

# Russia's International Integration and Caspian Sea Oil

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Since the collapse of the Soviet Union, Russia's international integration has been complicated by both its economic weakness and its unpredictable foreign policy. In 1996-97, as a result of the size of the potential revenues from the oil and gas sectors and the need to boost the economy, these issues have dominated Russian foreign policy, increasingly bringing Russia into direct competition with the United States. This is particularly evident in Russia's dealings in the arena that has become the focus of attention since the appointment of Evgeny Primakov as Foreign Minister in January 1996--the broader Caspian region on Russia's southern flank, which includes Central Asia and the Caucasus and extends to the Black Sea and Eastern Mediterranean.

This region, stretching from the Eurasian steppe to Asia Minor and then Europe, was historically integrated as a trading route, as part of the old "Silk Road." Traditional communication routes and new commercial ties based on the production and export of oil, gas and refined products provide the basis for regional re-integration today. For Russia, this integration to the south could complement its integration into Europe and the Asia-Pacific, establishing it as the bridge between the dynamic emerging markets of the East and the developed economies of the West. Unfortunately, this process has been retarded by the weakness of the new states in the region, political instability, ethno-political and inter-state conflicts, as well as the confrontation between the most important newcomer to the region, the United States, and one of the key regional powers, Iran. Russia has also been one of the major obstacles to regional integration, driven by fears of losing its formerly decisive influence, and has succeeded in encouraging efforts to bypass it in developing new lines of communication.

In terms of oil, the Caspian Sea, bordered by Russia, Azerbaijan, Iran and the Central Asian states of Kazakstan and Turkmenistan, has been a major commercial oil producing area since 1871. From the beginning, the region's oil industry has been dependent on foreign capital and technology. In the late 1980s, after expert estimates suggested that the Caspian still held somewhere in a range from 32-200 billion barrels of recoverable oil reserves, US oil companies were quick to appreciate its potential. The US oil giant, AMOCO, was the initiator of the Azerbaijan International Operating Company (AIOC)--a consortium of major international oil companies which was first established in October 1991 to exploit off-shore oilfields in Azerbaijan--while another major US company, Chevron, pioneered the development of Caspian reserves in Kazakstan.

## **Strategic Issues in the Caspian**

Oil and gas production and export in the broader Caspian region are dominated by two strategic issues: which states have ownership or title to oil and gas reserves; and transportation of oil from a landlocked sea to world markets, involving development of old and new communication routes.

1. Title--the bulk of the oil reserves are located in Kazakstan and Azerbaijan, with smaller amounts in Turkmenistan, Russia and Iran. There are also substantial gas reserves in Turkmenistan and Kazakstan as well as the other states. Since 1991, there has been a long-running dispute between Russia and the other littoral states over the status and delimitation of the Caspian Sea, and who really has title to the oil and gas. The key question is whether the Sea should be defined as a "sea" under the terms of the International Law of the Sea and then subject to division into national sectors, or whether it should instead be designated as a lake and thus fall under the joint jurisdiction of all the bordering states.
2. Transportation--the principal issue is the fact that the Caspian is landlocked: all transportation options from it inevitably lead across the territory of one of the littoral states with an outlet to major seaways.

Only two states fall into the category of littoral states with a direct outlet to major seaways--Russia and Iran--which respectively border the Black Sea with its outlet to the Mediterranean; and the Persian Gulf with its outlet to the Indian Ocean. All other routes require crossing 2-3 states. Here, the key question is: which route can ensure a reliable flow of oil to world petroleum markets? The bottom line is there is no single good route. There are serious geographical impediments or political risks associated with any transport route from the Caspian: problems of limited capacity in the existing old Soviet routes across Russia mean that these have to be upgraded; other routes across Armenia, Georgia, and into Turkey need to be constructed; mountains in the region have to be traversed; there is serious ethno-political instability, including conflicts in Chechnya, Nagorno-Karabakh, Abkhazia, and Kurdistan; the US veto on Iran precludes the use of an Iranian route for US oil companies; and Turkey seeks to limit traffic in the Bosphorus Straits for political as well as environmental and safety reasons. An alternative route to the Bosphorus across the Balkans from the Black Sea to the Mediterranean also requires construction.

In October 1995, a partial solution to the problem of transporting oil from Azerbaijan was found with the backing of the United States government. Two routes were chosen for early oil production from AIOC projects in Azerbaijan: 1) from Baku through Chechnya to Russia's Black Sea port of Novorossiisk, and 2) from Baku across Georgia to its port of Supsa. The route for transporting long-term production from the Caspian has yet to be announced. Theoretically, the decision to use multiple pipeline routes should bring benefits for the largest numbers of regional players, in terms of revenues from oil transit fees, and foster regional cooperation. Instead, as of October 1997, the pipeline routes have been hostage to inter and intra-state squabbling and Caspian oil has become bottlenecked in Baku.

### **Russia's Policy in the Caspian Region**

Prior to the collapse of the USSR, Moscow monopolized oil production in the region. It also dominated the northern and eastern approaches to the Caspian and Black Seas--and thus the

principle communication routes along this axis. The dissolution of the Soviet Union, the independence of the Central Asian and Caucasus states, and the outbreak of serious conflicts on Russia's southern border, however, led to the deterioration of Moscow's strategic position, in particular concerning control of production and Caspian-Black Sea oil and gas pipeline routes. The potential reorientation of regional communication routes, cooperation between Central Asia and the Caucasus, and their alignment with Iran, Turkey, and the United States, posed a formidable geopolitical challenge to Russia.

As a result, the Russian Foreign Ministry initially saw oil and competition for it in the broader Caspian region as a "zero-sum game" and not one where there was necessarily an opportunity for mutual benefit with other regional powers. The goal became one of regaining control over the Caspian's oil and gas resources and keeping US companies out, unless it was on Russia's terms. Three policies were adopted:

1. Attempting to restore control over regional politics and oil production by force and intimidation, through: support for coups and armed conflicts in Azerbaijan and Georgia; the invasion of Chechnya in 1994; securing military basing rights in Armenia and Georgia; dominating mediation efforts in regional conflicts, including Nagorno-Karabakh; and blocking oil and gas exports from Kazakhstan and Turkmenistan through the existing Russian pipeline network.
2. Challenging the legal status of the Caspian Sea through demanding a post-Soviet renegotiation of the status of the Caspian that would result in the international recognition of the land-locked sea as a lake--preventing its division into national sectors and ensuring a Russian veto over all oil deals.
3. Forging an alliance with Iran specifically designed to challenge and counter US influence in the region, including the conclusion of a ten-year cooperation agreement in December 1995 on issues of military, energy and oil, and declaring the two countries to be "partners in strategic cooperation."

### **The Results of Russian Policy**

Russia's resort to force and intimidation and its encouragement of regional conflicts has had the paradoxical effect of severing its ties with the Caucasus--the region's strategic crossroads--and causing a precipitous fall in Russian-Caucasian trade. New East-West communications corridors for crucial roads, railways and pipelines from Central Asia and the Caspian to the Black Sea have developed, avoiding Russia's North-South axis and reducing its economic influence.

While Russia remains the region's primary creditor, and its political and military importance persists, trade between the Caucasus, Central Asia, Iran, Turkey and Ukraine has increased, along with US regional investment. Export routes from Central Asia across the Caspian Sea to Azerbaijan and then to the Black Sea ports of Georgia, across the Black Sea and up through Ukraine, and then to Lithuania and its Baltic Sea ports are now being utilized as alternatives to traditional routes through Russia. Russia's attempts to block the production and transport of Caspian oil have also sullied its reputation as a reliable long-term partner for Western oil companies, who have come to see Caspian development as the test of foreign investment in

Russia itself. US and Western companies in the region are searching for ways to limit or contain Russian influence in exploration and production deals and to avoid Russia in oil exports. Realization at the highest levels in Moscow of the detrimental effects on Russian economic interests in Caspian oil and inter-state trade has begun to encourage a reevaluation of Russia's policy the region. An economic lobby in Moscow in favor of the development of Caspian oil and the infusion of Western capital and advanced technology into the Russian oil industry--including the Fuel and Energy Ministry and Russian Prime Minister Viktor Chernomyrdin--has modified the Foreign Ministry's hard-line stance on the Caspian Sea regime. The lobby has also pushed for the inclusion of Russian companies, such as LUKoil, in international oil consortia, and promoted a more constructive approach toward projects such as the Caspian Pipeline Consortium (CPC), involving the building of a new oil pipeline running from Kazakstan to Novorossiisk, which had become mired in political disputes.

Russian analysts have also recognized that there has to be more to Russian relations with the Caucasus than conflicts and military bases if it wants to improve its trade position. In May 1996, for example, a major article on the Caucasus in the Russian newspaper Segodnya urged Moscow to forge alliances with local elites, find cooperative ways to resolve conflicts, improve bilateral relations with the governments of Georgia and Azerbaijan, and restore and upgrade Russia's transportation infrastructure.

### **Current Status of Issues in the Caspian**

"Early Oil" (the initial production of Caspian oil from Azerbaijan) was scheduled to flow from Baku in September 1997. As of early October 1997, the oil was still backed up in Baku. The route or routes for the long-term production and the main export pipeline were also to be announced in September. This announcement has yet to be made and seems likely to be delayed given persistent political difficulties.

The major obstacle to bringing the Russian route into operation is persistent instability in Chechnya. Although reports in late September suggested that repairs to the old Soviet pipeline--which was damaged in the war--are proceeding, the Chechen government's share of transit fees for their stretch of the Baku-Novorossiisk pipeline is still a major bone of contention. Ongoing kidnappings and other terrorist activities in the republic indicate that the Chechen government can guarantee neither the safety of the line nor those maintaining it; and Russian proposals to construct a pipeline through neighboring Dagestan suggest that the Russian government also has no confidence in the route's long-term viability.

The second pipeline for "early oil," running through Georgia and terminating at Supsa, is not scheduled for completion until late 1998, and has its own issues of political instability. In Kazakstan, the Caspian Pipeline Consortium (CPC) has also run into problems. Negotiations over transit conditions and social concessions are still proceeding with local Russian authorities along the route from the Tengiz oilfield to Novorossiisk.

## **Implications for the US**

United States policy in the region favors inter-state cooperation on oil and gas production and transport, regional integration, and economic development. However, the realization of these goals has been limited by US policy toward Iran, and by increasing competition with Russia:

- Iran cannot be isolated successfully or left out of Caspian calculations. Apart from Russia, it has the only other existing pipeline system in the region and close links with the key regional states.
- Although some oil swaps have been permitted and US opposition lifted to the construction of a gas pipeline from Turkmenistan through Iran to Turkey, there has been no major change in US policy
- US policy has pushed Russia and Iran together to obstruct developments in Caspian Sea oil that favor US companies. Russia and Iran are not natural allies and have considerable historical and contemporary regional rivalry--but they do have a shared interest in counterbalancing the US.

## **Recommendations**

First, if it seeks to promote regional integration, US policy must be multi-polar, focusing neither on Russia alone in the region, nor on the other states at Russia's expense. The region's complexities demand consideration of multiple states' interests. Secondly, the US must actively court Russia in the Caspian, taking advantage of Moscow's own reevaluation of its isolated position in the region. Russia cannot be excluded from oil production and transport calculations. Russian oil companies have the most experience in the region, are determined to be part of Caspian oil development, and are already entering into joint ventures with US and Western companies--this trend should be encouraged. Iran must also not be excluded from the Caspian, where US policy toward Iran has deformed the geopolitical situation. The size of the stakes of Caspian Sea oil merit a reconsideration of US policy in the region.