

Why Did Lukoil *Really* Pull Out of the Azeri-Chirag-Guneshli Oilfield?

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In late November 2002, Russia's largest oil company, Lukoil, created a flurry of speculation over its decision to withdraw from the Azerbaijan International Operating Company (AIOC), a major Caspian oil consortium. Given Lukoil's prominence in economic and political circles, much of this speculation quickly acquired a geopolitical and even Machiavellian nature. Although the complex and often conspiratorial nature of such explanations makes them inherently difficult to falsify, none of them are convincing, at least as primary reasons for Lukoil's decision. Instead, it will be argued that the main reason for Lukoil's move is related to the company's broader strategic retrenchment and debt consolidation, as reflected in a number of steps it has taken elsewhere, partly in response to pressures of private rating and investment agencies. Contrary to various rumors, Lukoil's pullout from this arrangement has no implications for Russian geopolitics, or even for the company's own long-term involvement in the Caspian region.

Overview

Sometime in mid-autumn 2002 Lukoil decided to sell its share in the AIOC, the consortium developing the Azeri-Chirag-Guneshli (ACG) oil complex in the Caspian Sea off the Azerbaijani coast. The consortium was established in 1994 and, at the time, was widely hailed as the "deal of the century." In retrospect, such forecasts were greatly exaggerated. Although not mammoth by world standards, the fields—estimated to hold between 3 and 5 billion barrels—are nevertheless significant. Moreover, the geopolitical importance of the oil exceeds its commercial significance, because the viability of the heralded Baku-Tbilisi-Ceyhan (BTC) pipeline depends crucially on its volumes. The United States has worked hard to ensure the successful completion of this project, which circumvents Russian soil to provide a potentially major source of transport diversification from the Caspian Sea. Indeed, largely for this very reason, the Russian government under Presidents Yeltsin and Putin has always evinced ambivalent feelings at best toward BTC. Accordingly, in support of the Russian government's position, Lukoil had planned to export at least part of its share of AIOC oil through the northern (Russian) route to Novorossiisk. That compromise arrangement appeared satisfactory for years. Now, suddenly, the company has sold its share to Inpex of Japan—despite the fact that BTC gained final approval this past September, which would seem to have increased the desirability of Lukoil's share in ACG. This tangle of events has left many analysts puzzled.

The Azeri-Chirag-Guneshli Withdrawal: Contending Theories

Establishing the rational, pragmatic explanation for Lukoil's pullout from ACG requires debunking a number of alternative explanations that have been raised in the media.

First, it has been suggested that this decision simply reflected the finalization of the BTC and the exclusion of Lukoil from the project. According to this argument, Lukoil's position is determined largely by geopolitical considerations based in Moscow. Thus, given the fact that ACG oil appears certain to transit the BTC line, Lukoil's continued presence in the consortium no longer makes sense politically. The main problem with this argument is that Lukoil has always reserved the option of transporting its share of the oil through the northern route, away from BTC. Therefore, Lukoil's withdrawal only reinforces the BTC by ensuring that an additional 10 percent of AIOC's volumes from these fields will be dedicated to the "main export pipeline." In addition, this theory assumes that the government was able to induce Lukoil to divest itself of a strategic investment, which appears dubious for the most part, as Lukoil has repeatedly pursued its own interests in the past even when they did not accord with the Foreign Ministry's priorities. On the other hand, it does appear that government leverage has been applied effectively in especially sensitive cases. This includes the BTC, where pressure from the Kremlin seems likely to have been involved in Lukoil's back-and-forth wavering between 1998 and 2002, leading to its ultimate decision not to participate. Nevertheless, the rationale for such continued pressure would seem to have waned in the aftermath of the project's final approval, because the project seems almost certain to proceed regardless of Lukoil's involvement.

A second explanation is economic, albeit related to political issues affecting the BTC. According to this reasoning, Lukoil withdrew from ACG because of concerns over impending political instability in Azerbaijan and/or neighboring Georgia. Arguably, one source of such instability might be the forthcoming change of power in Baku; another might be a resumption of hostilities between Armenia and Azerbaijan; a third could involve unrest or even overt hostilities in Georgia. Any of these circumstances could complicate construction of the BTC, ostensibly imperiling offshore oil extraction from ACG.

The main objection to these arguments is the lack of an empirical basis for believing that they represent imminent danger. Indeed, there is no particular reason to believe that any of these scenarios is imminent at all, raising the question of why Lukoil should suddenly reverse course now when the same possibilities have existed for years. Even if one or more of them were to transpire soon, there would still be no clear basis for assuming that it would represent a danger to the BTC. Any imaginable successor regime in Azerbaijan (or Georgia, for that matter) is virtually certain to continue to support the pipeline; even the outbreak of local conflicts in Nagorno-Karabakh, South Ossetia, Javakhetia, or Abkhazia would be unlikely to derail the BTC given the strong commitment to its security on the part of both national governments as well as the United States, which has agreed to provide training and logistical assistance for this purpose. The Russian army is not a realistic threat to the BTC either. Short of an all-out civil war in Georgia or a massive Armenian incursion, then, military sources of instability would not pose a danger to the project.

It should be noted that a somewhat related explanation was raised briefly concerning potential ecological damage to Georgia's Borzhomi Gorge. Like the above arguments, this one holds that if the BTC was undermined for environmental reasons, then the entire ACG holding would be cast into doubt, and Lukoil's withdrawal was prudentially related to these very

calculations. In addition to the above-noted weaknesses of this argument, the Shevardnadze regime's recent emphatic dismissal of such ecological obstacles effectively removed this scenario from the realm of foreseeable outcomes. Instead, various safeguards have been promised, as well as routing the pipeline away from the river itself. Even in the event of future oil spills in the region one should expect a simple clean-up solution, or a by-pass at most, rather than any real threat to the BTC.

Such unlikely contingencies are hardly likely explanations of Lukoil's decision to withdraw from the ACG at this particular time. In fact, any such disruptions would merely accentuate the desirability of sending oil through the northern (Transneft operated) pipeline to Novorossiisk, at least for the foreseeable future. Indeed, Russian Energy Minister Yusufov recently proposed expanding Azerbaijan's use of this line, the capacity of which could be increased four or five fold. Although Yusufov's overture was rejected, the very fact that it was made demonstrates that the Russian government does not have a fundamentally obstructionist attitude toward the ACG. Although Lukoil's calculations might differ on this score, they cannot be based strictly on rational concerns about the northern route's viability for transporting its share of oil.

Perhaps the most cynical and conspiratorial explanation for Lukoil's decision has to do with government manipulation of stock prices. In early December, soon after the sale of Lukoil's share in ACG was announced, the Russian government moved to sell 5.9 percent of the company's stock (it still retains 7.6 percent). In comparison to last August when the government first considered selling for \$703 million, this time the sale netted \$775 million—a difference of over \$70 million. Speculation soon followed that the two events were part of a conspiracy: Lukoil's withdrawal had been arranged in order to drive up its stock price, to facilitate the government's profit.

Although impossible to reject definitively (hence, in part, its attraction), this explanation is inherently implausible. First, it assumes, once again, that the government is able to effectively influence Lukoil's investment decisions, which as already observed does not generally appear to be true. Moreover, it assumes that the government was capable of exerting such leverage in preparation for *selling* rather than *buying* Lukoil's shares, which is at least highly counterintuitive. Far more likely is that the government simply waited until after August for a propitious moment to sell. In this context, it should be noted that the price of Lukoil shares have been affected by many factors besides its withdrawal from ACG, as discussed below.

Another set of explanations for Lukoil's decision involves pressure from the Azerbaijani government, possibly with U.S. connivance, for a variety of personal and/or pragmatic reasons. According to the more pragmatic variant of this theory, Lukoil was replaced because this would allow more of the oil from the ACG to be channeled through the BTC, as opposed to Lukoil's share being partly or wholly deflected northward. This explanation gains some apparent validity from the fact that the BTC has been troubled by doubts about whether adequate throughput volume of one million barrels per day can be assured. (Such volume can be guaranteed only in the event of Kazakhstan's participation, which remains uncertain.)

With regard to the U.S. angle, this explanation is confounded by well-publicized U.S. efforts to include Lukoil in the BTC, an approach that has been continued under President George W. Bush. Especially in light of the recent warming trend in U.S.-Russian relations following September 11, 2001, the symbolic importance of participation by Lukoil seems to far outweigh any slight commercial gains from adding its share of AIOC oil to the BTC line. Much of the

same observations apply to Azerbaijan, which has sought improved relations with Moscow since Putin's election. Indeed, it was precisely for such symbolic reasons that Baku initially invited Lukoil to participate in the ACG in 1994.

The personal or emotional explanation can be dismissed rather quickly. This theory postulates irritation on the part of the Azerbaijani president, Gaidar Aliev, ostensibly because Lukoil president (and fellow Azeri) Vagit Alekperov failed to gain Moscow's endorsement for Aliev's plan to have his son Ilham succeed him as president, or perhaps because Alekperov was unable to dissuade Russian policymakers from continuing to support Armenia. Such interpretations are inconsistent with the keen displeasure expressed by leading Azerbaijani officials in the aftermath of Lukoil's announcement. In addition, the notion that Alekperov might be used effectively for such political purposes is far fetched, even in light of the cabalistic tendencies prevailing in the Caspian region.

Not so far fetched, according to those who embrace these same tendencies, is the idea that Lukoil's decision (either on the ACG or the BTC or both) was somehow related to the abduction and death of the father of Lukoil Vice President Vagit Sharifov, near Tbilisi on December 1, 2002. In this connection it has been noted that Lukoil Vice President and CFO Sergei Kukura was abducted and released under mysterious circumstances two months earlier (the mother of a Slavneft official was also abducted in early December). Some have seen the kidnappings as part of an assault on the entire Russian oil industry. Others have suggested that they reveal an effort by the Russian government (or Russia's Federal Security Service (FSB) or the military) to coerce Alekperov to abandon the Azerbaijani fields, to drive down Lukoil's stock price, or possibly as Azerbaijani revenge for Lukoil's withdrawal. For our relatively modest purposes, however, the relevant point is that the kidnapping(s) cannot have caused Lukoil to withdraw from the ACG. Only the Kukura abduction preceded the company's decision to sell, and—although Lukoil officials clearly might have drawn any number of conclusions from these crimes—they have not disengaged from any other significant Caspian field. Explaining the Azeri-Chirag-Guneshli decision on this basis therefore requires an exceedingly narrow and unsubstantiated linkage between the abduction and these particular oilfields. Thus, although the inclination to eschew Ockham's Razor and to seek conspiracies is clearly a key aspect of the region's political culture, it does not appear helpful in explaining Lukoil's strategy in the Caspian Sea.

Lukoil's Caspian Strategy

This raises the question of what Lukoil's plans in the Caspian are, including its decision to leave the AIOC. It should first be stressed that although the company has jettisoned this particular investment, it is by no means abandoning the Caspian region, or even the Azerbaijani sector. On the contrary, Lukoil is involved in the Tengiz and Karachaganak oil and gas fields in Kazakhstan, and is a shareholder in the Caspian Pipeline Consortium (which constructed the route from Tengiz to Novorossiisk). The company will also be involved in two substantial oilfields in the large Severnyi block in the northern Caspian, possibly as well as fields in the Iranian sector in the foreseeable future. Specifically with regard to Azerbaijani oil, Lukoil remains invested in the Yalama and Govsani-Zikh blocks, and may have an interest in developing fields in the southern part of Azerbaijan's sector, whose ownership is currently disputed with Iran.

With regard to gas, Lukoil has reconfirmed (despite quiet rumors to the contrary) that it planned to remain an investor in the Shah Deniz gas field offshore Azerbaijan. Shah Deniz is scheduled to produce roughly 8 billion cubic meters of gas by 2006, when a pipeline paralleling the BTC to Erzurum in Turkey would be constructed. Incidentally, this posed a minor puzzle: why should Lukoil retain its interest in Shah Deniz at a time when it was abandoning its equally small position in the ACG and when it continued to resist inclusion in the BTC? Rather than reviewing the arcane speculations surrounding this issue, it might be suggested that Lukoil's apparent intention to remain involved in Shah Deniz is related to recent and prospective developments concerning the regional gas market. The main factor appears to be a set of recent agreements with Turkey and Greece about sending gas volumes from Azerbaijan on to Europe. Although talks about this possibility had begun two years earlier, they accelerated in the late summer and autumn of 2002 as government political and energy officials have moved vigorously to conduct feasibility studies for a pipeline that might continue on to Italy. Prior to these agreements, the depressed Turkish market had cast an increasingly long shadow over gas development projects in the western Caspian. In fact, the short-term outlook is sobering: the Blue Stream project is now operational and Iranian deliveries have been resumed (albeit at a lower level than originally planned), while there remains little likelihood of a dramatic turnaround in Turkey's economy. Nevertheless, thanks to the Turkey-Greece project (or larger "Southern Europe Gas Ring" idea), the future again appears more profitable for Shah Deniz.

Lukoil's Strategic Calculus

Fully understanding Lukoil's decision regarding the ACG requires an awareness of the company's strategic development plans. Briefly, these reflect a trend toward market consolidation, new capitalization, and strategic reorientation.

In addition to selling its 10 percent stake in AIOC, consolidation is evidenced in Lukoil's decision not to bid in the recent tender for Slavneft as well as its sale of a fleet of undersized tankers. Both sets of moves reflect sensitivity to pressures on the part of outside analysts, who over the previous year had questioned the company's fundamentals and reporting transparency. Furthermore, in addition to the roughly \$1.7 billion generated by the sales of existing assets, Lukoil raised \$350 million in convertible bonds in November. The favorable impact on fixed expenditures and cash flow impressed numerous observers, including Standard & Poor's, which raised Lukoil's credit rating in early December (from B+ to BB).

The company's reorientation is evident in its focus on particular projects in which it possesses a majority interest as well as areas, which have great long-term potential. In addition to the northern Caspian, this includes a new emphasis on exporting oil to North America, which is envisioned to link deposits in western Siberia and the port of Murmansk. Other recent infrastructure commitments appear directly related to Lukoil's export routes from the Caspian, including acquisitions in the Balkans and likely involvement in a forthcoming Burgas-Alexandropolis pipeline, as well as limited investments in the Baltic and Kaliningrad region.

Conclusion

In sum, Lukoil's recent decisions reflect a consistent pattern of focusing on profitability, overall cost/benefit, and other fundamental concerns. This explains the withdrawal from the ACG,

which was simply not a priority investment in which Lukoil commanded a majority share. Neither the Caspian nor Azerbaijan per se was at issue, much less Russian diplomatic relations throughout the Caspian region. Although it may be tempting to draw more far-reaching conclusions and to connect the dots in geopolitically relevant ways, such inclinations ought to be pursued with due caution.

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