# Great Power Politics and the Azerbaijan Oil Pipeline:

## An Update

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Brief Analysis

The South Caspian Sea, which is adjacent to Azerbaijan, will become a significant global supplier of energy in the next decade. It has a 17.5 billion barrel proven reserve, equivalent to that of Britain's North Sea. Based on geological studies, 20-30 billion more barrels of oil could be discovered in the South Caspian basin. The Azerbaijan International Operating Consortium (AIOC) estimates that 1.5-2 million barrels of oil per day (bpd) could be delivered to Western markets in the first decade of the next century.

The North Caspian Sea, with which AIOC is not involved, has 10 billion barrels of proven reserve, mainly in Kazakhstan. Its potential is two to three times that amount.

Geopolitical Factors

Although exploration risk is low, oil development and export in the Caucasus may be hindered by geopolitical factors. Chechnya and activism by other minority ethnic groups present potential threats to peace in the region. The dispute between Azerbaijan and Armenia over Nagorno-Karabakh, in spite of a cease-fire agreement, remains unresolved and potentially destabilizing. AIOC is actively encouraging Washington to promote diplomatic solutions to regional problems. On the other hand, AIOC believes that one of the region's biggest controversies, the division of the Caspian among its littoral states the "Caspian title" issue will be resolved peacefully over time.

Additionally, political influences in the region are changing. In the past two years, the Azerbaijani government gained greater freedom to determine its own policies as internal distractions caused Russian, Turkish, and Iranian influence over the Caucasus to wane. This void gave Western investors an opportunity to begin to develop the region. The introduction and operation of a Western-style business in a mature Soviet system posed a challenge to AIOC, but the consortium feels it is now well on the way to overcoming that problem. The consortium, the Azerbaijan government, and the state-owned oil company, Socar, have adapted to one another, and AIOC now includes a diverse range of investors, located in seven nations. As a result, AIOC and Azerbaijan have gained significant political leverage in many Western capitals.

Early Oil

AIOC's initial transport of limited amounts of oil "early oil" to the West will begin by the end of 1997. The Chirag One off-shore oil platform is half-complete, and first oil is expected in August or September 1997. In October 1995, AIOC chose two existing pipelines that terminate at the Black Sea as short-term export routes; a northern pipeline from Baku, Azerbaijan to Novorossiysk, Russia and a western one from Baku to Supsa, Georgia. By December 1997, AIOC will use the reactivated northern pipeline to transport oil to the Azerbaijani-Russian border. Transneft, a state-owned Russian oil company, will receive the oil and deliver the same volume to AIOC's tankers in Novorossiysk, thus providing the first funds for Azerbaijan. AIOC is in the process of awarding construction contracts to refurbish the western pipeline and to build a new terminal at Supsa. By the end of 1998, the early-oil pipelines will be able to accommodate 100,000 bpd. This progress has created momentum for further development and investment in

Caspian oil.

Main Export Pipeline

The main export pipeline will cost $1.5-3 billion, depending on the route, and will have the capacity to handle about 1 million bpd. AIOC will encourage other production-sharing companies to commit to using the pipeline to enhance the consortium's ability to obtain credit from financial institutions. By mid-1997, AIOC must deliver a recommendation to its shareholders and the government of Azerbaijan on the options for the main oil export pipeline. All potential routes under consideration are technologically and commercially feasible, if "transit governments" those whose territory the pipeline will traverse are reasonable in their demands for taxes and equity contributions. Two potential export routes parallel AIOC's northern and western early-oil pipelines to the Black Sea. To transport the oil from the Black Sea to the Mediterranean and westward, AIOC has studied using either the Bosphorus, to which the Turks now object on environmental grounds, or one of three different Bosphorus by-pass routes; from Burgas, Bulgaria to Alexandroupolis, Greece; from Burgas to Albania; or through Turkey just east of Istanbul. Another option is shipping the oil directly from Baku to Ceyhan, Turkey on the Mediterranean Sea. AIOC currently prefers a route that terminates at the Black Sea, because shorter pipelines are the cheapest on a strictly technical basis. Of course, this does not take into account any taxes and equity contributions to be negotiated with transit governments. Pending negotiations with transit governments, however, all of the options under consideration are roughly competitive with one another.

The Iranian-Persian Gulf route was eliminated as an unrealistic option due to commercial factors. The Persian Gulf is 3,000 miles further from the oil's natural West European markets than is the Black Sea, and therefore the market value of the oil would be lower.

AIOC expects to complete negotiations with transit nations and secure financing from international institutions such as the World Bank in two-to-four years. Full operation of the main export pipeline should begin in six-to-seven years.

International politics will influence the final choice of a main export pipeline. To the extent political considerations contradict commercial considerations, a question arises as to who should pay the shortfall for a "sub-optimal solution."

The Bosphorus

Turkey's objection to increasing tanker traffic through the Bosphorus is based on legitimate environmental concerns. The Bosphorus route should not automatically be dismissed, however. Turkey is currently issuing a tender for a Vessel Tracking System to insure safe traffic, which could ameliorate the situation. Also, some experts believe the current level of Russian oil exports through the Bosphorus will decline. Moreover, some 12 million tons of oil per year are now shipped northward through the Bosphorus to Bulgaria and Romania; this pattern could be altered when Caspian Sea oil comes on line.

If Turkey does impose restrictions on the transit of oil tankers in the Bosphorus, certain shippers will be forced to use higher-cost alternatives, resulting in a charge of up to one and a-half dollars more per barrel. Those excluded from the Bosphorus will thus be unfairly disadvantaged. In any case, the Bosphorus issue must be clarified and resolved through high-level political forums on navigational and environmental matters. The status of the Bosphorus will affect the speed of resource development in the Caspian.

This Special Policy Forum Report was prepared by Rachel Ingber.

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