the MFA are subordinate to the president, not the prime minister and the government. Chernomyrdin had long-standing ties to the energy sector.

<sup>44</sup>John Lloyd, "Kozyrev Adds to Doubts Over Azerbaijan Oil Deal," *Financial Times*, September 23, 1994.

<sup>45</sup>OMRI *Daily Digest*, October 7, 1994. The legal department was still outraged a year later: "If one considers [the energy ministry's? Russia's?] future interests, it is difficult to find a rational explanation for the agreement signed in 1993 with Azerbaijan by the Russian Minister of Energy, which recognized 'an Azerbaijan sector in the Caspian Sea.' Concluded in haste, without assurance that the government had given its endorsement and that the minister was authorized to sign, the agreement is worthless." Matveev, "Le statut de la mer Caspienne," p. 58.

<sup>46</sup>Charles H. Fairbanks Jr. and Elshan Alekberov, "Azerbaijan and the Ominous Rumblings Over Russia's 'Near Abroad'," *Washington Times*, November 1, 1994. Many Georgians believe there was a Russian hand behind the attempted assassination of Georgia's President Eduard Shevardnadze in August 1995, perhaps in connection with Georgia's claim for a pipeline route from the Caspian to Turkey's Mediterranean coast, which is discussed below. A second attempt on Shevardnadze's life came in February 1998 and was also blamed on Moscow. See below, p. 37.

The MFA may well have been concerned with broad national strategy in the Caspian; the Ministry of Fuel and Energy and Lukoil, its proxy or ally, were promoting more parochial if still ambitious interests.<sup>47</sup> Lukoil's top priority, its president declared, was increasing its participation in Caspian Sea development. "By the year 2005 Lukoil will extract 20 percent of the oil produced in that region," Alekperov promised.<sup>48</sup> After getting a tangible share of the "deal of the century", Lukoil, backed by considerable Russian government pressure, sought participation in other oil projects, in both Azerbaijan and Kazakhstan. In Azerbaijan:

- Lukoil joined Socar, Agip (Italy) and Pennzoil to develop the Karabakh deposit, just north of the AIOC sites (estimated reserves: roughly 85 million tons of oil and 18 billion cubic meters of gas<sup>49</sup>). Lukoil acquired a 7.5 percent holding for its own and shared another 50 percent with Agip.<sup>50</sup>
- Lukoil pursued a 20-40 percent stake in a consortium formed to work the Shah-Deniz oil and gas field, southeast of the AIOC sites, and one of the richest in the Sea (estimated 100 million tons of oil, 200 million tons of gas condensate and 400 billion cubic meters of gas). Lukoil was whittled down to 10 percent in the final distribution of shares, although it continued to press for more.<sup>51</sup>

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<sup>47</sup>Alekperov revealed that while the Fuel and Energy ministry did not manage state energy firms, it coordinated their activities and development strategy and directed the implementation of large scale projects. *Pipeline News*, 27, August 31-September 6, 1996.

<sup>48</sup>*Segodnya*, August 30, 1996, in *Economica WPS*, August 31-September 6, 1996.

<sup>49</sup>This deposit had never been drilled, so the estimate is more than normally hazardous. Another source claimed recoverable reserves of 130 million tons of oil. *Pipeline News*, 44, January 18-24, 1997.

<sup>50</sup>*Segodnya*, June 10, 1995, in *Economica WPS*, II:22, June 10-16, 1995; Reuters, June 10, 1996; *IF Oil and Gas Report*, 15 (278), April 18, 1997. Richard R. Dion ("Cutting Up the Caspian," *The World Today*, 54:3, March 1998, p. 81) maintains that Lukoil's share is 12.5 percent alone and 45 percent in partnership with Agip.

<sup>51</sup>*Monitor*, I:156, December 12, 1995; *OMRI Daily Digest*, 35, February 19, 1996; *Pipeline News*, 3, March 2-8, 1996; *Monitor*, II:68, April 5, 1996. Lukoil also obtained a controlling bloc of shares in the

- Lukoil negotiated with Baku and Socar for participation in Kyapaz, part of which Turkmenistan claimed, as noted earlier, and in Inam (estimated 120-150 million metric tons of oil), where Lukoil was seeking a 50 percent share.<sup>52</sup> Socar refused to invite Lukoil into the Inam project, reputedly in outrage at the demand for a 50 percent partnership, but also because Lukoil's participation in two major contracts had resulted in no apparent softening of Moscow's attitude on the legal status issue.<sup>53</sup>

- Perhaps partly as a consolation prize, Socar gave Lukoil a 40 percent share in developing the Yalama structure (estimated 50-100 million tons of oil) in the northern part of the Azerbaijan sector. Later this was raised to 60 percent, with Socar retaining 40 percent. Never before had Baku granted a majority stake to a single foreign concessionaire. Baku's generosity may also be explained by Lukoil's promise to finance Socar's share of project outlays for the first six years. In any case, this was the first and only contract Socar signed exclusively with a Russian company.<sup>54</sup>

Lukoil did not however succeed in entering all the major ventures in the Azerbaijan sector. Neither did any other Russian company. Baku signed ten major contracts with international consortia from the fall of

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Azerbaijan bank, Azakbank, to help service the AIOC project. *Kommersant-Daily*, April 5, 1995, in *Economica WPS*, II:13, April 1-7, 1995.

<sup>52</sup>*Business Segodnya*, 1996, No. 22, in *Economica WPS*, III:23, June 15-21, 1996; *OMRI Daily Digest*, 204, October 21, 1996.

<sup>53</sup>*Pipeline News*, 39, November 23-29, 1996; *Monitor*, II:223, November 27, 1996.

<sup>54</sup>*IF News*, May 28, 1997 and July 3, 1997; *Pipeline News*, 61, May 24-30, 1997; *Monitor*, III:208, November 6, 1997. Lukoil also had plans to develop oil and gas resources in the Russian sector of the Caspian as well as in the Volga delta emptying into the Sea. *Business World*, 1996, No. 40, in *Economica WPS*, III:35, October 12-18, 1996.

In the spring of 1997 Azerbaijan began participation discussions with two other Russian oil companies, -- Rosneft and the Tyumen Oil Co., whose president was the former Russian fuel and energy minister. *IF News*, May 13, 1997; *RFE/RL Newslines*, 30, May 14, 1997; *Monitor*, III:117, June 16, 1997. Nothing seem to have come of these discussions.



1994 to the spring of 1998, of which five included Lukoil or another Russian partner.<sup>55</sup> Lukoil may have limited its involvement partly as a matter of choice, but in at least one case, the deal to develop the Inam deposit, as indicated, it was refused admission.<sup>56</sup>

In Kazakhstan. In the fall of 1995, the company sought a 20 percent share in Tengizchevroil, the joint venture of Chevron and the government of Kazakhstan to develop the Tengiz field, the country's richest, located on the northeast shore of the Caspian.<sup>57</sup> Chevron's agreement to enter negotiations, a Russian report suggested, was probably due to Tengizchevroil's problems in concluding the contract to lay a pipeline westward to the Russian port of Novorossiisk (see the next section). The consortium was forced to cut back production at Tengiz and seek increased access to Russian pipelines.<sup>58</sup> Tengizchevroil evidently believed that allowing the Lukoil camel into the tent would help it secure a higher pipeline quota from Moscow. Chevron finally agreed to sell 5 points of its 50 percent share to Lukoil, but the latter sought part of the Kazakhstan government holding as well.<sup>59</sup> Lukoil has still not persuaded the Kazakhstan government or Chevron to turn over more of their stake, perhaps because granting Lukoil a foothold in the consortium did not make the Russian government any more generous with pipeline quotas.<sup>60</sup>

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<sup>55</sup>*If News*, November 7 and 11, 1997; *Pipeline News*, 79, November 10-16, 1997; *IF News*, June 2, 1998

<sup>56</sup>Lukoil is also pursuing on-shore oil field development in Azerbaijan and has become involved in such varied enterprises as construction, insurance, repair of offshore drill platforms and retail gas stations. *Pipeline News*, 31, September 28-October 4, 1996; 34, October 19-25, 1996; 50, March 1-7, 1997; and 79, November 10-16, 1997.

<sup>57</sup>*IF News*, October 18, 1995; *OMRI Daily Digest*, 204, October 19, 1995.

<sup>58</sup>*IF News*, July 10, 1996, in *Pipeline News*, 19, June 29-July 5, 1996. One wonders, too, about the coincidence of the Russian fuel and energy minister's agreement, after an initial refusal, to increase the Kazak quota for oil export through Russian pipelines with Chevron's entrance into negotiations with Lukoil. *Business Segodnya*, 1995, No. 40 in *Economica WPS*, II:41, October 21-27, 1995 and *Delovoi mir*, December 29, 1995 in FBIS, SOV-96-015-S, January 23, 1996, p. 73.

<sup>59</sup>*Wall Street Journal*, January 17, 1997, p. B4; *Pipeline News*, 44, January 18-24, 1997.

<sup>60</sup>*IF News*, January 15, 1998.

Lukoil is also interested in Kazakhstan's offshore deposits, which are believed to be even richer than Azerbaijan's. The company solicited up to 20 percent of the prospecting consortium Kazakstankaspiishelf, the major current international in the field, but so far has not succeeded in joining the projects just being formed.<sup>61</sup> Almaty did not rule out involvement by Russian enterprises in the offshore fields, but balked at allowing their participation in the consortium.<sup>62</sup> The limitation suggests that Lukoil or other Russian companies will be bit players in the exploitation of Kazakhstan's sector of the Caspian. President Nazarbayev insists that Russian investors have only themselves to blame for losing out in Kazakhstan: "The place of Russian capital in Kazakhstan is being taken by more resourceful, American, German, Turkish Chinese and other investors. And not because we did not invite Russian capital, but because these investors win out in open tenders".<sup>63</sup>

Lukoil seems to be less interested in Turkmenistan, after having withdrawn from the disputed Kyapaz project. The first two tenders for Turkmenistan's offshore deposits were won by groups that did not include Lukoil or any other Russian company. Niyazov complained that Russian companies did not respond to invitations to cooperate in exploiting Turkmenistan's hydrocarbon reserves.<sup>64</sup>

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<sup>61</sup>*Pipeline News*, 19, June 29-July 5, 1996; *RFE/RL Newsline*, 163, November 19, 1997.

<sup>62</sup>Jamestown Foundation, *Prism*, III:17, October 24, 1997.

<sup>63</sup>*Monitor*, IV:108, June 5, 1998. Lukoil's investment in some seven projects in on-shore Kazakhstan came to about \$300 million by the beginning of 1998. Alekperov has declared the company's intention to raise that investment level to \$740 million by January 1, 2000, which, he asserts, would make Lukoil the biggest investor in the country. *IF News*, January 15, 1998.

Note too that Lukoil has taken over the 15 percent share that the Russian gas monopoly Gazprom acquired in 1995 in the development of the giant gas and oil field Karachaganak, located near Kazakhstan's border with Russia. The field has estimated recoverable reserves of 1.33 trillion cubic meters of gas, 644 million tons of gas condensate and 189 million tons of crude oil. The other partners are British Gas and Agip, each with 32.5 percent, and Texaco, with 20 percent. *Pipeline News*, 29, September 14-20, 1996; 72, March 1-7, 1997; and 79, November 10-16, 1997.

<sup>64</sup>*IF News*, May 16, 1998.

In contrast, Lukoil was awarded the tender for development of some 8000 sq. km. in the northern, Russian sector of the Sea. Kazakhstan has protested that the award infringes in part on its own sector<sup>65</sup>. An unsuccessful Russian bidder in the competition has disputed the award to Lukoil. The latter claims that it will sign with Kazakhstan to develop two offshore blocks, one of which overlaps a Russian sector block that is the subject of Almaty's protest. If so, that might help allay Almaty's concerns and also secure Lukoil's Russian award.<sup>66</sup>

This outline of Lukoil's participation in the major Caspian projects of the last few years suggests an ambitious program indeed. How was Lukoil to pay for it all, especially as it was known to be cash-poor? Part of the answer lies in the minimal initial investment called for by most Caspian development contracts, with heavy investment scheduled for later years. Lukoil found another channel of funding by, in effect, collateralizing its participation rights. In September 1996 Lukoil and the American oil firm ARCO formed a joint venture with a program of investing \$5 billion over 10 years in various oil projects. Of that amount, \$4.5 billion was to be provided by ARCO as a low interest loan to Lukoil. The latter's contribution, for which it obtained a 56 percent share in the joint venture, was to consist of its existing stakes in the Caspian Pipeline Consortium (see the next section), Caspian offshore oil development and oil fields in Kazakhstan.<sup>67</sup>

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<sup>65</sup> *IF News*, December 30, 1997.

<sup>66</sup> *Energy and Politics*, 12, April 7, 1998.

<sup>67</sup> *OMRI Daily Digest*, 183, September 20, 1996; Vanora Bennett, "Arco-Lukoil Boost Russian Oil Ventures", *Los Angeles Times*, September 20, 1996; *Monitor*, II:176, September 23, 1996. The ARCO loan was neither guaranteed by the Russian government nor secured by Lukoil assets.

#### 4. PIPELINES AND THE ROUTES TO MARKET

Exploration and extraction of the Caspian's oil resources is, for the most part, only a question of time. Companies from around the globe are beating a path to the doors of the littoral capitals, eager to get a share of the bonanza. Export to non-CIS countries is however a major problem, particularly as the consumption requirements of Azerbaijan, Kazakstan and Turkmenistan are small and Russia is the world's third largest producer of crude oil. The strongest leverage Moscow has held over Caspian basin hydrocarbon development stems from geography and the legacy of Soviet policy. The Caspian is landlocked, so export requires pipelines or rail transportation crossing national frontiers. Soviet policy left just a few pipelines in the region and almost all of these run north-south through Russian territory. To get Caspian oil to world markets through Russian pipelines -- by land via Eastern Europe or via the Baltic and Black seas -- requires applying for higher quotas from the Russian government-owned pipeline monopoly, Transneft. The Russian trunkline network is comparatively small for the vast size of the country and operates at or near capacity; it is aging -- 40 percent of the total length is over 20 years old, 70 percent over 15 years -- and leakprone.<sup>68</sup> At its peak, the AIOC's Caspian oil output is expected to reach some 40 million tons a year; other Azerbaijan-sector sites will come on stream over the next 10-20 years; Kazakstan is dreaming of annual output levels of 130 million tons by 2015<sup>69</sup>; Turkmenistan may be a significant producer too. Such volumes of crude are far beyond the capacity of existing lines. Export to east or west is clearly mandatory, but, given the pipeline capacity limitations and the character of the terrain through which new ones must be laid, it requires massive new investment.

There are four main routing alternatives for exports to the West:

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<sup>68</sup> *IF Oil and Gas Report*, 8 (271), February 28, 1997.

<sup>69</sup> *IF News*, March 31, 1998.

- Through Iran to the Persian Gulf may well be the shortest, quickest and cheapest route, but it is presently ruled out by American political opposition. Should the current hesitant moves for rapprochement between Washington and Teheran prove serious, the outcome might affect the battle over Caspian pipelines dramatically. At this time Washington would probably also frown on a variant that would move Caspian oil from Iran to the Mediterranean via Turkey.

- The so-called "northern" route would take Azerbaijan's oil to Novorossiisk. This is Moscow's urgently proffered choice. Exit via Novorossiisk is currently the accepted main export path for Kazakstan's Tengiz oil as well, but much of the pipeline remains to be constructed.

- Under the "western route", oil would be piped from Baku through Azerbaijan and Georgia to the latter's Black Sea port of Supsa. A long-shot variant would then ship some of the oil across the Black Sea to Odessa, from where it would be piped directly to Eastern or Western Europe via the old Soviet Druzhba line.<sup>70</sup>

- Turkey has pushed hard for a pipeline from the Caspian through Azerbaijan and Georgia to the Turkish Mediterranean port of Ceyhan.

Another way of distinguishing these alternatives is by sea of egress -- Persian Gulf, Black Sea or Mediterranean. So far the first is politically out of consideration, the second is the focus of most current projects, while the third has weighty political support and is potentially important.

Still other proposals look eastward, to the markets of South Asia, China and Japan. These would be reached by a pipeline through

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<sup>70</sup>Nazarbayev proposed shipping at least some Kazak oil through Russian pipelines and by rail to the Baltic, where, he maintained, he was prepared to invest in construction of a new terminal at Klaipeda in Lithuania. *If Oil and Gas Report*, 11 (274), March 21, 1997.

Afghanistan to Pakistan's shore on the Arabian Sea and one across Kazakhstan to China. The latter is an active element of Almaty's planning.

The debate about routes to the West is naturally only in part about technical considerations, whether engineering or economic. It is political and economic advantage that impels Russia to lobby for pipelines running through Russian territory to a Russian Black Sea port.<sup>71</sup> At issue are not only substantial transit fees but also the potential for great political and economic leverage.

#### *Northern route*

When the Caspian oil boom began, there was only one complete pipeline in existence on the western side of the Sea, from Baku via Grozny in Chechnya to Novorossiisk (hereafter, the BGN pipeline) . Another, only partially complete line in poor repair led across Azerbaijan to the Georgian Black Sea coast. The oil from AIOC-leased deposits was expected to flow in two phased waves -- "early oil", in limited quantities until about 2002-2005, when "later oil", the full stream, would come on line. The expected volume of later oil would require one or more "main export" pipelines significantly larger in size than those that could be used for early oil. The BGN pipeline has been the natural candidate for the export of early oil from the early 1990s, and Azerbaijan oil has been flowing through it since the late fall of 1997. Moscow has pressed the AIOC to send not only early but also later oil through the BGN. As the only export pipeline currently operating, it would seem to have a clear advantage. Several problems weaken Moscow's case.

The most apparent is the threat to the security of the BGN pipeline from political instability in the north Caucasus, most especially in Chechnya. Some 150 km of the existing pipeline runs through that republic's territory. Many have speculated that the Russian invasion of

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<sup>71</sup>For example, Novorossiisk has limited handling capacity and is plagued by loading interruptions in even moderately bad weather. *Monitor*, II:47, March 17, 1996.

Chechnya at the end of 1994 represented at least in part an attempt to ensure the viability of the BGN route.<sup>72</sup>

The immense havoc from the war affected the Chechen segment of the BGN line as well. Portions of the Chechen line had been seriously damaged not only in the fighting but by "backyard refiners" who tapped the pipeline almost at will when there was still oil running through it.<sup>73</sup> The thefts were so large that the line was closed down in the fall of 1996.<sup>74</sup> Repairs of the segment took the better part of 1997, and it was opened to Azerbaijan oil only in November of that year. Illegal tapping of the pipeline continued even as the line was being reopened.<sup>75</sup>

A more important war legacy was the poisoned relations between Chechnya and Russia. Hence, the peace agreement in 1996 did not eliminate the threat to the security and integrity of the BGN line. The new government in Grozny had far from complete control over the numerous armed detachments left over from the war, as witnessed by the frequent kidnappings of foreigners, including Russians, for ransom and incursions of armed groups into the neighboring Russian province of Dagestan.

The hostility between Moscow and Grozny was also manifested in the protracted negotiations in 1996-97 over the conditions of transit through Chechnya. Grozny demanded a stiff price for the right to pump oil across Chechen territory. Despite repeated assurances from Transneft to Baku and the AIOC that the Russian segments of the pipeline would be ready on time, the delay in repairing the line and the lengthy

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<sup>72</sup>E.g., the *Economist*, January 7, 1995, p. 39. The June 1993 agreement under which Russia joined the Caspian Pipeline Consortium, created to ship Tengiz oil to market, provided for use of the route, Tengiz-Astrakhan-Grozny-Novorossiisk. In January 1995 Russia designated the Tengiz-Astrakhan-Grozny pipeline as its contribution to the package. *Kommersant-Daily*, January 10, 1995, in *Economica WPS*, January 7-13, 1995; *OMRI Daily Digest*, 12, January 17, 1995.

<sup>73</sup>See, e.g., *Pipeline News*, 26, August 24-30, 1996. The president of the Chechen oil monopoly Yunko lamented that 3000 tons a day were being extracted illegally. *Monitor*, II:225, October 3, 1996.

<sup>74</sup>*Pipeline News*, 71, August 9-15, 1997.

<sup>75</sup>*RFE/RL Newslines*, 178, December 12, 1997.

negotiations over tariffs and fees compelled Transneft to postpone pumping Azerbaijan oil from the early months to the fall of 1997.<sup>76</sup>

The sides finally came to an agreement in September 1997. Transneft did not budge from its original tariff offer, but Moscow promised to provide a substantial supplement out of federal budget funds and to repair the Chechen segment of the pipeline at its own expense.<sup>77</sup> It is indicative of the hostile atmosphere in Grozny that within days of the signing, the Chechen vice-president threatened to open a criminal case against members of the Russian government and to publicly execute those found guilty of war crimes.<sup>78</sup> Moreover, the agreement applied only to 1997. A follow-on was signed in May 1998, but within a month the Chechen government was threatening to close down its section of the pipeline unless Moscow fulfilled its financial commitments.<sup>79</sup>

These negotiating difficulties and security concerns about the Chechen stretch of the pipeline apparently induced Moscow in September 1997 to announce a projected bypass around Chechnya through Dagestan. An additional consideration was to provide more throughput capacity for the expected higher volume of later oil and thus preempt construction of pipelines running through non-Russian territory.<sup>80</sup> The security of the bypass is however not to be taken for granted, as Dagestan is itself the scene of frequent group violence linked to Chechnya and Chechen-related ethnic groups in Dagestan.

The project has already experienced cost escalation. The line was to have cost \$220 million and have a planned capacity of 40 (sic!) million tons a year, enabling Russia to become a major transporter of "main" Caspian oil.<sup>81</sup> Construction had barely started in the first quarter of 1998; the route seemed to be longer (330 vs. 283 km), the

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<sup>76</sup>American Embassy Moscow dispatch, "Oil in Chechnya: Prospects for Revival," October 24, 1996, copied in *Johnson's Russia List*, November 1, 1996; *Monitor*, III:25, February 5, 1997; *IF News*, March 29, 1997.

<sup>77</sup>*IF News*, September 9, 1997; *RFE/RL Newsline*, 114, September 10, 1997; Liz Fuller, "The Great Power Game," *RFE/RL Newsline*, 120, September 18, 1997.

<sup>78</sup>*Monitor*, III:169, September 12, 1997.

<sup>79</sup>*IF News*, May 13 and June 14, 1998.

<sup>80</sup>*Pipeline News*, 72, August 16-22, 1997.

<sup>81</sup>*IF News*, September 14 and 24, 1997; *Monitor*, III: 179, September 26, 1997.



cost was higher (over \$300 million), and the scheduled completion date was pushed back to early 2000.<sup>82</sup> In June 1998 Moscow was said to be having trouble funding the bypass, whose construction "seems to stagnate". Deputy Prime Minister Boris Nemtsov insisted however that "most" of the line would be completed by the end of 1998.<sup>83</sup>

The acrimonious Russian-Chechen negotiations and Moscow's announcement of the bypass project triggered a series of threats and counter-threats. The president of Chechnya signed a protocol of intent with several British businessmen in October 1997 to lease the Chechen segment of the BGN pipeline to an international consortium. Moscow was predictably furious: "The pipeline is the exclusive property of the Russian Federation, and any deals concerning it will be illegal."<sup>84</sup> The president of Chechnya countered that he was ready to annul his pledge to guard the Chechen segment of the pipeline. The Chechen oil sector head threatened to demand a tariff ten times what Moscow was offering.<sup>85</sup> And the former head of Chechnya's state oil company, appointed advisor on energy issues to the Chechen president, issued this veiled threat: "Any attempts by Moscow, which has certain interests in the North Caucasus, to bypass Chechnya by building alternative pipelines, transport corridors, or power lines are doomed (my underscoring)."<sup>86</sup>

Baku and the AIOC were also concerned about the risks of dependence on Transneft, which controlled the Russian sections of the BGN pipeline. Transneft interrupted the shipment of Azerbaijan oil twice in a period of about 12 months. It refused to accept Socar oil in early 1997, claiming that it had agreed to take AIOC oil only, but reluctantly acknowledged shortly afterwards that the Russian sector of the pipeline

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<sup>82</sup>IF News, January 21 and 26, 1998; *Energy and Politics*, 2, January 26, and 4, February 9, 1998.

<sup>83</sup>Monitor, IV:115, June 16, 1998.

<sup>84</sup>RFE/RL Newsline, 153, November 5, 1997. See also, Hugh Pope, "Chechen Fighter Battles to Lure Business," *Wall Street Journal*, April 13, 1998.

<sup>85</sup>Floriano Fossato, "Mounting Moscow-Grozny Tensions," RFE/RL Newsline, 29, February 12, 1998; *Energy and Politics*, 5, February 17, 1998.

<sup>86</sup>IF News, April 11 and 13, 1998.

was simply not ready to accept the Socar oil on schedule.<sup>87</sup> The flow through the BGN pipeline was halted again on February 7, 1998, because of "technical issues related to documents".<sup>88</sup> It took more than a week to resolve the problem.<sup>89</sup> Transneft's obduracy in refusing to grant higher quotas for Tengiz oil, noted below, may have heightened these concerns and reinforced the case for multiple routes.

*Tengiz and the pipeline to Novorossiisk*

Kazakstan emerged from the Soviet era with considerable economic promise residing in its extensive natural resources, particularly oil and gas. That promise was however constrained by the geography of the new state's transportation system. Its railroads and pipelines were predominantly north-south arteries, to and from Russia, rather than east-west to other parts of Kazakstan and central Asia or to neighboring foreign countries. The complete dependence on Russian pipelines was the more painful because Transneft and the energy ministry have tended to grant only limited volume, short term contracts.<sup>90</sup>

The richest oil field so far discovered in Kazakstan is Tengiz. An east-west pipeline exists only part of the way to Novorossiisk; the completing links remain to be built. In 1992 the Caspian Pipeline Consortium (CPC) was put together by Kazakstan, Russia and, oddly, Oman, to construct the necessary segments. But a dispute between CPC and Chevron, the main developer of Tengiz, held up the project for several

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<sup>87</sup>*Pipeline News*, 46, February 1-7, and 47, February 8-14, 1997; *IF News*, March 29, 1997.

<sup>88</sup>Michael S. Lelyveld, "Russia Puts a Halt to Flow of Caspian Oil to Black Sea," *Journal of Commerce*, February 11, 1998.

<sup>89</sup>Michael S. Lelyveld, "Russia's Motives Questioned in Caspian Blockage," *Journal of Commerce*, February 23, 1998; John Helmer, "Russians Play Down Azeri Oil-Flow Problem," *Journal of Commerce*, February 25, 1998.

<sup>90</sup>*The Economist*, February 1, 1997. Russian restrictions on the export of gas to Western Europe were even more severe than on oil. The chairman of Gazprom declared in the summer of 1997 that he had no intention of letting any Central Asian gas, from Turkmenistan or Kazakstan, pass through Russian pipelines to Western Europe. *Energy and Politics*, 1, January 19, 1998.

years. A rearrangement of shares in March 1996 broke the logjam.<sup>91</sup> The final agreement in May 1997, hammered out after arduous negotiations, allocated 24 percent to the government of Russia, 12.5 percent to the Lukoil/ARCO joint venture, and 7.5 percent to a partnership of Rosneft, another Russian oil major, and Shell. Thus, the Russian state and company share came to 35-40 percent. Almaty's holding was reduced to 19 percent with an additional 1.75 percent stake for the Kazakhstan company, Munaigaz.<sup>92</sup>

Construction of the 1500 km pipeline, with a planned initial capacity of 28 million tons a year, was originally set to begin in 1997 and take two years to complete at a scheduled cost of about \$1.5 billion. Feasibility studies will not be ready however before September 1998, pushing the availability of the pipeline into late 2000, or more likely in the first half of 2001; costs are now quoted at around \$2.5 billion.<sup>93</sup>

When the CPC pipeline is completed, it will initially transport some 12 million tons per year of Tengiz oil. In the meantime, Transneft

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<sup>91</sup>"Caspian Pact May Bolster Chevron Effect," *Wall Street Journal*, March 11, 1996. Chevron undoubtedly exerted strong leverage over the CPC by refusing to ship more than a minimum volume with the consortium unless its own share demands were satisfied. One wonders whether Russian pressure had anything to do with Oman's agreement to reduce its share drastically, making possible the revival of the CPC.

<sup>92</sup>OMRI *Daily Digest*, 236, December 9, 1996. *Pipeline News*, 38, November 16-22, 1996, and 60, May 17-23, 1997. The other partners and their respective shares were: the government of Oman (7 percent), Chevron (15), Mobil (7.5), British Gas and Agip (each 2) and the U.S. company Oryx (1.75).

Transneft, the Russian pipeline monopoly had pushed hard to be admitted into the consortium as an equity member, based on a high valuation of its technical expertise. *Pipeline News*, 38, November 16-22, 1996, and 49, February 22-28, 1997. Other CPC partners apparently believed that such expertise was amply recompensed by the fees Transneft would collect for operation of the pipeline's segment running through Russian territory.

<sup>93</sup>OMRI *Daily Digest*, I:236, December 19, 1996; *Pipeline News*, 57, April 26-May 2, 1997 and 62, May 31-June 6, 1997; *IF News*, October 7, 1997; *Energy and Politics*, 8, March 10, 1998. *Monitor*, IV:69, April 9, 1998, reports that the start of construction on the CPC line has been put off until 2000. The president of Lukoil said in mid-April 1998 that the CPC line must be commissioned in the fourth quarter of 2001. *IF News*, April 13, 1998.

allowed Tengizchevroil, the Kazakhstan-Chevron joint venture, to ship no more than 3-3.5 million tons via the Russian pipelines in 1997; it was expected that an additional 2.5 million tons would be sent by rail. That meant that already in 1997 about 5 million tons of Tengiz output was looking for alternative export routes, and this amount would rise by a million tons in 1998 and 2.5 millions in 1999.<sup>94</sup> The limitation on Kazakhstan exports was explained by Russian sources as due to the "unfavorable conditions for Russian oil" created by exports of oil from the former Soviet republics to the world market.<sup>95</sup> In short, Transneft had no interest in increasing competition with Russian crude exports.<sup>96</sup>

The long delay in the construction of the CPC line and the limitation on the amount of oil Transneft would consent to ship through Russian pipelines impelled the consortium and Kazakhstan to search for supplementary channels. A major potential candidate for large scale exports to the West was a pipeline to Turkey, discussed below. But this was off in the future. Several interim expedients were explored:

- In March 1997 Tengizchevroil began to ship crude by tanker across the Caspian and then by rail to Georgia's Black Sea port of Batumi. If the experiment proved a success, some one million tons per year of Tengiz oil would find its way to European markets this way.<sup>97</sup> Tengizchevroil expects to send 2.5 million tons of oil in 1998 across the Caspian to Baku and then by pipeline and rail to the Georgian port of Poti.<sup>98</sup> Georgia's railway chief stated that another 600,000 tons of Azerbaijan oil would be brought out the same way and boasted that Georgia had a 40 percent cost advantage in cargo transportation compared to Russia.<sup>99</sup> Turkmenistan joined

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<sup>94</sup>IF News, October 3, 1997.

<sup>95</sup>IF News, October 5, 1997.

<sup>96</sup>Chevron also complains that Transneft mixes lower quality Urals crude with the Tengiz oil.

<sup>97</sup>OMRI Daily Digest, 200, October 15, 1996; IF News, March 24, 1997.

<sup>98</sup>Energy and Politics, 4, February 9, 1998.

<sup>99</sup>IF News, March 26, 1997.

the experiment in March 1998 with a first tankerload of crude shipped across the Sea to Baku.<sup>100</sup>

- Almaty negotiated a swap arrangement with Tehran for 2-6 million tons annually of Kazakhstan oil to be refined in northern Iran and paid for in Iranian oil shipped from the Persian Gulf. Problems in treating the Kazakhstan oil in Iranian refineries forced suspension of the agreement in the fall of 1997.<sup>101</sup> The arrangement is still on hold, apparently at least in part because of the recalcitrance of the Kazakhstan oil company charged with carrying out the arrangement.<sup>102</sup>

- Beijing and Almaty agreed on the construction of a pipeline south across Turkmenistan to Iran, to ship Kazakhstan oil to the Persian Gulf. Washington would probably frown on that idea. Almaty was still holding this option in reserve in the spring of 1998.<sup>103</sup>

#### *The Western Route*

Concerns about security in Chechnya, but probably also qualms about complete dependence on Russia, impelled the government of Azerbaijan and the AIOC to look for other early oil routes. Unwillingness to offend Moscow as well as the apparent availability of the BGN line suggested the desirability of using the northern route. In October 1995 Socar and

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<sup>100</sup>*IF News*, March 6, 1998; *Monitor*, IV:57, March 24, 1998. Chevron, the leading partner in Tengizchevroil, proposed to take over an existing Georgian pipeline leading to Batumi on the Black Sea and link it to a new pipeline to be laid in Azerbaijan, for the shipment of Tengiz oil. Rebuilding the Georgian segment was to take four months, while the Azerbaijan pipeline was to be completed in mid-1999. The project was supposed to enable transport of 7-8 million tons a year. *IF News*, March 2, 1998. The relation of this plan to the Baku-Supsa project and its fate are not clear.

<sup>101</sup>*IF News*, October 22, 1997.

<sup>102</sup>*Energy and Politics*, 18, May 20, 1998. Iran is actively encouraging swap arrangements, not just with Kazakhstan, by plans to construct a pipeline from its Caspian coast to Tehran. *Ibid*, 19, May 28, 1998.

<sup>103</sup>*Pipeline News*, 77, October 27-November 2, 1997; *IF News*, May 9, 1998.

the AIOC announced a compromise agreement to ship early oil -- originally due on stream in 1996<sup>104</sup> but later deferred several times to the fall of 1997 -- through two pipelines, the BGN and the Baku-Supsa. A decision on the ultimate main routes for later oil was left to the future.<sup>105</sup>

The compromise was hailed by Azerbaijan, Georgia, Turkey and the United States.<sup>106</sup> Not by Transneft however, which grouched that the consortium decision had to be considered "purely political", because "the Russian route is the only feasible option financially and technically".<sup>107</sup> A senior MFA official also threw cold water on the compromise. Moscow "would like Caspian oil to go only through Russian territory"; at best it would accept the Georgian route only as an auxiliary. The official warned that Russian permission to use the pipeline to Novorossiisk would depend "on many conditions, primarily on the amount of oil to be transported."<sup>108</sup>

Again, the energy complex diverged from the Foreign Ministry. Shafranik, the Fuel and Energy Minister, and Lukoil's president, Alekperov, both pronounced themselves satisfied with the compromise.<sup>109</sup> The latter also urged: "Russia should now provide efficient transportation of the early oil, so that discussions on the transportation of future Caspian oil unconditionally choose the Russian

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<sup>104</sup>OMRI Daily Digest, 197, October 10, 1996.

<sup>105</sup>OMRI Daily Digest, 197, October 10, 1995.

<sup>106</sup>The compromise was strongly supported by the United States in the interests of balancing "transportation safety" and preventing the isolation of Russia. *Monitor*, I:108, October 3, 1995.

<sup>107</sup>Lowell Bezanis and Elizabeth Fuller, "Routing Decision Suggests Wrangling to Come," *Transition*, 1:21, November 17, 1995, p. 45.

<sup>108</sup>*Monitor*, I:114, October 12, 1995. Perhaps the MFA was particularly upset because Terry Adams, then the president of AIOC, declared: "As we see it now, Ceyhan will be the eventual exit point for the main pipeline." *Financial Times*, October 10, 1995. He restated this position several months later. *Pipeline News*, 27, August 31, September 6, 1998. Georgia, in an effort to soften Russian opposition, offered "at least" a 25 percent share in the reconstruction of the Georgian segment of the pipeline. *Moscow News*, 2, 1996, in *CIS WPS*, III:2, January 13-19, 1996. Russia is apparently not involved in the construction of the pipeline.

<sup>109</sup>Initially, Shafranik also reacted negatively, but two days later he decided that the northern pipeline bird in hand was a win for Russia. Bezanis and Fuller, note 107 above.

route."<sup>110</sup> Perhaps the stress on the importance of assuring a Russian route for the main export pipeline proved compelling; in any case, the MFA ceased carping.

Security is an important concern in Georgia too. The conflict between Azeris and Armenians over the Nagorno-Karabakh enclave continues to fester and is responsible for eliminating Armenia, at least for the time being, as a possible transit route. Armenian-Karabakh hostility carries potential threats to pipeline segments in nearby Azerbaijan and Georgia. Also unsettled are Georgian disputes with South Ossetia and especially with the breakaway province of Abkhazia on the Black Sea coast. The latter conflict, which Georgians believe was exacerbated and prolonged by Russian intervention, is still generating casualties.<sup>111</sup> A bit further south, the ports of Batumi and Supsa lie in the region of Ajaria, whose relations with Tbilisi are intermittently troubled.<sup>112</sup> The insecurity of the region adds sizably to the costs of operating any projected pipeline through the Caucasus. On the other hand, the Georgian ports have the advantage of being open almost year-round, whereas storms frequently close down operations in Novorossiisk.

In November 1996 the AIOC had hoped to begin work on the Baku-Supsa pipeline by March 1997 and complete the line by the end of 1998. The cost was estimated at \$250 million for a 925 km line with an annual capacity of 5 million tons, upgradeable subsequently to 7.5-10 million tons.<sup>113</sup> But the line was in worse condition than expected: By the summer of 1997 the cost estimates had risen to \$330 million, and completion did not seem likely before the second quarter of 1999.<sup>114</sup>

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<sup>110</sup>Monitor, I:116, October 16, 1995.

<sup>111</sup>The *Christian Science Monitor* of May 1, 1998 reported a threat by Abkhazian separatists to blow up any pipeline from the Caspian through Georgia. *Energy and Politics*, 17, May 13, 1998.

<sup>112</sup>See "The Fortnight in Review," *Prism* (Jamestown Foundation), II:1, January 10, 1997.

<sup>113</sup>*Pipeline News*, 39, November 23-29, 1996; *IF News*, September 17, 1997. Around this time the British president of AIOC, Terry Adams, was sufficiently optimistic to prefer the Georgian route for the much larger oil flows of the future: "In terms of distance, cost and political balance, I think it's our best option." *Pipeline News*, 27, August 31, - September 6, 1996.

<sup>114</sup>*Pipeline News*, 71, August 9-15, 1997; *Energy and Politics*, 10, March 25, 1998.

Cost projections in mid-1998 were almost twice as high, generating public spatting between the AIOC and Baku. The Azerbaijan and Georgian governments continue to promise that the pipeline, the Supsa terminal and attached facilities would be ready by the end of 1998, but the controversy over funding the increased costs of the line suggests otherwise. Baku is now arguing for doubling the diameter of the Georgian pipeline -- to increase the projected throughput six times, to 30 million tons a year -- and making it part of a proposed line to Ceyhan (on which more below), but that would certainly delay completion considerably further.<sup>115</sup>

From Supsa Azerbaijan's oil would be shipped to Europe via the Turkish straits. In March 1997 the presidents of Azerbaijan and Ukraine proposed to send some Azerbaijan oil to Ukraine via Georgia and the Black Sea for both Ukrainian consumption and reexport to Western Europe. Russian official reaction was again unfavorable. The then secretary of the Russian Security Council, Ivan Rybkin, deplored the idea as likely to harm not only Russia's economy but also that of Chechnya.<sup>116</sup> Transneft, struggling to repair the Chechen segment, hastened to announce that the BGN pipeline "could be completed in a very short time".<sup>117</sup>

The idea of an Azerbaijan-Georgia-Ukraine oil route had been in the air for several years but was still producing only a memorandum of understanding by the spring of 1997. The difficulty in realizing the concept was easy to understand, as it involved four major investment projects: the pipeline across Georgia, a fleet of tankers to make the sea link to Odessa,<sup>118</sup> an oil terminal near Odessa and a pipeline from there to Brody on the Polish border to connect up with the Druzhba

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<sup>115</sup>Hugh Pope, "Cost of Pipeline in Azerbaijan Sparks a Debate," *Wall Street Journal*, April 13, 1998; *RFE/RL Newslines*, 94, May 19, 1998; *IF News*, May 18 and 29, June 2 and 9, 1998.

<sup>116</sup>*Monitor*, III:61, March 27, 1997.

<sup>117</sup>*IF News*, March 27, 1997.

<sup>118</sup>Georgia's railway chief claimed that the tank cars transporting oil by rail from the Caspian to Batumi would be ferried directly to Ukraine. *IF News*, March 26, 1997.



pipeline through Poland and Germany.<sup>119</sup> An Azerbaijan-Ukraine working group estimated the capital cost at \$1.3 billion. Operating costs were also bound to be high because of the multiple transshipments required. Not surprisingly, a senior officer of the AIOC indicated that it would consider the Ukraine option only if the consortium encountered difficulties shipping through the Turkish Straits. Even the president of Socar dismissed the idea as lacking "technical merit".<sup>120</sup>

The project suddenly gained new impetus in the spring of 1998. President Aliyev expressed confidence that "the future ferry route from Poti to Odessa, which Ukraine is helping to construct, will become a very important element of the Eurasian transportation route and the program for restoration of the 'silk way'".<sup>121</sup> The Ukrainian cabinet voted to create an international consortium to implement the proposal, and the prime minister declared the project a "national priority".<sup>122</sup>

Why was a seemingly moribund idea suddenly revived? True, Azerbaijan was interested in expanding its export options, and Ukraine had long been concerned to break its dependence on Russian energy imports. Kyiv was also excited by the prospect of opening a channel of trade and cooperation with the Caucasus and Central Asia. Observers however credited two main factors for the renewal of interest at this time. The first was the delay in beginning the construction of the Baku-Ceyhan pipeline, which was attributed to investor reluctance stemming from the high cost of the project and the softening of world crude prices in 1997-98. The second factor was Azerbaijan's proposal to double the diameter of the Baku-Supsa pipeline and increase its capacity by a factor of six, thereby sharply reducing the throughput unit cost. If that were to happen, there would be enough oil presumably to supply the proposed Ukrainian route as well.<sup>123</sup>

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<sup>119</sup>OMRI *Daily Digest*, 59, March 25, 1997; *Monitor*, III:60, March 26, 1997; IF (Ukraine), *Ukraine Daily News*, March 27, 1997; If (Ukraine), *Ukraine Business Review*, No. 219, March 25-31, 1997.

<sup>120</sup>*Pipeline News*, 62, May 31, June 6, 1997.

<sup>121</sup>IF *News*, May 8, 1998.

<sup>122</sup>*Monitor*, IV:94, May 15, 1998.

<sup>123</sup>*Monitor* IV: 91, May 12, 1998.

Compared to the northern and Turkish routes, with their threats of disruption by Chechens, Dagestanis, or Kurds, the Ukrainian project promised assured security, if one ignored the real security problems of the segment through Georgia. High costs and uncertain financing nevertheless becloud the project's future. Only 35 percent of the Odessa-Brody pipeline is ready so far; the Odessa oil terminal can currently process only 30 percent of the projected throughput; the tanker fleet remains to be built; and there have been no negotiations yet on the technical and financial requirements of the project.<sup>124</sup>

*Black Sea vs Mediterranean; Novorossiisk vs Ceyhan*

Whether through Novorossiisk (the BGN and CPC pipelines) or through the Georgian ports (the Baku-Supsa pipeline and rail shipments), the export routes discussed so far involve shipment through the Black Sea. The sole maritime exit from the Black Sea is the Turkish Straits -- the Dardanelles and the Bosphorus. Some 30,000 CIS tankers sailed through the Straits annually in the early 1990s,<sup>125</sup> and the number of transits could be expected to jump dramatically after the turn of the century if most Caspian Sea production were tankered through the Black Sea.

On July 1, 1994, the Turkish government introduced restrictions on the passage of oil tankers through the Straits, ostensibly in response to a number of accidents that polluted the waters close to Istanbul. But Ankara also made clear its intention to reduce the number of transiting tankers drastically. Russians charged that the real Turkish motive was not fear of oil spills and environmental degradation but the desire to have Caspian oil marketed as far as possible from Turkish ports, reached by pipelines laid through Turkey, whose construction would be financed by others.<sup>126</sup> Indeed, former Turkish President Turgut Ozal had expected

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<sup>124</sup>IF (Ukraine), *Daily Ukraine Report*, May 26, 1998. Also, *Monitor*, IV:111, June 10, 1998.

<sup>125</sup>*Izvestiya*, June 15, 1995, in *Economic WPS*, II:23, June 17-23, 1995.

<sup>126</sup>One account sees the Turks engaged in a "quiet but persistent struggle for *de facto* reorientation of the entire regional energy transportation system, something that must necessarily have far-reaching geopolitical consequences." *Kommersant-Daily*, February 24, 1995, p. 4, in SOV 95-049S, March 14, 1995, pp. 1-2.

to be able to route both Azerbaijan and Kazakhstan oil from the Caspian through a new pipeline to Ceyhan on Turkey's Mediterranean coast. But the deaths of Ozal and Azerbaijan's President Elchibey in the first half of 1993, as well as the beginnings of a more assertive Russian policy in the region, dimmed Turkish hopes.

Ankara's attempts in 1994-95 to limit oil tanker access to the Turkish straits, on the other hand, placed in question the value of Russian Black Sea ports as pipeline terminals and tanker ports. By the same token the Straits restrictions added value to alternatives that connected to Turkish pipelines or terminated at a Mediterranean port. Even before the Turkish action of July 1994 Russia had been interested in the concept of a pipeline from the Bulgarian Black Sea port of Burgas to the Greek port of Alexandroupolis on the Aegean. The project assumed greater importance in the new environment, promising to circumvent Turkish restrictions and revalidate the Russian Black Sea ports.<sup>127</sup> In 1995 the three governments signed several agreements in principle to build the Balkan pipeline,<sup>128</sup> but financing proved a major hurdle. Remarkably, Moscow invited Azerbaijan, Kazakhstan and Turkmenistan to cover 50 percent of the cost of a pipeline in which none of them was interested then.<sup>129</sup> Presidential elections in Bulgaria and Russia, the uncertain state of Yeltsin's health and disagreements among the partners about shares delayed implementation further.<sup>130</sup> Financing difficulties and disputes between the Greek and Bulgarian parties over the allocation of stakes continue to keep the project on a back burner.<sup>131</sup>

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<sup>127</sup>A Russian report claimed that the pipeline was projected to carry 30 million tons of oil per year, twice the projected capacity of the northern route. *Monitor*, I:145, November 27, 1995.

<sup>128</sup>*Wall Street Journal*, September 11, 1995, p. 17; *Monitor*, I:98, September 19, 1995; Minas Analytis, "Le projet d'oleoduc Bourgas-Alexandroupolis; un enjeu geostrategique," *Courrier des pays de l'Est*, No. 411, August 1996, pp. 50-51

<sup>129</sup>*Monitor*, I:120, October 20, 1995. On the lack of interest in Azerbaijan and Georgia, see *Nezavisimaya gazeta*, February 29, 1996, in CIS WPS, III:8, February 24-March 1, 1996.

<sup>130</sup>Analytis, "Le projet d'oleoduc Bourgas-Alexandroupolis," p. 52.

<sup>131</sup>*Pipeline News*, 44 and 80, January 18-24 and November 17-23, 1997. At one point Russia was considering shipping oil from a Georgian Black Sea port via the Danube to Europe, thus avoiding the Turkish

The conclusion of the major deal between Azerbaijan and the AIOC in the fall of 1994 joined with Turkey's concerns about the Straits to revive the proposal for a pipeline between Baku and Ceyhan as the main export route for AIOC oil. Turkey was the chief proponent of course, but Azerbaijan was certainly interested, given its misgivings about the BGN line and its interest in warm relations with Ankara.

Russia expectedly did not welcome the idea, and it has campaigned for the northern route with both public contention and private pressure. An early argument cited a threat to the security of the Turkish route. Moscow rebutted Turkish criticism of Russia's behavior during the Chechen war and publicly voiced doubts about the security of oil transportation through Chechnya by pointing out that a Georgia-Turkey pipeline would pass through Kurdish-inhabited regions of eastern Turkey that have been in almost open insurrection against Ankara. A Russian deputy foreign minister charged that Ankara allowed Chechen separatists to operate freely on Turkish territory, and he warned the Turks against throwing stones while living in a glass house.<sup>132</sup> Later polemics focused on the costliness of the long land route through Georgia and Turkey. Then First Deputy Prime Minister Boris Nemtsov offered the bypass pipeline as "the most reliable guarantee" for Caspian oil producers. That assured a "one hundred percent" chance, he proclaimed, that the main pipeline to export late Azerbaijan oil would pass through Russia.<sup>133</sup>

Moscow intermittently prodded the governments of Azerbaijan and Georgia to support the northern route. This was the purpose of a mission to Baku in the fall of 1996 by Boris Berezovsky, then the deputy secretary of the Russian Security Council, according to the Azerbaijan news agency.<sup>134</sup> A top official of the Russian Fuel and Energy Ministry urged the AIOC to conduct an international tender to select the main export pipeline, acknowledging that Russia expected a tender to favor the northern route on economic grounds. Baku would only agree that

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Straits and possibly preempting a Baku-Ceyhan pipeline. *Delovoy mir*, January 18, 1996, in SOV-96-013, January 19, 1996, p. 70.

<sup>132</sup>*Monitor*, I:62, July 28, 1995.

<sup>133</sup>*IF News*, September 14 and November 12, 1997.

<sup>134</sup>*OMRI Daily Digest*, 222, November 15, 1996.

"there will be many routes for transporting main flows of Caspian oil, and none of them will be the main route."<sup>135</sup>

Moscow also offered specific incentives: lower prices (pipeline tariffs?) and more "effective" patterns of building oil terminals;<sup>136</sup> an increase in the capacity of the northern route pipeline to 17 million tons a year from the current 5 million, and if this proved successful, additional investment to raise capacity to 30 million tons. Aliyev responded evenly that he would not rule out the possibility of increasing export through the northern route but the Turkish route was more important.<sup>137</sup>

The lure held out to Georgia was a steady supply of oil by pipeline from Novorossiisk via Abkhazia. This would strengthen economic links between Georgia and Russia and facilitate the settlement of the conflict with Abkhazia, Moscow suggested.<sup>138</sup> Tbilisi was unimpressed by this offer, but it was electrified by an attempt to assassinate Georgian president Shevardnadze on February 9, 1998, followed 10 days later by an abduction of several UN officers. Shevardnadze charged Russia with a plot to damage the perception of Georgia's stability as a transit route for Caspian oil and thus undermine Georgian independence. The plot, he declared bluntly, was hatched

in Moscow... I do not mean Boris Yeltsin, but forces in Moscow who would do anything to prevent the oil pipelines from being built through Georgian territory. Once these projects are launched, the world will have a stake in Georgia as a country.<sup>139</sup>

Neither blandishments nor covert action have visibly affected either Aliyev or Shevardnadze. The former, who is likely to have a major say on the route of the main pipeline for AIOC oil, continues to affirm his preference for Baku-Ceyhan;<sup>140</sup> the latter would prefer a much

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<sup>135</sup> IF News, November 13, 1997.

<sup>136</sup> IF News, November 13, 1997.

<sup>137</sup> Lada Yevgrashina, "Focus: Russia Says Willing to Compromise on Caspian," Reuters, March 30, 1998, copied in *Johnson's Russia List*, 2125, March 31, 1998.

<sup>138</sup> *Energy and Politics*, 3, February 3, 1998.

<sup>139</sup> "The Fortnight in Review", *Prism*, IV:5, March 6, 1998.

<sup>140</sup> IF News, May 10, June 1 and 9, 1998; *Energy and Politics*, 21, June 11, 1998.

enlarged Baku-Supsa pipeline but will be pleased with any line to Ceyhan that still crosses Georgia.

As exploitation of Kazakhstan and Turkmenistan offshore reserves became more likely, the idea arose of joining the Central Asian to the Azerbaijan flows via a pipeline across the Caspian seabed.<sup>141</sup> Azerbaijan and Kazakhstan had agreed tentatively on the desirability of such a trans-Caspian link in the summer of 1997.<sup>142</sup> The concept picked up momentum, particularly after it received warm support from then U.S. Secretary of Energy, Frederico Pena, during a trip to the region in the fall: "The United States strongly supports Turkey as an export route for Caspian and Central Asian energy exports."<sup>143</sup>

Moscow equally strongly objects to the trans-Caspian pipeline, allegedly because it would pollute the Sea and seriously impair its valuable fish resources, including the legendary sturgeon.<sup>144</sup> That did not prevent Aliyev from giving his official blessing to the idea. Significantly, he welcomed the project "not only for economic but also for strategic reasons".<sup>145</sup>

The Caucasus and Central Asia appear to be lining up in support of the trans-Caspian-to-Turkish Mediterranean route. In January 1998 the presidents of Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan declared their preference for oil pipelines from Central Asia

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<sup>141</sup>See for example, *IF News*, November 11, 1997.

<sup>142</sup>Liz Fuller, "Caspian Ups and Downs," *RFE/RL Newsline*, 74, April 17, 1998.

<sup>143</sup>*IF News*, November 11, 1997; *Pipeline News*, 79, November 10-16, 1997. At almost the same time Vice-President Gore declared: "The United States strongly supports a policy of rapid energy development and multiple transport routes for the Caspian region, with a particular interest in (an) East-West transportation corridor linking the states of Central Asia and the Caucasus to Europe and East Asia." Reuters, November 17, 1998. Secretary Pena, on the same regional trip, claimed that Washington favored Armenia as the transit point from Baku to Ceyhan. Neither Baku nor Tbilisi reacted favorably to this idea, for obvious reasons.

<sup>144</sup>*IF News*, February 25 and April 13, 1998.

<sup>145</sup>*IF News*, April 16, 1998. Turkmenistan's Niyazov has asserted however that the trans-Caspian pipeline is out of the question until he and President Aliyev settle the sovereignty disputes over the Azeri and Chirag oil fields. *IF News*, May 16, 1998.

via the Caspian Sea, Azerbaijan, Georgia and Turkey to Europe.<sup>146</sup> At a conference of Caspian littoral states held in Istanbul on March 1-2, 1998, to which Russia and Iran were not invited, the foreign ministers of Azerbaijan, Georgia, Kazakhstan, Turkmenistan and Turkey endorsed the east-west corridor, including both the Baku-Ceyhan and trans-Caspian pipelines, as the main export route for Caspian oil. The foreign ministers also espoused Turkey's cause of insuring ecological and navigational security in the Bosphorus, and they endorsed the use of "multiple pipelines", presumably allowing for the BGN pipeline or its bypass, the CPC and other routes.<sup>147</sup>

The MFA protested its exclusion from the Istanbul conference and insisted that "the northern route... is the most economical and rational route for transporting early [sic; an error?] Caspian oil".<sup>148</sup> Not for the first time, the Russian government displayed its internal divisions on Caspian energy policy. Asked whether Russia continued to support the northern route, the Minister of Fuel and Energy responded that "economics" should be the deciding factor in the choice of route. That sounded like a renewal of the commitment to the primacy of the northern route, but a day later he maintained that Moscow did not oppose the Baku-Ceyhan pipeline project. After all, he noted, the northern route would only be able to handle 15-17 million tons a year and the western route 5-7 million, whereas Azerbaijan expected to be able to export 40-60 million tons a year; Moscow wished to see multiple routes for the export of Caspian oil.<sup>149</sup> Then Prime Minister Chernomyrdin himself seemed to concede the round when he said a few days later that the route for the main export pipeline "will be determined by the owners of the oil". Russia, he added, was ready "to participate, if invited."<sup>150</sup>

The First Deputy Foreign Minister remained unpersuaded:

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<sup>146</sup>Monitor, IV:3, January 7, 1998.

<sup>147</sup>Monitor, IV:42, March 3, 1998; RFE/RL Newsline, 42, March 3, 1998.

<sup>148</sup>IF News, March 2 and 3, 1998.

<sup>149</sup>Reuters, March 3, 1998, copied in *Johnson's Russia List*, 2091, March 4, 1998; RFE/RL Newsline, 44, March 5, 1998; *Energy and Politics*, 9, March 18, 1998.

<sup>150</sup>Monitor, IV:52, March 17, 1998.

The wish of some countries which have very little to do with the Caspian Sea to manipulate the pipeline issue is easy to understand. The transit of Caspian oil is very profitable, particularly if Russia is pushed to the sidelines.

...Supporters of this project are ready to use any argument to force oil companies to send oil via alternative routes -- from tax privileges and low tariffs to a highly exaggerated problem of safety of navigation in the Black Sea straits.<sup>151</sup>

In this controversy as in the one over participation, Lukoil goes its own way:

- Lukoil's Alekperov made clear that the interests of Tengizchevroil, the consortium developing Tengiz oil, were paramount (although Lukoil held only a 5 percent stake) : "(one) of our priorities today is transport of Kazakstan oil through Azerbaijan."<sup>152</sup>

- Lukoil announced its interest in participating in construction of an oil export pipeline via Georgia.<sup>153</sup> Presumably, the company had in mind not the Baku-Supsa early oil line but a main export line.

- Lukoil explored possible participation in the planned Baku-Ceyhan pipeline with Turkish authorities .<sup>154</sup>

The main impediment to selection of the Baku-Ceyhan route is the projected construction tab, at least \$2.5 billion,<sup>155</sup> as well as the expected high operating costs of sending oil over a long distance through sometimes inhospitable terrain. To surmount this hurdle apparently, the U.S. government, which vigorously backs the Turkish

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<sup>151</sup>*IF News*, April 13, 1998.

<sup>152</sup>*Energy and Politics*, 4, February 9, 1998.

<sup>153</sup>*RFE/RL Newslines*, 176, December 10, 1997.

<sup>154</sup>*RFE/RL Newslines*, 35, February 20, 1998.

<sup>155</sup>This figure was cited by the Turkish energy minister for a line with 45 million tons throughput per year, from a feasibility study carried out by a team of German experts and financed by the World Bank. *Energy and Politics*, February 17, 1998.



route, is also strongly in favor of the trans-Caspian pipeline, because the addition of eastern Caspian oil to the western Caspian stream destined for Ceyhan would cut throughput costs and raise profit margins.<sup>156</sup> The same reasoning was a factor both in inducing Azerbaijan to urge a significant increase in the projected capacity of the Georgian pipeline and in stimulating the revival of the "Ukrainian option", the proposal for a Supsa-Odessa-East-and-West Europe route, mentioned earlier.

The Caspian producing states, and the international consortia as well, clearly understand that their economic and even political well-being hinges on developing more than one route for sending their hydrocarbons to market. It is for this powerful reason that various alternatives to the northern route have been under active consideration, despite their evident costs and risks. And this is why the Baku-Ceyhan line is likely to be the choice for the main export route of Azerbaijan's output. Kazakhstan maintains that it expects to have at least four and possibly six export pipelines in operation by 2015: the Atyrau (Kazakhstan)-Samara (Russia) pipeline, broadened and reconstructed to enable export of 5 million tons of oil per year through Russia; the CPC pipeline; the trans-Caspian-Ceyhan pipeline; and a 3000 km pipeline to China's Xinjiang province, where it would link up with the Chinese network.<sup>157</sup> If the four proved insufficient, additional pipelines would be considered for shipment to the Persian Gulf through Iran and to the Arabian Sea through Afghanistan and Pakistan.<sup>158</sup>

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<sup>156</sup>Michael S. Lelyveld, "Russia, in Shift, Turns Cooperative on Caspian Pipeline," *Journal of Commerce*, April 6, 1998.

<sup>157</sup>Based on a September 1997 agreement in principle between China and Kazakhstan. *Monitor*, III:178, September 25, 1997; *RFE/RL Newslines*, 125, September 25, 1997. The first rail shipment of Kazakhstan crude arrived in Xinjiang in October 1997, and Tengizchevroil expects to ship one million tons of crude to China in 1998. *Pipeline News*, 77, October 27-November 2, 1997; *Monitor*, IV:11, January 19, 1998.

<sup>158</sup>*IF News*, March 31, 1998.

## 5. WHAT HAS MOSCOW WROUGHT?

The behavior of Russia and the three other CIS littoral states in the Caspian Sea oil and gas drama reveals a clash of two elemental interests. On the one side, the smaller states are making intensive efforts to attain relative economic independence, particularly from Russia. Development of the Caspian's hydrocarbons and pipelines to get them to market are seen as the main avenue of escape from Russian economic domination.<sup>159</sup> The first is fairly easy to realize; the second is not, because of the Caspian's remoteness from western or eastern markets. Turkmenistan found itself in the most difficult position of the three states. Its abundant gas reserves were shut out of western markets by Gazprom's refusal to carry Turkmen gas except to other CIS countries. Azerbaijan and Kazakhstan have fought hard to preserve freedom of maneuver in extracting and shipping the oil of the Caspian areas they claim, and they are actively promoting two large export pipelines outside of Russia, the trans-Caspian-Baku-Ceyhan (which could benefit Turkmenistan too) and the Kazakhstan-China.

On the other side is Russia's struggle to maintain control over the exploitation and disposition of the Caspian's mineral wealth. This paper has examined the recent history of that attempt in terms of three cardinal issues:

On the status of the Caspian, it seems clear that Russia has lost the battle for joint control of the entire seabed. Moscow is currently attempting to secure agreement on the principle of joint control of the waters and the surface of the Sea. But the right of each littoral producer to develop the resources of its own sector, with whomever it wishes and for its own national benefit, now has Moscow's reluctant concurrence. Whether the right will be challenged on the surface or subsurface of the Sea remains to be seen.

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<sup>159</sup>"The pipeline is the issue that could give us our real independence." An ambassador from one of the small producers, in Georgie Anne Geyer, "Oil Pipelines Russia Wants to Control," *Washington Times*, September 5, 1995.

On participation rights, opposition of the MFA to Russian oil company membership in the international consortia working the Sea's deposits gave way before the pressure of the energy sector. Lukoil managed to win entrance to the consortia involved in five of ten major Azerbaijan-sector exploitation projects, but it has a controlling interest in only one of these. The Russian partners, public and private, do have the largest share jointly in the CPC, and Lukoil has a small stake in Tengizchevroil. The company also has the inside track for development of Russia's sector of the Caspian, but it is not now a major player in either Kazakhstan's or Turkmenistan's Caspian development plans.

Lukoil had hoped to account for 20 percent of all Caspian oil output by 2005. That would hardly constitute a controlling interest; nor would it guarantee dependence by the non-Russian producers on Russian resources and services. It appears unlikely however that Lukoil will come close to reaching that goal.

On pipelines, the most significant potential lever of Russian control, the battle is still being waged, but on less advantageous terms for Russia than seemed likely a few short years ago. True: the BGN pipeline is still the only significant export line in actual operation; the cost estimates for the Baku-Supsa line have jumped sharply; conflict between Baku and AIOC has further delayed completion; and Russia unequivocally opposes the trans-Caspian link. There is however a good deal of political steam behind the trans-Caspian-Baku-Ceyhan project, despite its length and costliness. China may also be motivated to carry through on the projected Kazakhstan-Xinjiang pipeline. The idea of multiple pipelines, most of which would cross non-Russian territory, is being pursued with vigor. The producer states and the consortia have found expedients to bridge the gap until one or more main export pipelines become available. Moscow has acknowledged the legitimacy of multiple lines, although it still extols the superior merit of the northern route.

The multi-sided contention over these three issues has had two salient outcomes. Most important is Russia's failure to secure control over the exploitation of the Caspian basin. The second is that changes

have taken place in Russian government policies -- that of the Foreign Ministry on the status of the Sea and the rights of participation in national sector development, and of the government as a whole with regard to choice of pipeline routes. Both the failure and the change of Russian policy impel us to seek an explanation. Several contributing factors suggest themselves:

1. Credit the determination of the heads of the Caucasus-Central Asian states -- in the first place, Heydar Aliyev, Nursultan Nazarbayev and Eduard Shevardnadze. They stood their ground under at times intense Russian pressure. Moscow was initially confident that neither the West nor the local regimes would challenge the legitimacy of its claim to a *droit de regard* over the affairs of a strategically vital region that has long been its subject. The Russian ambassador to Baku in 1994 put it bluntly: "The West must accept that Russia is a great neighbor of this country. We have had 200 years of co-operation [sic!] with Azerbaijan. Any politician denying the reality of Russian power is not going to remain long in office".<sup>160</sup>

The last sentence was apparently an allusion to the overthrow of President Abulfaz Elchibey in a coup in June 1993. Perhaps it also foreshadowed the attempted revolt against his successor, Heydar Aliyev, in the autumn of 1994. Shevardnadze was the object of two assassination attempts, and he blames Russian interference for the persistence of the Abkhazian defection. Nazarbayev suffered no such indignities, but he had to be concerned about Moscow's hold on Kazakstan's large Slav minority, dwelling principally along the Russian-Kazakstan border.

Authoritarian leaders of states that are still far from Western models of free economies and democratic polities, Aliyev and Nazarbayev were able to resist Russian pressure without significant internal hindrance. Shevardnadze plays in a more difficult political arena, but national resentment of Moscow and the hope of substantial gain from a cross-Georgian pipeline have buttressed his stance.

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<sup>160</sup>"Russian Pressure on Azerbaijan," *Foreign Report* (The Economist), 2311, July 14, 1994, p. 2.

2. What *The Economist* called "simple realism" eventually came to the fore.<sup>161</sup> The Russian Foreign Ministry's dogged insistence on the "lake" theory of Caspian status did not succeed in moving Azerbaijan and Kazakhstan. Then Turkmenistan came around to share their view. Throughout this period of demands for rights in sectors claimed by Baku and Almaty, Moscow threatened to exercise its spoiling power -- to raise the political risks of the foreign investment that was critical to unlocking the Caspian's treasure -- unless Azerbaijan and Kazakhstan agreed to share the wealth. Moscow's persistence did create some political uncertainty in the region, but the threat proved hollow. Azerbaijan concluded ten major deals with international consortia; Kazakhstan and Turkmenistan joined the game. Moscow finally accepted the inevitable. Deputy Prime Minister Nemtsov was candid: "We have wasted a lot of time and the Americans have taken root in the Caspian region....[Russian] oil companies must be encouraged to be more actively involved in the development of oil fields in the region."<sup>162</sup>

3. The Russian energy complex, supported by the prime minister, opposed the Foreign Ministry's policy direction and subverted its militant demands. This is not to say that the government and the energy sector were uninterested in control of the Caspian. On the contrary, but their approach was through participation rights and penetration by Russian oil companies.<sup>163</sup> To a degree hard to imagine in the West, the Russian energy industry and the government, particularly the Fuel and Energy Ministry, viewed their interests as almost identical and said so publicly. According to the then energy minister, Yuriy Shafranik: "The interests of our [oil] companies outside of Russia [meaning, the near abroad] are Russia's sacred interests." He had no doubt of government backing: "If a Russian company pursues an active, strict policy of

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<sup>161</sup>"Caspian Carve-Up," *The Economist*, March 7, 1998, p. 66.

<sup>162</sup>*IF News*, November 17, 1997; *RFE/RL Newslines*, I:160, November 14, 1997.

<sup>163</sup>Russia's Ministry for Cooperation with CIS Countries urged its government to seek agreements with the other littoral states that would grant Moscow "priority rights" ahead of "third parties" in developing Caspian resources. Such agreements would exempt Russian companies from taxes and royalties and would give Russia priority in choosing export routes. *Monitor*, I:152, December 6, 1995.

movement into the near abroad, the support of both the ministry and the government is guaranteed."<sup>164</sup> Shafranik called Russia's integrated oil companies powerful levers for restoring Russia's influence in the world and pursuing its geopolitical interests.<sup>165</sup>

The energy sector believed with some justification that their chances of getting in on the bonanza were being undercut by the MFA's obduracy. Back in 1994, after the conclusion of the "deal of the century", Shafranik defended the right of Russian oil companies to join the international development consortia :

Russia must have only one version of access to the resources of the Commonwealth of Independent States. We, by virtue of our labour, mind, energy have created all this...We think that it is in Russia's interest to participate in resource-related projects in other CIS countries.<sup>166</sup>

After a year of harsh debate between the Foreign Ministry and Azerbaijan, Shafranik urged an end to the polemic:

Having visited Baku and the other capitals of the Caspian states, I believe that Russia can now win only in one instance -- if it urgently conducts separate bilateral negotiations with each party, Iran included. This is perfectly possible inasmuch as we have a certain influence on each party. And while conducting negotiations with each country, we should be reaching agreement on our shares in the prospected and the main prospective fields. Without terminating discussion of the legal status, we would thereby be protecting Russia's economic interests.<sup>167</sup>

The accession of Boris Nemtsov to a prominent position in the Russian government seems to be associated with the change in Moscow's tone. Nemtsov personally attended the ceremony marking the piping of the

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<sup>164</sup>*Interfaks-AIF*, 23, December 4-10, 1995.

<sup>165</sup>*Finansoviye izvestiya*, No. 67, 1996, in *Economica WPS*, III:25 June 29-July 5, 1996.

<sup>166</sup>Russian international news broadcast on November 8, 1994, cited in Henn-Juri Uibopuu, "The Caspian Sea: A Tangle of Legal Problems," *The World Today*, 51:6, June 1995, p. 121.

<sup>167</sup>*Interfaks-AIF*, No. 23, December 4-10, 1995; translated in "Shafranik on Russian Oil Interests Abroad," FBIS, SOV-96-004-S, January 5, 1996.

first AIOC oil from Chirag on November 12, 1997, which also attracted the presence of Ukraine's first deputy prime minister, Britain's senior foreign office minister and US energy secretary Frederico Pena. Nemtsov's appearance was remarkable, considering how vehemently Russia had once objected to Azerbaijan's "unilateral" exploitation of oil reserves on the Caspian shelf. After hailing the initiation of production in the offshore fields and Azerbaijan's quest to become a second Kuwait, Nemtsov then bemused his audience by claiming that the event marked a major stage in the integration of Russia and Azerbaijan. The two countries were "embedded in each other", due to the BGN pipeline. "It is very important to us," he declared, "that Russia's Lukoil and Transneft companies take part in the recovery and pumping of oil across Russia."<sup>168</sup>

4. Nemtsov was indulging in wishful thinking. Russia's efforts at integration in the Caspian basin failed at the macro level and made only slight progress at the micro level through development participation. The drive for macrointegration in fact hindered further microintegration, as when Lukoil was barred from involvement in the Inam project, because Baku saw no change in Moscow's position on the legal status of the Sea. Even if Lukoil or other Russian companies do manage to participate in other Caspian development consortia, the effect on macrointegration is still likely to be small.

Azerbaijan is not on the road to economic integration with Russia. Neither is any of the other principals in the Caspian drama. Azerbaijan's role in Russian trade is of course minuscule. Russia's share in Azerbaijan's trade is about one-fifth, but this is below the level observed during the first two years of the CIS. Russia is even less of a factor in Turkmenistan's trade.<sup>169</sup> Turkey, not Russia, is Georgia's principal trade partner.

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<sup>168</sup>*IF News*, November 12, 1997. Nemtsov delivered a message of congratulations from President Yeltsin, expressing pleasure that the event coincided with the start of transportation of Azerbaijan oil across Russia.

<sup>169</sup>IMF, *Direction of Trade Statistics Yearbook 1997*, 1997, and *Direction of Trade Statistics Quarterly*, March 1998.

Kazakhstan is the more interesting case, owing to its membership in a "customs union" whose other partners are Russia, Belarus, and Kyrgyzstan. The effect of forming the customs union should have been an increase in intra-union trade, especially with Russia, the dominant partner. Russia's share of Kazakhstan's exports instead declined from 45 percent in 1996 to 34 in 1997 and 32 percent in the first two months of 1998; the import trend was the same, down from 55 percent in 1996 to 46 in 1997 and 42 percent in early 1998. Kazakhstan's trade outside the CIS, particularly with the European Union, was on the upswing over the same period.<sup>170</sup>

Russia's inability to achieve economic integration, not just in the Caucasus-Central Asia but in the CIS as a whole, is an important supplementary factor helping to explain Russian policy failures in the Caspian area. CIS integration is a cardinal Russian foreign policy goal, as was noted in the paper's introduction. A Soviet-type, "correlation of forces" analysis would have predicted Russian success in attaining this objective. The actual results however mark that effort as a failure, at least so far. Some of the reasons for Russian lack of success were set out in a previous article.<sup>171</sup> It was argued there, first, that integration with Russia in the CIS holds out the prospect of uncertain economic benefits and possible unpleasant political costs for the Commonwealth's members. The lure of integration into the world market and the international community is proving more powerful, certainly to the Caspian littoral states. Second, Moscow has vacillated on its own role in economic integration, and this apparently traces to ambivalence in the face of fundamental dilemmas: between the benefits of union with one or more CIS states versus deeper integration into the world economy; and between the possible political-strategic gains of union against the costs of a renewed "burden of empire". This is not to say that one or more of the Caucasus-Central Asian states will necessarily opt out of the CIS, although that should not be ruled out further down the road,

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<sup>170</sup>Government of the Republic of Kazakhstan, European Expertise Service, *Kazakhstan Economic Trends*. First Quarter 1998, May 1988. The report was actually prepared by the Deutsches Institut für Wirtschaftsforschung.

<sup>171</sup>Becker, "Russia and Economic Integration in the CIS."



but that their membership in the CIS will likely remain a fairly token involvement.

5. The debilitating economic and military weakness of the post-Soviet Russian state appears as the ultimately decisive factor in both the Russian change of position and its policy failure in the Caspian. It is impossible to imagine that Soviet Moscow, even allowing for the independence of the former Soviet republics, would have tolerated such deviations from central policy as Azerbaijan and Kazakstan managed to pull off in the last few years. In their recent associations, the Caucasus-Central Asian states seem to be pulling further away from Russia. Consider only a few of the region's major political developments in recent years:

- Azerbaijan and Georgia have been drawing closer to Turkey, a NATO member. A Georgian-Turkish summit meeting in March 1998, which dealt with the Baku-Ceyhan pipeline, other transportation and communications links between the two countries, and cooperation of their coast guards, was described on the Georgian side as "historic".<sup>172</sup>

- Azerbaijan has been eager to draw closer to NATO. Tbilisi is gradually edging Russian troops out of Georgia with the help of material help and technical assistance from the West. NATO exercises have been conducted in the Black Sea and in Central Asia. Who would have predicted even five years ago that an American four-star general would parachute into Kazakstan at the head of a detachment of American troops, joined by Turkish, Central Asian and even Russian soldiers?<sup>173</sup>

- Azerbaijan, Ukraine and Georgia have drawn closer together, finding strong common strategic interests, especially with respect to energy. An association formed by Azerbaijan, Georgia, Moldova

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<sup>172</sup>Monitor, IV:51, March 16, 1998

<sup>173</sup>Paul Goble, "A Jump Too Far?," RFE/RL Newsline, 115, September 11, 1997.

and Ukraine in late 1996 (known as GUAM, after the initials of the members) has had several meetings, including one at the summit, to discuss mutual concerns. One of the most prominent is the development of an east-west transportation corridor from Central Asia through the Caucasus to Europe, TRACECA, which is partly funded from the European Union's TACIS program of technical assistance to the CIS.<sup>174</sup>

- The Central Asian countries have formed a "union" that meets frequently. A recent summit meeting declared its support for the trans-Caspian-Baku-Ceyhan pipeline and evoked an outraged response from then Prime Minister Chernomyrdin: "We know only too well who they are, these forces that advocate the southern pipeline routes; the Russian side knows these people's faces....These people seek to distance themselves from Russia."<sup>175</sup>

Nor is it likely that the West would have been nearly as bold in promoting the national cause of the CIS littoral states -- and incidentally, the commercial interests of Western oil companies -- if the Soviet Union had held together. When Chernomyrdin castigated the Central Asians "who seek to distance themselves from Russia", he also fumed helplessly at

the numerous countries that are far away from the Caspian Sea, yet have recently taken to defining that sea as strategically important to them....Only we who live around the Caspian are entitled to resolve these issues.

Foreign Minister Primakov insisted that Russia's post-Soviet weakness would not preclude a vigorous pursuit of Russia's foreign policy goals -- one of which is the integration of the CIS states.<sup>176</sup> The MFA did act with vigor and dedication, but its tenacity could not screen the decline in Russia's power. Former U.S. Secretary of State James A. Baker overstated the case when he affirmed that "the Caspian is

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<sup>174</sup>Monitor, III:24, December 12, 1997.

<sup>175</sup>Monitor, IV:15, January 9, 1998.

<sup>176</sup>Monitor, IV:54, March 3, 1998.

not an economic problem or a geological or an engineering problem." But he was certainly right that the Caspian "is a geopolitical problem of the first magnitude."<sup>177</sup> Russia's inferior geopolitical position forced it into distasteful compromise and policy failure.

One cautionary note. The high costs of extraction and disposition of Caspian oil render the region's ambitious development projects vulnerable to price weakness in the world market. The average export price received for Azerbaijan oil fell by one-third between the first quarters of 1997 and 1998, from \$20.10 to \$13.40 a barrel.<sup>178</sup> A Texaco executive worried that "if oil stays under \$15 [a barrel] for another year or two, this could all come screeching to a halt."<sup>179</sup> The most likely to fall victim would be higher cost projects, and the trans-Caspian-Baku-Ceyhan pipelines might suffer additional delays. Continued, extensive oil price softness could be the basis for one of the few scenarios in which Moscow would regain a larger foothold in the disposition of Caspian resources.

Absent such a development, or a far more improbable sudden rejuvenation of Russian economic and military power, Moscow will not regain anything like its pre-1991 hold on the region, at least in the foreseeable future.

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<sup>177</sup>"The New Oil Rush: High Stakes in the Caspian," *Los Angeles Times*, February 23, 1998.

<sup>178</sup>Michael Wyzen, "Oil Price Decline Fails to Dampen Azerbaijan's Recovery," *RFE/RL Newsline*, 123, June 29, 1998.

<sup>179</sup>Hugh Pope, "Scramble for Oil in Central Asia Hits Roadblocks," *Wall Street Journal*, March 13, 1998.





