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Caspian Pipeline Consortium, Bellwether of Russia's Investment Climate?

Adrian Dellecker

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Summary

The Caspian Pipeline Consortium (CPC), a shipper-owned oil pipeline carrying Caspian oil to Russia's Black Sea port of Novorossyisk, remains to this day the only oil export pipeline on Russian territory that is not under the control of the state company Transneft. Completed in 2001, the CPC was, from the start, the product of a fragile balance of power between states eager to maintain control of hydrocarbon flows and private companies able to finance the necessary infrastructure. Despite its economic success, the future of the CPC currently hinges on a shareholding dispute pitting Russia against private shareholders. This essay places the CPC dossier in the broader context of Russia's investment climate and argues that the dispute's dynamic is an important bellwether of the Russian energy policy.

Introduction

In the energy world, few regions have come under as much scrutiny as the Caspian Sea area has since the breakup of the Soviet Union. Initially touted as a "new Persian Gulf" by more than mere wishful-thinkers, and the subject of intense lobbying by Western governments and companies for new reserves and transit routes, the region has gradually sobered even the most optimistic observers. Wells have come up dry, interstate cooperation has not been forthcoming—especially with regard to Caspian Sea delimitation—and the investment climate has become increasingly nationalistic.

Since 1991, Western majors have acquired significant stakes in the region that they will not walk away from willingly, despite an increasingly difficult investment climate. The Caspian, in fact, is still perceived as "one of the last frontiers for investors."[1] With reserves of 48 billion barrels of oil and 9,100 billion cubic meters (bcm) of natural gas (or 4% and 5% of world reserves, respectively), and production at 2.4 million barrels per day (b/d) of oil and 148 bcm per year of gas (or 2.9% and 5.16%, respectively)[2]—the region remains important for world energy supply.

However, too often analyses of Caspian energy focus solely on exploration and production activities, to the detriment of pipeline geopolitics. With this in mind, this essay seeks to go beyond the Caspian Sea region's reserves and production—already amply documented—and instead give an up-to-date assessment of developments in the *evacuation* of Caspian oil, more specifically oil production from Kazakhstan's north and eastern Caspian fields (the most important being Tengiz and Kashagan), which is slated to increase dramatically in the coming years.

Two main pipelines currently transport Caspian oil to world markets: the Baku-Tbilisi-Ceyhan (BTC) and the Caspian Pipeline Consortium (CPC). Both were the product of the post-Soviet transition era (the BTC was inaugurated in 2005 and the CPC in 2001), and were intended to open the newly independent region to world markets—as well as decrease its dependence on Russia.

For Kazakhstan both pipelines are choice routes for export. Yet each presently suffers from a handicap: the BTC has no Transcaspian

[1] J. Nanay, "The Caspian Oil Export Puzzle," *Energies,* No. 12, Autumn 2007, available at: <www.total.com/energies/N12/en/comprendre/details/dossier03.htm>.

[2] *BP Statistical Review of World Energy*, June 2007: these figures include all known petroleum reserves for Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan plus the Russian fields of the Caspian (Kurmangazy, though it is only a prospect) but also Orenburg (which is essentially depleted) and Karachaganak in the South Volga, as these are connected to the Caspian's oil pipeline network.

pipeline linking it to the eastern shores of the Caspian, and the CPC is already operating above its stated capacity. Though a link across the Caspian from Aqtau to Baku was initially envisaged, it is as far from being built now as ever. The CPC, for its part, is currently mired in a shareholder dispute concerning its planned expansion; this dispute is the subject of this essay.

Both the BTC and CPC were once hailed as making significant inroads for Western-type economic liberalism in the post-Soviet energy sector. Today, the CPC is under serious threat from Russia's resurgence and its claims on what it considers a strategic industry. Though largely eclipsed in the European Union (EU) and United States (US) by Russia's "gas wars" with Ukraine and Belarus, which seem closer-to-home, recent developments surrounding the CPC are telling of a broader shift in Russian policy which is directly linked to the country's overall energy strategy.

The CPC in Context

If only because they funnel oil out of the Caspian sea Region (CSR) in an east-west corridor funded by the West as part of a strategy of diversification and competition for resources, the two Caspian pipelines, BTC and CPC, stand for liberal enterprise in a region where it was inconceivable just a few years ago.[3]

Yet the BTC and CPC also set strong precedents for the region insofar as they helped lay an entirely new legal and commercial foundation in a region newly opened to global capital. After 1991, a US-led drive for liberal petroleum legislation, backed up by tenacious diplomacy, seemed to have largely prevailed in Azerbaijan, Kazakhstan and Russia. With the CPC and BTC completed, the paradigm of economic liberalism advanced by oil executives and US-government officials for developing the Caspian region's energy resources had clearly won important victories. Such success was all the more important in the case of pipelines, as opposed to exploration & production projects, since "agreements, treaties, and alliances can, to varying degrees, be ignored, disavowed, or reinterpreted, while pipelines outlive the circumstances that produced them as 'steel umbilical chords' that tie together economic interests and often link political interests as well."[4]

Enter the West

To illustrate the long-term ramifications that pipelines may have, it is worth highlighting here one particular aspect of the BTC's genesis.[5] The pipeline, which was to traverse over 1,700 km of mountainous terrain through three countries with often confrontational relations, required a solid legal, fiscal, and security foundation to get off the ground. This was achieved essentially by importing the Western model of petroleum governance to the project.

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[3] For a good summary of US regional pipeline strategy, see R. Soligo and A. Jaffe, "The Economics of Pipeline Routes: The Conundrum of Oil Exports from the Caspian Basin," in Y. Kalyuzhnova *et al.* (eds.), *Energy in the Caspian Region: Present, Past and Future*, Basingstoke, Hampshire, Palgrave, 2002, p. 114-117.
[4] L. Ruseckas, "State of the Field Report: Energy and Politics in Central Asia and the Caucasus," *Access Asia Review*, Vol. 1, No. 2, 1998, p. 51.
[5] The BTC as a whole is already broadly documented. For an extensive study see F.S. Starr and S.E. Cornell, "The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West," *Silk Road Paper*, 2005, available at: <www.silkroadstudies.org/new/inside/publications/BTC.pdf>.

The first step was for each host country to sign a Bilateral Investment Treaty (BIT) with the United States (US). Ostensibly aimed at helping to "protect private investment, develop market-oriented policies in partner countries, and promote U.S. exports,"[6] the BIT's real function is to introduce international law to contractual frameworks in countries where the domestic judiciary is far from predictable. It is this treaty which allows investors to challenge a country in an international court for failure to uphold a contract, meaning that "breaches of contract under domestic law are… elevated to violations of international law."[7] With these BITs annexed to the BTC Intergovernmental Agreement, it was this last document—written by Baker Botts LLP, a US-based law firm specializing in this form of international contract—that laid down the law governing the BTC, rather than the host governments. George Goolsby, head of the law firm's BTC project, sums this up best: "Without having to amend local laws, we went above or around them by using a treaty."[8]

What was particularly novel in the case of the BTC (the law firm's website boasts of a "creative approach" to legal and business issues) is that the BTC Agreement consecrated the "principle of the freedom of transit of petroleum."[9] Among other things, this freedom ensured a "virtual freeze of future developments in local regulatory law, an expedited process for the expropriation of land needed for the pipeline, and indemnification from liability for human rights violations resulting from pipeline security control."[10] As with several other international pipeline projects, contractual violations would become a matter for international law to arbitrate—yet in the case of the BTC the exploiting company was free from almost any liability, more so than any other project in the post-Soviet sphere.[11] In addition to funneling oil westward out of the Caspian, therefore, the BTC was a significant victory for the proponents of economic liberalism in the sense that it protected private investors from host countries' authority to affect the investment climate in the future.

The CPC, though less markedly perceived as a victory of the liberal economic paradigm, was equally revolutionary in disrupting Soviet practices. Indeed, it introduced Western business models to the management of oil pipelines within Russia itself, effectively wresting Central Asian oil out of Moscow's outright control. When the pipeline was inaugurated in November 2001, President George W. Bush even issued an official congratulatory statement praising the project's "transparent and stable environment for international trade and investment."[12] Thus the CPC became—and remains to this day—the only oil export pipeline on Russian

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[6] Office of the US Trade Representative, <www.ustr.gov>.
[7] A. Reyes, "Protecting the 'Freedom of Transit of Petroleum': Transnational Lawyers Making (Up) International Law in the Caspian," *Berkeley Journal of International Law*, Vol. 24, No. 3, 2006, p. 853.
[8] Quoted in A. Reyes, *op. cit*. [7], p. 856.
[9] Agreement among the Azerbaijan Republic, Georgia, and the Republic of Turkey, Preamble, 18 November 1999, available at: <subsites.bp.com/caspian/BTC/Eng/agmt4/agmt4.pdf>.
[10] A. Reyes, *op. cit*. [7], p. 844.
[11] *Ibid.*
[12] G. Bush, "President's Statement on Caspian Pipeline Consortium," 28 November 2001, available at: <www.whitehouse.gov/news/releases/2001/11/20011128-11.html>.

territory not controlled by Transneft, the Russian state monopoly. Coupled with the BTC, it fulfilled the US's wish of "multiple pipelines" evacuating Caspian oil westwards. Unlike the BTC, however, the CPC is not governed by international private law but by specially tailored decrees issued by President Yeltsin and Prime Minister Victor Chernomyrdin establishing the required protections for foreign investment, but these remain *national* decrees.[13] Russia never having signed a BIT with the US, nor having ratified the Energy Charter Treaty, means that the enforcement of these decrees remains subject to Russia's own judicial system.

For this reason, the present developments surrounding the Consortium—which is under siege from the Russian party, as we will see—are of utmost importance not only for the International Oil Companies (IOC) present in the Caspian, but for Russia's entire petroleum industry, as well as the country's broader role in the post-cold war international order. In short, recent developments around the CPC are an excellent gauge with which to measure Russia's oft-mentioned resurgence on the international scene, all the more since the pipeline's shareholding structure reflects a fragile balance between the interests of producers and consumers.

Russia's structured resurgence

It must be pointed out that, when the BTC and CPC were being negotiated in the 1990s, Russia was not only "extremely weak"[14] but, as Richard Morningstar, the US Special Advisor for Caspian Basin Energy Diplomacy, stated in 1998, it "ha[d] still to define what its national interests [were]."[15] In a 1998 study by the James A. Baker III Institute for Public Policy entirely devoted to Caspian energy ("Unlocking the Assets"[16]) only one of the 15 essays dealt directly with Russia's role in the region, generally concluding that "Russia has been adjusting economically and psychologically to the loss of an empire."[17] Yet Russia's oil & gas companies, for their part, saw themselves "as more than just well-placed asset-grabbers in the Caspian," with a "vigorous sense of national pride and entitlement… underpin[ning] their commercial pursuits" there.[18] If this was true when Russia was broadly weak, it has today been brought to the fore, now that Russia is more powerful again.

[13] Akin Gump Strauss Hauer & Feld LLP, "Agreements Signed in Historic Caspian Pipeline Consortium Restructuring," 27 May 1997, available at: <www.akingump.com/ru-RU/communicationcenter/pressreleases/pressreleasedetail.aspx?news=1075>.
[14] O. Antonenko, "Russia's Policy in the Caspian Sea Region: Reconciling Economic and Security Agendas," in S. Akiner (ed.), *The Caspian: Politics, Energy and Security*, London, RoutledgeCurzon, 2004, p. 246.
[15] Cited in J.-C. Peuch, "Russian Interference in the Caspian Sea Region: Diplomacy Adrift," in D. Lane (ed.), *The Political Economy of Russian Oil*, New York, Rowman & Littlefield Publishers, Inc., 1999, p. 189.
[16] Available at <www.rice.edu/energy/publications/unlockingtheassets.html>.
[17] I. Gorst, "Petroleum Ambassadors of Russia: State versus Corporate," in James A. Baker III Institute for Public Policy, *Unlocking the Assets*, April 1998, p. 3.
[18] *Ibid*, p. 4.

The "fundamental shift" in the Caspian began with Putin. In December 1999, only a few months after being appointed Prime Minister and two weeks after the CPC groundbreaking ceremony (17 November), Putin organized a meeting in Moscow between Russian representatives and the principal directors of the private CPC shareholders.[19] Ostensibly to assess the progress already made on the CPC, the meeting was also to offer RF support for the project.[20] The private shareholders were reassured: "After meeting with Putin we are sure that we are going to honor our commitments," Vagit Alekperov (Lukoil) commented, while Richard Matzke (Chevron) stated that his "general attitude is of complete satisfaction with [the CPC]."[21] Revealingly, Putin also stated after this meeting that the CPC was of "exceptional significance for Russia, both from an economic and from a geopolitical point of view."[22] In short, Putin was clearly signaling that Russia would show a keen interest in the pipeline.

Then, almost immediately after having acceded to the Presidency in 2000, Putin convened a broader meeting on the Caspian, and named former Minister of Energy, Victor Kalyuzhny, Special Representative of the Russian President in the Caspian Region,[23] mirroring the US's own Special Advisor for Caspian Basin Energy Diplomacy who had been very active in lobbying for the BTC.[24] Lukoil, a private company which nevertheless maintains very close ties to the Kremlin (its President, Alekperov, is said to spend 80% of his working hours in the Kremlin[25]) was another of Russia's "ambassadors" in the region,[26] entering and leaving Production Sharing Agreements (PSAs) seemingly on command, for political reasons rather than industry imperatives.[27] In short, Putin's strategy toward the Caspian closely mirrored his overall approach to Gazprom: installing his men, offering Kremlin support, and micro-managing.

In the Caspian, where Russia's sense of "national pride" and "entitlement" are additional driving forces, belligerence came before Putin and Russian resurgence. One notable expert dates Kazakh complaints of Russian belligerence as early as 1993, when Russia did not hesitate to

[19] In attendance, in addition to Putin, were: Minister of Foreign Affairs Igor Ivanov, Minister of Fuel and Energy Viktor Kalyuzhny, and Minister of the Economy Andrei Shapovalyants. Vagit Alekperov of Lukoil and Richard Matzke of Chevron represented private shareholders. "CPC's Progress Evaluated at Moscow Meeting," *Alexander's Oil & Gas*, 14 December 1999.
[20] CPC website: <www.cpc.ru>.
[21] Cited in S. Blagov, "Petrodollars behind the Chechen Tragedy," Global Policy Forum, 7 December 1999.
[22] "CPC's Progress Evaluated at Moscow Meeting," *Alexander's Oil & Gas*, *op. cit.* [19].
[23] G. Chufrin, "Russia's Caspian Energy Policy and its Impact on the US-Russian Relationship," in James A. Baker III Institute for Public Policy, *The Energy Dimension in Russian Global Strategy*, October 2004.
[24] See A. Jaffe, "US Policy towards the Caspian Region: Can the Wish-List Be Realized?" in G. Chufrin (ed.), *The Security of the Caspian Region*, Oxford: Oxford University Press, 2001.
[25] I. Gorst, "Lukoil: Russia's Largest Oil Company" in James A. Baker III Institute for Public Policy, *The Changing Role of National Oil Companies in International Energy Markets*, March 2007.
[26] I. Gorst, *op. cit.* [17].
[27] See Stratfor, "Moscow's Heavy Hand Seen in LUKoil Pullout from Caspian Project," 19 November 2002, or D.W. Blum, "Why Did Lukoil *Really* Pull Out of the Azeri-Chirag-Guneshli Oilfield?," CSIS, *Ponars Policy Memo,* No. 286, January 2003.

make a profit out of its position as monopsony purchaser in western Kazakhstan and monopoly shipper in eastern Kazakhstan.[28] As early as 1998, another expert noted that "the tortuous history of the CPC has taught foreign oil producers in Kazakhstan that it is unwise to rely on a single route to market."[29]

Today this belligerence is emboldened by Russia's oft-mentioned resurgence on the international scene. Yet what is more note-worthy is that Russian policy, under Putin, has also demonstrated significant coherence.[30] With this in mind, Russia's actions with regard to the CPC need to be closely monitored, especially since the Head of the Federal Energy Agency (*Rosenergo*), Sergey Oganesyan, explicitly threatened to nationalize the pipeline in December 2006.[31]

[28] J. Roberts, *Pipeline Politics*, in S. Akiner, *op. cit.* [14], p. 79.
[29] I. Gorst, *op. cit.* [17], p. 12.
[30] A. Dellecker, "Kremlin Inc. : le système juridique au service de l'industrie énergétique" ["Kremlin, Inc.: Gaming the Energy Landscape"], *Politique étrangère*, No. 4, 2007 (available in in English at:
<www.ifri.org/files/Russie/Note_Gaming_the_Energy_Landscape.pdf>).
[31] "Caspian Pipeline Consortium to Be Nationalized?," *Russia Intelligence*, 18 January 2007.

The CPC Business

The Caspian Pipeline Consortium was initially conceived in 1992, championed by John Deuss (founder of the Oman Oil Company) and drawn up on a Bermuda island.[32] Russia signed up to the plan in 1994, but the three investors (Russia, Kazakhstan and Oman) were unable to finance the project themselves. Thus, in December 1996, the three original states (Deuss having been sidelined) traded half the Consortium's equity with private oil companies in exchange for financing the actual pipeline. This resulted in a 50-50 split in the shareholding structure between the original three states (Russia retaining 24 percent, Kazakhstan 19 percent and the Sultanate of Oman 7 percent) and private oil companies sharing the remaining 50 percent as follows:

- Chevron Caspian Pipeline Consortium Co. (15 percent);
- LukArco B.V. (12.5 percent);
- Rosneft-Shell Caspian Ventures Ltd. (7.5 percent);
- Mobil Caspian Pipeline Co. (7.5 percent);
- Agip International (2 percent);
- British Gas Overseas Holding Ltd. (2 percent);
- Kazakhstan Pipeline Ventures LLC (1.75 percent);
- Oryx Caspian Pipeline LLC (1.75 percent).[33]

From the start, therefore, CPC shareholding mirrored the fragile balance of power between states eager to maintain control of hydrocarbon flows and private companies able to finance the necessary infrastructure. It also represented a balance between suppliers and operators, the first being those who own the oil transiting through the pipeline and the second those who merely receive transit fees and sell quotas.

Structure and management

Table 1 shows current CPC stakeholders taking into account the various joint ventures and subsidiaries, as well as the recent IOC mergers. The table also shows these companies' stakes in the BTC, as well as Tengiz and Kashagan oilfields (both before and after the January 2008 reshuffle). What this table does not show, but is nevertheless important, is that Tengiz

[32] See J. Roberts, "Pipeline Politics," in S. Akiner, *op. cit.* [14], p. 80-81.
[33] It is worth noting that British Petroleum (BP) is present in LukArco (46%) and Kazakhstan Pipeline Ventures (49%).

stakeholders own 55.75 percent of the CPC compared to 26.85 percent of the BTC, and Kashagan stakeholders own 33.1 percent of the CPC compared to 15 percent of the BTC.[34] This is important in order to clearly identify the main actors concerned, as well as gain a better understanding of the crisscrossing interests of all actors, since stakeholders in a pipeline get quotas for transiting oil, as well as preferential tariffs. These numbers point to the fact that, at least from a purely business point of view, Tengiz and Kashagan shareholders have a far stronger interest in using the CPC than the BTC to ship their Kazakh production. Since the production from Tengiz and Kashagan will make up the vast majority of future Caspian oil exports—thus making their shareholders potential customers for CPC capacity—this subtle distribution of interests is of crucial importance.

Table 1: CPC shareholders and stakes in BTC, Kashagan, and Tengiz

Compagny	CPC stake, in %	Other CSR Stakes, in %			
		BTC	Kashagan		Tengiz
			To Dec. 2007	As of Jan. 2008	
Transneft	24,00	-	-	-	-
KazMunaiGaz[a]	19,89	-	8,33	16,81	20,00
Chevron	15,00	8,90	-	-	50,00
ExxonMobil	7,50	-	18,52	16,81	25,00
Oman	7,00	-	-	-	-
Lukoil[b]	6,75	-	-	-	2,70
BP[c]	6,61	30,10	-	-	2,30
Rosneft[d]	3,83	-	-	-	-
Shell[d]	3,68	-	18,52	16,81	-
BG	2,00	-	-	-	-
Eni	2,00	5,00	18,52	16,81	-
Oryx	1,75	-	-	-	-
TOTAL	**100,00**	**44,00**	**63,89**	**67,24**	**100,00**

[a] Kazakhstan's 19% stake plus KazaMunaiGaz's 51% stake in Kazakhstan Pipeline Ventures;
[b] From Lukoil's 54% stake in LukArco;
[c] From BP's 46% stake in LukArco and 49% stake in Kazakhstan Pipeline Ventures;
[d] From Rosneft-Shell Caspian Ventures (Rosneft 51% Shell 49%).

Source: Company reports.

Although the final Shareholder Agreement is not available for independent review, some of the Agreement's features have appeared over time. They notably include the following elements:[35]

– The private companies were to finance the entire 2.67 billion US dollar cost of constructing the pipeline;

[34] Author calculations based on company reports.
[35] All information in the bullet list comes from the CPC website and brochure, available at: <www.cpc.ru/_press/documents/cpc_a4_0303_en.pdf>, and J. Nanay, "US Energy Security Issues: Russia and the Caspian," Testimony before the US Senate Committee on Foreign Relations Subcommittee on International Economic Policy, Export and Trade Promotion, 30 April 2003; available at: <www. foreign.senate.gov/testimony/2003/NanayTestimony030430.pdf>.

– In exchange for its 24 percent stake in the Consortium, the Russian Federation contributed unused pipeline assets worth 293 million US dollars, which the CPC subsequently paid 115 million US dollars to renovate;

– The CPC had to pay compensation for land use under the laws of the Russian Federation;

– Initial transport capacity would be 27 million tons per year (mt/y), and this was to be progressively expanded to 67 mt/y by 2014—most of which would be complete by the end of 2008. Though agreeing to such an expansion project from the start put its investment cost upfront, it had the merit of facilitating future engineering and planning. This agreement is to expire in September 2008 if expansion has not taken place.[36]

With regard to the structure of its management, even less information is available because the CPC shareholding and management structures were very complex from the start. In fact, according to Ian MacDonald—formerly the President of Chevron Neftegaz Russia, and Director General of the CPC from April 2002 to April 2006—"if you had to sit down and design a structure for a major project, you would be hard pressed to come up with anything more complex than the CPC structure."[37]

First, the Consortium was officially split into two separate Joint Stock companies, CPC-R (in charge of the Russian section) and CPC-K (in charge of the Kazakh section), with each having their own distinct management in addition to that of the CPC. Second, there was to be no Board of Directors, but only a management team—itself managed by Secondees appointed by the shareholders—elected for four years by all shareholders. The course of decision-making was thus to be charted in annual shareholder meetings. Last but not least, every decision was to be reached by consensus rather than majority vote. In other words, each shareholder was given a veto over the CPC's management. Though reaching a consensus between three national governments and nine private companies (BP being the ninth) would clearly be difficult in itself, this was soon compounded by the various interests of numerous independent shippers that became affiliated with CPC over time.[38]

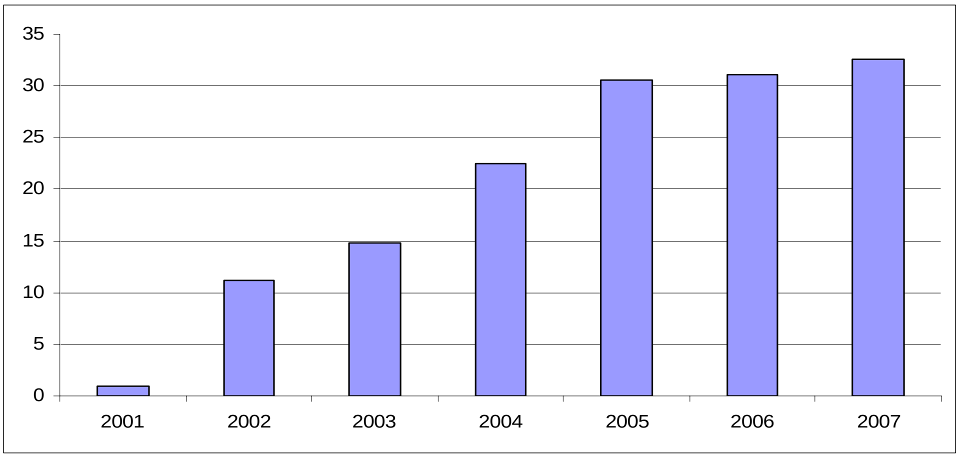
Such a complex and fragile balance of power within the CPC's management makes any alteration of its structure of utmost importance to the geopolitics of Caspian energy supply. In the words of an expert, the CPC has come to be "seen by the international investment community as a bellwether of Russia's investment climate."[39]

Expansion becomes a hostage

[36] J. Nanay, *op. cit.* [1].
[37] I. MacDonald, "A New Dimension," *CIS Oil & Gas*, No. 211, available at: <www.cisoilgas.com/pastissue/article.asp?art=270690&issue=211>.
[38] All information for this paragraph comes from the CPC website, news reports and remarks by the Director General, Ian MacDonald (2002-2006).
[39] S. Heslin, "Key Constraints to Caspian Energy Development: Status, Significance, and Outlook," in in *Unlocking the Assets*, *op. cit.* [16].

The pipeline, which was completed in November 2001 nearly on schedule and at very little cost-overrun, was an immediate success. Increasingly solicited by various shippers, the CPC began functioning above its stated 27 mt/y capacity in late 2004.

Figure 1: CPC Oil Shipments to Novorossyisk, 2001-2007 (mt per year)



Source: CPC website, <www.cpc.ru/portal/alias!press/lang!en-US/tabID!3369/DesktopDefault.aspx >.

On the chart above, the data for 2002 roughly represents the amount shipped from the Tengiz oil field. Thereafter, numerous other shippers claimed their allotments: Oryx began shipping oil from Karachaganak in late December 2002, and in 2003 oil was supplied from the Kumkol, Aktoboe and Emba fields, as well as from various Russian fields coming in from barge and train, loading in Atyrau and Astrakhan. Such success prompted the CPC's management to present the shareholders a preliminary plan in March 2003 moving the pipeline's designed expansion forward. This expansion made "unarguable" economic sense to its Director General Ian MacDonald, and in October 2004 he claimed to have support from all shareholders to move the project forward.[40]

The real problem for the Director General was for everyone to agree on "the basis for proceeding with expansion." Indeed, the CPC's system of operating by consensus effectively meant that any shareholder could hold up the project. As it turned out, satisfying all shareholders "proved to be far more of a challenge than anticipated." Yet the Director General pointed the finger at Russia in particular: what MacDonald saw as a "business imperative," Russia saw as an opportunity for increasing its clout.

Thus, Russia quickly produced a list of demands to be met before it would agree to any expansion, essentially single-handedly holding up the

[40] Unless otherwise noted, all quotes from Ian MacDonald come from his *Remarks* at the Kazakhstan International Oil & Gas Exhibition and Conference, Almaty, October 2005, from his *Remarks* at the CIS Oil & Gas Summit, Paris, June 2005, or CPC Press Releases, all available on the CPC's website at: <www.cpc.ru>.

project until it was satisfied. These demands included a change in the tariff review mechanism so as to increase transit tariffs by more than the mandated rate tied to inflation, a dismissal of CPC claims to account for the rehabilitation of transferred assets in its balance sheet, the lowering of the interest rates for the loans provided to the Consortium by the operating companies, external financing of pipeline expansion, and the introduction of "send or pay" clauses for any expansion oil. The Russian party also manifested its desire to see the elimination of Management Secondees and the creation of a representative Board of Directors.[41]

Taken individually, these demands were not in themselves unreasonable. Combined, however, they amounted to a serious change in the structure of investor interests. Succinctly, the real problem with Russia's position resided in the fact that this list of demands, taken as a whole, was clearly "designed to address what the Government saw as structural faults in the original CPC contract."[42] Thus, a "send or pay" clause would change the contractual framework of quotas; a Board of Directors would alter pipeline management; the external financing of expansion and restructuring of past debt would be a modification of the conditions of investment; a tariff review would change the structure of turnover. In other words, Russia was asking for a complete overhaul of the original contract.

For the IOCs involved in the project, the stakes are high: "If an agreement with Transneft for CPC expansion is not approved this year," one expert has warned, "the TCO [Tengizchevrvoil, Tengiz operator] partners will have to invest in alternative export avenues. Other producers could be forced to reassess the timing of their planned output increases. While this would be a setback for Kazakhstan, it would also have a negative impact on US and EU companies and dampen the West's expectations on the volumes and timing of Caspian oil flows."[43]

41 The full list of Russian conditions can be found in MacDonald's *Remarks*, June 2005, *op. cit.* [40].
42 I. MacDonald, *Remarks*, October 2005, *op. cit.* [40].
43 J. Nanay, *op. cit.* [1].

Russia's Position and its Possible Consequences

Though a Task Force was established in July 2004 to address these issues, and despite a sensible compromise being reached on each of them by October 2005, expansion still had not received the go-ahead by the time Ian MacDonald's four-year term ended in April 2006. Time and again Russia came up with new demands.

It is difficult to understand Russia's actions as being driven by purely economic considerations. For example, holding up CPC expansion costs the Consortium 60 million US dollars a month in lost transit fees, according to calculations by its Director General: by single-handedly holding this project up, therefore, Russia stood to lose 173 million US dollars a year in transit fees alone, to say nothing of associated contractual work.[44] Instead, the struggle at the heart of the CPC management must be understood in the wider framework of its geopolitical context.

Russia closes in

From a strictly economic point of view, Russia would benefit from the increased sales generated by greater oil flows. Yet the key to understanding the struggle over CPC is that Expansion would not actually transport *Russian* oil, but that of Kazakhstan and IOCs. Indeed, Expansion is clearly more of an imperative—despite what MacDonald might claim—to the *shippers* (those investors who have stakes in Tengiz and Kashagan) rather than the *operators* (those having transit quotas but little oil).

If we refer to Table 1, which broke down the various CPC stakeholders' interests in the CPC upstream, it is clear that Lukoil would be the only Russian stakeholder east of the Caspian that could ship extra oil in the expanded pipeline, thanks to its 2.7 percent stake in Tengiz. To be fair, we might add its 50 percent stakes in North Buzachi and Kumkol—two fields which also supply the CPC—to this, as well as its 15 percent stake in Karachaganak (see Annex) which also supplies the CPC in part.[45] Yet neither of these fields is slated to increase production, which in any event is

[44] This sum would in fact now be higher, since transit fees have been increased since MacDonald's calculations in October 2005.

[45] Lukoil, *Fact Book 2007*, available at <www.lukoil.com/materials/doc/DataBook/DBP/2007/FactBook/factbook2007eng.pdf>.

significantly lower than that of Tengiz or Kashagan's projected output (4.74 mt for Kumkol and North Buzachi combined in 2006 compared to Tengiz's 13.3 mt, which is set to double very shortly). Of course all stakeholders—not only shippers—would benefit from expansion, witness MacDonald's 60 million US dollars-a-month figure. Thus Transneft and Rosneft might benefit from increased tariff revenues by selling some of their transit rights to third parties, yet clearly that increased revenue is not, in itself, satisfactory enough.

The most plausible answer is that Russia really wants greater control—and not only income—over the only pipeline on Russian territory that is still shipper-owned, that is, owned and operated by the companies exploiting the oil it transports as opposed to by a third party with management powers, in this case Transneft. With such control, or at the very least the *threat* of a takeover, Russia would also have an indirect say in the upstream fields that it could not otherwise control. In fact, controlling the flow of Caspian oil to world markets is perceived as a powerful tool for Russia's broader foreign policy and an important chip in any international negotiation, for instance for the Burgas-Alexandroupolis pipeline. CPC expansion should not even be considered as merely an oil issue, as the CPC dossier may also be used to obtain concessions elsewhere from all its partners, be it upstream or down, in gas or oil, or indeed even beyond the energy sector.

Several recent events seem to confirm this reading:

1) In April 2006, pursuant to one of Russia's long-standing demands, a Russian was appointed as the new General Director. The job went to Vladimir Razdukhov, at the time Deputy Director General of the oil company Zarubezhneft. Though a mechanical engineer by training, Razdukhov spent most of his career in government, primarily in the ministries of foreign trade and economic relations.[46] Zarubezhneft was created by the USSR to operate in "fraternal" countries—notably Vietnam, Angola and Iraq, where it was very active in the Saddam-era and frequently cited in the UN's 2005 report into the Iraqi Oil-for-Food scandal.[47] It is also thought by some to be a haven for ex-KGB members.[48]

2) In April 2007, Russia's 24 percent stake in the CPC, initially held by the Federal Property Management Agency *(Rosimushchestvo)* was transferred to Transneft by Presidential decree. This was widely perceived as a victory for Transneft—for whom the CPC was a direct rival—and its President Semyon Vaynshtok who had long argued in favor of this development.[49] Such a move certainly consolidated Transneft's monopoly

[46] Before joining Zarubezhneft, Razdukhov was the RF Trade Representative to the UK. He also worked at the RF Ministry of Economics and the Ministry of Foreign Economic Relations. He had been a Senior Expert the USSR Ministry of Foreign Trade as well as at the USSR Chamber of Trade and Industry and Gosplan (CPC website).

[47] UN Independent Inquiry Committee, "Report on the Manipulation of the Oil for Food Programme," 27 October 2005, available at: <www.iic-offp.org/documents/IIC%20Final%20Report%2027Oct2005.pdf>.

[48] "Zarubezhneft, Such a Discreet Company," *Russia Intelligence*, 18 January 2007.

[49] "Caspian Pipeline: The Final Victory of Semyon Vaynshtok," *Russia Intelligence*, 28 September 2007.

in Russia and confirmed the trend to establish "national champions" in strategic industries.

3) In October 2007 a member of Putin's entourage, Nikolay Tokarev, was appointed President of Transneft. Tokarev is supposedly a former KGB officer. Interestingly, until then Tokarev had been Director General of Zarubezhneft, and brought much of the company's top management to Transneft with him. By transferring most of Zarubezhneft's top-level staff to Transneft and the CPC, Putin seems to have allowed his KGB peers to "graduate" to more important positions in the Russian power structure. This also highlights one of the Kremlin's greatest weapons in domestic power politics: the distribution of favor and disfavor, promotion and demotion, reward and punishment based on political allegiances and strategic projects—beginning with the sidelining of Gazprom's former Chairman, Viktor Chernomyrdin, in June 2000. Yet it remains unclear if the Kremlin or its "national champions" are the ones in control of policy: revealingly, Putin took nearly a year and a half to sign the decree transferring the Rosimushchestvo stake to Transneft, raising questions concerning the real power dynamic in Moscow.[50]

Divide and conquer

FSB and "palace politics" aside, the developments surrounding Russia's oil export infrastructure point to a "tightening of the screws" on the CPC. Though the Kremlin will be reluctant to nationalize the Consortium outright,[51] it must be assumed that it will try everything else short of this.

Ever since Transneft took over, it has been pushing hard to abolish the policy of consensus in the CPC's management in favor of majority voting.[52] This of course would not give Transneft control over the CPC—in fact, such a move might even be seen to strip power from the Russian party: with a non-blocking minority stake, Transneft would not command the CPC's agenda or its direction, while a system of consensus would mean that no management decisions could be made without its approval. Yet if Transneft can somehow entice or threaten private companies within an enlarged range of business interests—and not only in the oil business—then it might bring the Board of Directors to heel far more easily. In other words, if the Russian party can insert the CPC debate into the more transversal stakes of Russian energy and foreign policy, then it might be able to control the pipeline even if it does not have an outright majority. Through a "divide and conquer" strategy, which so closely mirrors that of Transneft's main shareholder—the Russian state—with regard to its foreign partners, Transneft might gain a plurality of votes, dictate the agenda, and thus control the flow of North Caspian oil coming from Kazakhstan—

[50] "Transneft to Manage Caspian Pipeline Consortium for $0.04 a Year," *Kommersant,* 2 May 2007.
[51] A. Dellecker, *op. cit.* [30].
[52] "Transneft Left Out of the Consortium," *Kommersant*, 4 July 2007.

including transit fees. Shy of actually owning the fields in the former Soviet space, this would be seen as a big victory for Russia.

Such a strategy, which consists of broadening the stakes for CPC shareholders by linking compliance to larger issues in the Russian energy landscape—and perhaps even beyond the energy landscape—seems to be vindicated by the latest news coming from the CPC. On 3 July 2007, for example, Transneft convened an extraordinary shareholder meeting in Moscow, in order to bring to a vote a tariff increase and a 5.5 billion US dollar Eurobonds issue for CPC debt restructuring. Though it was soundly defeated in the vote, both Lukoil and BP voted with Transneft. BP being part of LukArco and under great pressure at TNK-BP may help to explain its position. In a consensual system, Transneft would need to convince everybody; in a system of majority voting, it would only need to convince Chevron and have Kazakhstan abstain.[53]

Despite this latest defeat, Transneft remains defiant. After the July shareholder meeting it gave two weeks to shareholders to hold another vote, and Semyon Vaynshtok declared that Russian demands were "becoming more severe" toward its CPC partners.[54] When no such vote took place, Russia's Federal Tax Service came up with back-tax claims of 290 million US dollars for the 2004-05 period. It is entirely possible that these back-tax claims have nothing to do with Transneft's agenda, though it is difficult to imagine.

The Russian Federal Tax Service had already claimed back-taxes from the CPC in July 2006, shortly after Razdukhov had been appointed, though the sums were far smaller (2.1 billion rubles for 1999-2002 and 4.7 billion rubles for 2002-03).[55] So far, such pressure from the Russian state has not dislodged CPC shareholders. Nevertheless, more votes will certainly take place under Razdukhov's directorship, and expansion will clearly be on the line. The way private shareholders vote will be of utmost importance for the future of Caspian oil, and indicative of the present balance of power in the region.

Yet Russia's tactics also run the risk of being counterproductive. Indeed, not only is the Russian party likely to scare off future oil & gas investments by the West, its behavior is also influencing its Caspian partners. The fact that Kazakhstan abstained in the July 2007 vote held by Transneft at the shareholder meeting is of notable significance. Since Tengiz production has already begun to increase, and CPC delays mean that extra capacity will not be online for some years, Russia might inadvertently be the best advocate for Kazakhstan's "Plan B" for evacuation: the so-called Kazakhstan Caspian Transportation System (KCTS), a barge-and-tanker alternative to a Transcaspian oil pipeline running from Aqtau to Baku, able to ship between 25 and 50 mt/y through the BTC.[56] Though the Transcaspian pipeline may have no chance of being

[53] *Ibid.*
[54] V. Socor, "Transneft Squeezing Oil Majors in the Caspian Pipeline Consortium," *Eurasian Daily Monitor*, 23 July 2007.
[55] *Ibid.*
[56] For a good summary, see J. Delly, "Kazakhstan Eyes New Oil Export Route Via Caspian Sea," *Eurasianet.com*, 11 April 2007, available at:

built in the near future, in large part because of Russian foot-dragging, the idea of sending regular tankers from Aqtau to Baku to top-up the BTC has gained much ground in the past few years, and no doubt has been aided by Russian intransigence on the CPC dossier, despite the project clearly being less economically sound than adding another pipe to the CPC route. As MacDonald noted as early as 2005: “[t]he completion of BTC and the construction of a China pipeline mean that Caspian producers have choices”—which was precisely the aim of the “multiple pipeline strategy” in the first place. Of course, the “decision to make this [KCTS] investment is not easy for those Kashagan partners that do not have a stake in the BTC.”[57] As we have seen, Kashagan shareholders control only 15 percent of the BTC. The next few shareholder meetings, which seem to be happening more and more often, will need to be followed with care in order to gauge the direction of Russia’s oil and gas industry.

<www.eurasianet.org/departments/insight/articles/eav041107.shtml>; see also J. Nanay, *op. it.* [1].
[57] J. Nanay, *op. cit.* [1].

Conclusion

In 2003, an expert on energy in the Caspian area testified before the US Senate Committee on Foreign Relations that "experience in the region has shown that politics can play an important role in pipeline commitments, but politics can be hard for companies to predict."[58] Five years on, this trend has clearly been confirmed.

Nevertheless, Transneft and Russia's position on the CPC can seem somewhat puzzling at first glance: while natural gas, with its regional markets, long-term contracts and massive investments, has proven to be a key instrument of foreign policy, the same cannot be said of oil. The oil market is global and CPC oil, no matter who "controls" it will contribute to the global supply and hence positively affect Western consumers' interests. In this light, it is difficult to fully gauge Russia's aims in blocking expansion. Even taking the two most sensible aims into consideration (making expansion contingent on Burgas-Alexandroupolis and the increase in transit tariffs), the ends hardly justify the means. On Burgas-Alexandroupolis, Transneft clearly cannot force private investors into a project where the stakes are politically charged. As for increased tariffs, revenues of a few million US dollars a year—if that—are clearly a drop in the ocean for the Russian Federation.

Three other possible reasons emerge:

1) Russia's stance on the CPC is hostage to Transneft's own demands: while a few million dollars in revenue might be very little for the Federal government, it becomes more significant when looking at Transneft's own turnover, not to mention the individual wealth of those who control it. This raises the issue of whether it is the Kremlin who uses the "national champions" as a vehicle of policy, or the other way round;

2) Russia's aim is to send a strong signal to upstream producers that it cannot control directly, particularly Chevron and Kazakhstan but by no means just them, that in order to do business with Russia they need to comply with the Russian political agenda and business model: the CPC is one of the last barriers to this becoming a reality;

3) Russia is strongly motivated merely by the *psychological* factor of simply *desiring* to own all export pipelines on its territory.

While clearly all of these factors are at play, it seems worrying to consider that it may be this last one, psychology, which explains best the larger part of Russia's stance. Total control is just "comfortable,"[59] even if it

[58] J. Nanay, *op. cit.* [35].
[59] Interview with the author in Moscow, April 2008.

is not clear what Russia will gain, politically or economically, from controlling the CPC dossier.

As Ian MacDonald warned shortly after the CPC opened, the "CPC is governed by a comprehensive Shareholder Agreement to which the Russian Government is a signatory" and that "respect for the sanctity of contracts is the foundation of all successful international business and trade." An infringement of this respect for the law—especially since the CPC is a case study where *Russian* and not international law applies—may in the long-term bring disadvantages in terms of foreign investment that far outweigh the benefits of eventually controlling the CPC. In the short-term, Russia's position threatens to divert future oil export from Kashagan and Tengiz out of its territory entirely. In the long-term, it could deter the foreign investments, technology, and managerial skills that its oil and gas industry will need to develop its offshore fields, which are often very challenging to exploit. The entire ramifications for the struggle over the CPC are still open-ended, yet Russia has clearly taken a big gamble in the CPC dossier, with a lot to lose and little to gain.

Annex

IOC Oil & Gas Investments in the Caspian Sea Region, as of December 31, 2007

Company	Country	Field	Part, in %	Reserves (2006)*	Production (2006)*
				million tons oil equivalent (mtoe)	
Chevron	Azerbaijan	Azeri-Chirag-Guneshli	10,3	11,124	3,09
	Kazakhstan	Karachaganak	20,0	45	4,222
		Tengiz	50,0	142	9,35
		total:		198,12	16,66
British Petroleum	Azerbaijan	Azeri-Chirag-Guneshli	34,1	36,828	10,23
		Shah Deniz	25,5	30,37305	5,4162
	Kazakhstan	Tengiz (LukArco 5%)	2,3	6,532	0,4301
		total:		73,73	16,08
LUKoil	Azerbaijan	Shah Deniz	10,0	11,911	2,124
	Kazakhstan	Karachaganak	15,0	33,75	3,1665
		Kumkol	50,0	1,59	1,7
		North Buzachi	50,0	1,59	0,67
		Tengiz (LukArco 5%)	2,7	7,668	0,5049
		total:		56,51	8,17
Statoil	Azerbaijan	Azeri-Chirag-Guneshli	8,6	9,288	2,58
		Shah Deniz	25,5	30,37305	5,4162
		total:		39,66	8,00
ExxonMobil	Azerbaijan	Azeri-Chirag-Guneshli	8,0	8,64	2,4
	Kazakhstan	Tengiz	25,0	71	4,675
		Kashagan	18,52	48,152	0
		total:		127,79	7,08
British Gas	Kazakhstan	Karachaganak	32,5	73,125	6,86075
		total:		73,13	6,86
ENI	Kazakhstan	Kashagan	55,52	40,352	0
		Karachaganak	32,5	73,125	6,86075
		total:		113,48	6,86
KazMunaiGaz	Kazakhstan	Tengiz	20,0	56,8	3,74
	Russia	Kurmangazy	50,0	73,3	0
		total:		130,10	3,74

SOCAR	Azerbaijan	Azeri-Chirag-Guneshli	10,3	11,124	3,09
		total:		11,12	3,09
Inpex	Azerbaijan	Azeri-Chirag-Guneshli	10,0	10,8	3
	Kazakhstan	Kashagan	8,33	21,658	0
		total:		32,46	3,00
CNPC	Kazakhstan	Kumkol	50,0	1,59	1,7
		North Buzachi	50,0	1,59	0,67
		total:		3,18	2,37
TotalFinaElf	Azerbaijan	Shah Deniz	10,0	11,911	2,124
	Kazakhstan	Kashagan	18,52	48,152	0
		total:		60,06	2,12
Hess	Azerbaijan	Azeri-Chirag-Guneshli	2,7	2,916	0,81
		total:		2,92	0,81
Conoco Phillips	Kazakhstan	Kashagan	9,6	24,96	0
		total:		24,96	0,00
Rosneft	Russia	Kurmangazy	50,0	73,3	0
		total:		73,30	0,00
Shell	Kazakhstan	Kashagan	18,52	48,152	0
		total:		48,15	0,00

*Reserves and production reflects percent participation in fields.

Source: Operating Companies' Annual Reports.