Moscow Eager to Retain Azeri Oil Transit

By: John Daly – June 2, 2013

One of the world's most important energy developments of the past two decades since the collapse of the Soviet Union in 1991 has been the development of the Caspian's energy potential, which has attracted worldwide investor attention.

On 23 June 1998, at a "Collateral Damage Conference" hosted by the Cato Institute in Washington DC, Halliburton CEO and later U.S. Vice President Dick Cheney observed, "I can't think of a time when we've had a region emerge as suddenly to become as strategically significant as the Caspian. It's almost as if the opportunities have arisen overnight."

The "opportunities" introduced a geostrategic struggle between the Russian Federation and the United States. Russia wished to retain as much control over the region's energy resources as possible and the United States wanted to exploit the Caspian's reserves for the benefit of Western nations and energy companies.

Given the Soviet Union's skein of pipelines, now under control of Russia's state monopoly Transneft, Moscow initially had the inside track, unless Western businesses could build alternatives.

But Azerbaijan and Kazakhstan, seeing the development of their economies proceeding better with Western interests than Moscow, had other plans. In September 1994 Azeri President Heydar Aliyev signed a $7.4 billion "deal of the century" with 11 Western oil companies to develop Azerbaijan's Chirag concession and the country's offshore Caspian sections of the Guneshli oil fields. The agreement was bitterly objected to by Russia, but Aliyev showed his political skills when he agreed to use Russia's Transneft existing pipeline network to ship Azeri "early crude" to Russia's Novorossiisk port on the Black Sea, mollifying the Kremlin with transit revenues.

U.S. penetration of Azerbaijan's and Kazakhstan's energy sectors continued apace during the conflict. Asreported by the European Commission's Technical Assistance to the Commonwealth of Independent States program for the period 1994-1999 the main sources of foreign direct investment in Azerbaijan were the United States with 28 percent, followed by Britain with 15 percent.

FDI in Azerbaijan exploded from only $30 million in 1994 to $827 million in 1999, about 17 percent of Azerbaijan's GDP, with approximately 90 percent of FDI concentrated in the country's hydrocarbons sector, while Kazakhstan FDI accounted for $1.6 billion in the same period, but which now exceeds $160 billion of foreign FDI.

Until Western alternatives were built however, Azerbaijan was forced to pay handsomely to use Transneft's Soviet-era Baku-Novorossiisk pipeline, its sole outlet. Azerbaijan was appalled not only by the extortionate transit rates, but the fact that the pipeline could not "batch ship," which meant that high-grade Azeri crude was blended with lower quality Western Siberian crude by the time that it reached Novorossiisk, resulting in a lower price.

The picture changed with the $3.6 billion, 1 million barrel per day, 1,092-mile Baku-Tbilisi-Ceyhan (BTC) pipeline, which began operations in May 2005. BTC now supplies a million barrels per day to thirsty Western consumers, transiting high-quality crude from Azerbaijan's offshore Azeri-Chirag-Guneshli fields to Turkey's deep-water Mediterranean terminus at Ceyhan, generating transit fees for Azerbaijan, Georgia and Turkey along the way.

Needless to say, with the opening of BTC, the State Oil Company of the Azerbaijani Republic (SOCAR) subsequently began to downgrade its shipments via the Baku-Novorossiisk pipeline, to Moscow's increasing annoyance.

Accordingly, earlier this month Russia unilaterally abrogated its 1996 transit agreement with SOCAR. On 14 May SOCAR that it had not received any advance warning of the termination.
Why the cutoff?

Lavrov said that Moscow had abrogated the transit agreement "on the assumption that the pipeline would be filled 100 percent and based on that, the tariff was established," but that the condition was not met, adding the agreement had been terminated for economic reasons.

Moscow saw the 1996 agreement to transport SOCAR oil via the Baku-Novorossiysk pipeline providing at least five million metric tons of oil a year, with a tariff of about $15.70 per metric ton, but in 2011 and 2012 sent only about two million metric tons of oil via the pipeline and planned to further reduce that to 1.6 million metric tons this year, leading Transneft to say that it had lost about $50 million a year because the pipeline was operating at half capacity.

After a meeting in Moscow with Lavrov, Azerbaijan's Foreign Minister Elmar Mammadyarov stated that talks are currently underway between SOCAR and Transneft on this issue, and urged people not to politicize the issue.

The long and short of it is that Transneft needs SOCAR more than SOCAR needs Transneft – whether Russia and Azerbaijan can come up with a diplomatic fig leaf to cover this hard truth remains to be seen.