

## **Moscow transforms real-world game of RISK**

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In early 2002, some 200 U.S. Special Forces soldiers landed in the former Soviet republic of Georgia to train the Georgian army in anti-terrorism techniques, including how to protect a planned oil pipeline from secessionist or anti-Western saboteurs.

With strong encouragement from Washington, Georgia was finalizing a deal with its neighbours, Azerbaijan and Turkey, and Britain's BP PLC to build a \$3.9-billion (U.S.) pipeline from the oil-rich Caspian region to the Turkish port of Ceyhan on the Mediterranean Sea.

The 1,768-kilometre, somewhat-circuitous route bypassed major U.S. rivals in the region, Russia and Iran, as well as Armenia, the traditional enemy of Turkey and Azerbaijan.

The Baku-Tbilisi-Ceyhan (BTC) project, completed in 2005, entailed tremendous commercial risk because the three participants were involved in violent struggles with neighbours or internal separatist groups, and the pipeline would be vulnerable to sabotage. Under the agreement with BP, each country was to provide security within its borders and be responsible for losses should the pipeline be shut down as a result of political violence.

It was part of the United States' effort to reduce Russia's dominance of the region's booming oil trade, and by doing so to encourage the development of independent-minded states on its rival's southern flank.

Now, with its invasion of Georgia, Moscow has dramatically transformed the real-world game of Risk that is being played out in the region.

For more than a decade, Russia watched while the U.S. and Europe played the new “great game” of energy geopolitics in its own backyard. It was 10 years ago this weekend that Russia plunged into financial crisis by devaluing the ruble and defaulting on its mounting debt.

With the Georgian invasion, the Kremlin has sent notice that it now controls the Risk board. And that it is willing to use its armed forces to back up what it regards as its national interest in neighbouring states.

At stake is control over one of the world's most promising new sources of crude oil – one that could rival the impact of the North Sea a generation ago. The U.S., in particular, has worked strenuously to minimize Russia's influence over this energy development.

“While it is early days to say what the security situation is going to look like in Georgia longer term, the events of the past few days deal a blow to the U.S.'s plans to support existing and new oil and gas routes that bypass Russia,” Tanya Costello, Eurasian director with the political risk consultancy, Eurasia Group, said yesterday.

For BP, the Russian invasion of Georgia could turn into a nightmare if it forces it to keep closed two oil pipelines that pump more than a million barrels a day of high-quality oil into world markets. They represent an overall revenue stream of \$100-million (U.S.) a day among the oil company and its partners.

But then, BP recognized the risks before going into the project and insured against losses with host governments and export credit agencies. David Kirsch, an analyst with Washington-based PFC Energy Group, said multinationals like BP have no choice but to operate in extremely risky areas. "You go where the oil is," he said.

However, the Russian economy may also pay a price over the conflict, which further tarnishes its reputation as a safe, reliable economic partner and has provoked confrontation with the United States.

Ms. Costello said the Georgian war – which was motivated by political rather than energy concerns – has added to the nervousness of foreign investors, who dominate the Russian stock market.

In recent months, Russian markets have been rattled by the battle between BP and its Russian partners, who received government support for control over joint venture TNK-BP, as well as government threats to prosecute companies that raise prices too aggressively.

"What happened in Georgia has come on the back of other events in Russia that have increased market concerns," she said. "Together, these are increasing the risk perception around the Russian market."

Moscow's aggressiveness and lawlessness has clearly turned off some Western investors. "Take all the money you want to lose to Russia and you won't be disappointed," quipped Toronto business leader Seymour Schulich, who has spent a lifetime in global businesses.

But the country's vast energy and mineral wealth, and its booming construction and retail sector, amount to a lure that is too enticing for many to pass up, regardless of the widespread criticism.

Inbound direct investment in Russia totalled \$45-billion in 2007, and is not expected to be dramatically affected by domestic squabbles or Russia's foreign adventure.

"I don't think direct investors will be so easily deterred and they will still be seeking opportunities across all different sectors of the Russian economy, including energy," Ms. Costello said.

Despite setbacks, most of the international oil companies continue to operate profitably in Russia. BP has made enormous returns from its TNK-BP partnership, even as its battle with its Russian billionaire partners heated up and its executives either fled the country or were expelled for overstaying their visas. Fadel Gheit, an analyst with Oppenheimer & Co. in New York, said BP has already earned back its investment in the joint venture, though it may still lose out if forced to unload its interest in a fire sale.

## **PUTIN'S HAND**

Western governments and producers regard the Caspian-Central Asian region as they had viewed Russia not so long ago – an important source of production growth outside the cartel of the Organization of Petroleum Exporting Countries, and an attractive area for investment by their multinationals.

But as the West has had to reconsider Russia's role in the global energy picture over the past five years, it will now have to recalibrate its assessment of the security of supply from the former Soviet states.

Moscow's aggressive energy policy in seeking to dominate energy trade in its “near abroad” – as it calls the former Soviet republics – is consistent with the approach taken to the oil and gas industry by former president Vladimir Putin. In bare-knuckle fashion, Mr. Putin reversed a decade of wide-open capitalism to reassert the dominant role of the Russian state, heavily dependent on oil and gas for revenue.

Mr. Putin “intended to reorganize the Russian oil and gas industry to enhance the power of the Russian state,” says Martha Brill Olcott, an expert on Russia with the Carnegie Endowment for International Peace. “Only then, after the reorganization was complete and the state's capacity to protect the national interests in this strategic sector was reaffirmed, would Western firms be invited to participate in the Russian market.”

As rising oil prices strengthened the Kremlin's hand, the former president, who still wields considerable power as Prime Minister, acted to correct what he viewed as the unacceptable status quo in the energy sector.

His government reined in the freewheeling Russian businessmen known as oligarchs, most famously through the controversial prosecution of OAO Yukos chief executive officer Mikhail Khodorkovsky. Yukos' assets were later sold at bargain prices to state-owned companies.

He changed the advantageous terms for Western companies operating in his country, annulling exploration licences won by Exxon Mobil Corp. and Chevron Corp. in the Sakhalin offshore, and then forced Royal Dutch Shell PLC to sell its Sakhalin holdings to state-owned OAO Gazprom.

He unilaterally raised previously subsidized natural gas prices to former Soviet republics such as Ukraine and Belarus, raising the threat of disruptions to gas exports that flow through those states to Europe.

Mr. Putin's assertiveness was fuelled by Russia's growing economic clout, which resulted from rising oil and gas prices. Russia remains the world's second-largest producer of oil, at close to 10 million barrels a day, and the largest producer of natural gas.

When he took power in 1999, crude prices averaged \$10 a barrel and Russia was virtually bankrupt. Since then, Russia has averaged 7-per-cent economic growth a year – 8 per cent in

2007 – and has run a string of budget surpluses that last year topped 3 per cent of gross domestic product.

As a result, its foreign reserves grew from \$12-billion in 1999 to \$470-billion at the end of last year, a measure of economic strength equalled only by countries such as China, India and the oil producers of the Middle East.

The added riches stoked Russia's ambitions to be an energy superpower. To bolster its presence in energy markets, Moscow not only boosted the government's role domestically but has also sought to dominate the export of oil and, especially, natural gas, from its southern neighbours.

The transportation issue is both economic and political: Russia reaps huge revenues and more control over export prices by having its state-owned firms deliver crude and gas from competitors in the Caucasus and Central Asia. At the same time, control of those exports gives the Kremlin massive political leverage over Europe.

“Russia knows they are providing huge amounts to natural gas to Europe – that they have a stranglehold on Europe,” said Oppenheimer's Mr. Gheit. “There is no question in my mind that Russia is going to play its energy card as much as it can.”

Few analysts believe this week's invasion of Georgia was motivated by Russia's energy ambitions, but it clearly supports the Kremlin's goal of exercising more clout in the broader region.

As a result of the invasion, Georgia's reputation as a safe alternative for transporting crude oil and natural gas is threatened, and Central Asian producers will have to reconsider the risk involved in their various plans for getting their oil and natural gas to Western markets.

“There are certainly very strong parallels between the development of Russia's domestic policy and its projection of influence over the other former Soviet countries,” Julian Lee, a senior analyst with London-based Centre for Global Energy Studies, said in an interview. “Russia has always felt it would like to exert a high degree of control over the development of the oil and gas industries of both Central Asia and the Caucasus, as well as its own.”

Stephen Blank, a professor of national security affairs at the U.S. Army War College in Carlisle, Pa., highlights the American distrust of Russia's energy policy in the region, though he added those energy goals were of secondary importance in the current crisis. “Russia's energy objective is to monopolize all Caspian energy flows to Europe, so that it can then blackmail Europe and force political changes to European policy,” Prof. Blank said.

It can then play that energy card to block further NATO expansion to its borders, to prevent criticism of its anti-democratic government, and to win support for the foreign ambitions of its state-owned companies, he added.

## **PIPELINE POLITICS**

The United States has long viewed the Georgian energy corridor as the linchpin of its policy of encouraging independent, pro-Western states to develop in the former Soviet states in the Caspian and Central Asian regions.

At a meeting of the Organization for Security and Co-operation in Europe in Istanbul in 1999, then-U.S. president Bill Clinton lobbied hard and won agreement from Azerbaijan, Georgia and Turkey to proceed with the Baku-Tbilisi-Ceyhan (BTC) pipeline project.

The deal represented a major victory for U.S. foreign policy.

The high stakes in the “new pipeline politics” had been clearly spelled out two years earlier – somewhat undiplomatically – by Sheila Heslin, who had earlier served on Mr. Clinton's National Security Council as director of Russian, Ukrainian and Eurasian affairs.

At the time, Western oil firms were making major investments in the energy-producing states of Azerbaijan, Kazakhstan and Turkmenistan, but export routes were still under discussion.

Washington's fear was that the former Soviet producers would be forced to market their oil and gas through Russia and Iran, thereby conferring both economic and political clout on America's rivals. (Even then, the U.S. was enforcing sanctions against Iran over its nuclear program.) In a New York Times opinion piece, Ms. Heslin wrote that “the consequences would be dire” if Russia and Iran locked up the main pipeline routes for the Caspian and Central Asian resources.) At the time, Shell was planning to build a \$2.5-billion natural gas pipeline from Turkmenistan through Iran to Turkey. An oil pipeline was already under construction that would move crude from Kazakhstan's rich Tengiz field to Russia's Black Sea port of Novorossiysk.

A second oil pipeline was being considered, and it would be routed either directly through Iran, or by a more circuitous path through Georgia. Ms. Heslin said vital American interests required Washington to ensure the Georgian route won out.

Washington's staunchest ally for the Georgian route – in addition to Tbilisi itself – was Azerbaijan, which was already sending crude exports through a Russian-controlled pipeline but wanted to diversify and did not trust Iran.

When the agreement was struck in 2003, the BTC pipeline had generous backing from Western governments, including the World Bank's International Finance Corp., the European Bank for Reconstruction and Development and seven national export credit agencies.

The BTC pipeline opened in 2005, complementing the smaller Baku-Supsa line that BP also operates and the Russian line that ends in Novorossiysk.

This week, BP was forced to shut down the Baku-Supsa line, which delivers 100,000 barrels a day of oil from Azerbaijan to the Black Sea port of Supsa. The company said it was planning to reopen the line as soon as possible.

The larger BTC pipeline had been shut down last week as a result of apparent sabotage by a Kurdish separatist group. BP is hoping to reopen the line after Turkish officials complete repairs next week, assuming the situation in Georgia has stabilized.

Georgian officials – backed up by Western press reports – claimed Russian bombers had targeted the buried BTC pipeline, but BP said it saw no evidence to support those allegations. Analysts said they did not expect Russia to deliberately target the Georgian pipelines, noting that the Kremlin is eager to bolster its claim that it is a reliable energy partner.

## **NO TEARS IN MOSCOW**

Fallout from this week's Georgian war may, however, affect future decisions regarding pipeline routes, and persuade Central Asian states – which have better relations with Moscow than either Georgia or Azerbaijan – that the risks of partnering with those U.S.-friendly states is too great.

Those decisions will not only affect Europe's dependence on Russia for its gas supplies, but **will directly affect the return on investment of international oil companies that are operating in Azerbaijan, Kazakhstan and Turkmenistan.** (CK: This means potential big lost for Big Oil.)

Those states are expected to contribute major growth in non-OPEC global oil and gas production. Azerbaijan and Kazakhstan are expected to boost crude production from 11/2 million barrels a day two years ago to 21/2 million currently, to up to six million barrels a day within the next 15 years.

**“What is really at stake is the unrestricted access of Caspian oil to world markets,”** said the Centre for Global Energy Studies' Mr. Lee. “If, as a byproduct of the conflict in Georgia, people become more wary in the future of expanding the capacity of the export corridor through Georgia, then there will be no tears shed in Moscow.” (CK: This means threat to lower oil supply or a risk premium will be added to oil price.)

Eurasia Group's Ms. Costello said the key to future projects through Georgia will be the degree to which the country returns to normal after the Russia occupation of up to a third of its territory. Serious and continuing instability in Georgia could force producers like Kazakhstan and Azerbaijan to rely more heavily on Russian export routes.

Russian President Dmitry Medvedev said Russia's sole motivation for its incursion was to defend the residents of separatist Georgian enclaves, South Ossetia and Abkhazia, from Tbilisi's aggression. The Kremlin has long denied it covets “energy superpower” status or that it uses energy as a political weapon. It insists it remains a dependable supplier of energy to world markets.

By yesterday, a de facto ceasefire was in effect, though Russian troops remained in Georgian territory beyond the disgruntled enclaves where they had previously maintained a peacekeeping force. With U.S. Secretary of State Condoleezza Rice at his side, Georgian President Mikheil Saakashvili signed a ceasefire that would require Russian forces to withdraw to South Ossetia and Abkhazia, though not out of the country completely. (CK: The cease fire could mean

unilateral, i.e. Georgia that could end Georgia's Western affiliate. If that happens the American's ex-Soviet shield, Latvia, Ukraine could rejoin the Russian protection.)

Short of a continuing crisis, the regional oil producers are likely to continue developing non-Russian export routes to reduce their dependence on their aggressive northern neighbour.

Kazakhstan already exports 60 per cent of its oil through Russian pipelines, but Moscow is blocking expansion of a line owned by a broad consortium that delivers Kazakh oil directly to Russian terminals on the Black Sea. Instead, it would force Kazakhstan to blend its high-quality crude with lower-grade Russian oil in the line controlled by state-owned Transneft.

There has been some speculation about building a pipeline across the Caspian Sea to link Kazakh production with an expanded BTC line, but both Iran and Russia – which have sea coasts on the Caspian – would have veto rights over those plans.

Instead, Kazakhstan is likely to ship the oil across the sea by tanker, and then feed it into pipelines leaving Azerbaijan.

European consumers are also hungrily eyeing Turkmenistan's growing natural gas production, as a way to reduce reliance of Russian exports, which account for 25 per cent of European demand and much greater than that in key markets like Germany.

But natural gas is more difficult than oil to transport because it cannot be loaded on tankers or rail cars. There are proposals to build a sub-Caspian pipeline and then ship the gas into central Europe, a project known as Nabucco.

Analysts say the Nabucco project faces commercial obstacles that are more problematic than the political resistances of Russia, largely because Russia and even China would provide greater prices – net of transportation – on gas sales from Turkmenistan than the Central Europe market could offer.

So while oil producers may succeed in diversifying their export routes, natural gas suppliers will remain beholden to Russian and its monopolist, state-owned Gazprom.

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