

Disrupting the Balance

Russian Efforts to Control Kazakhstan's Oil

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Moscow's recent petroleum and natural gas policies have alarmed many observers. The Kremlin has been reestablishing state ownership over its domestic extraction industries while driving foreign investors out. It has also used monopoly state control over its gas pipelines to exert political pressure on foreign partners.

Russia seems to have similar aims in neighboring Kazakhstan. Moscow left Kazakhstan's oilfields underdeveloped in Soviet times, concentrating its efforts on western Siberia instead. Yet a network of Soviet-built pipelines sent Kazakhstan's oil across Russia to the rest of the Soviet Union. Now Russia wants to reestablish an export pipeline monopoly in independent Kazakhstan, using Moscow's state-owned Transneft company, and expand control over associated oilfields.

Why Russia Wants Control

There are two reasons why Russia would wish to control Kazakhstan's oil exports. First, Kazakh oil is sweeter and lighter than Russia's own western Siberian crude and hence commands higher prices. Russia has used its ownership of pipelines crossing Kazakhstan to insist that the two be mixed into a "Urals blend" before hitting the export market. The more export alternatives Kazakhstan has, the less Russia can pad its own profits with Kazakhstan's riches.

Second, Russia might wish to decide at some future point to implement a targeted oil embargo for political purposes. Granted, Moscow could not gain much long-term advantage this way. Oil is a globally traded commodity with a wide variety of extraction sources. Even if Russia could corner a significant fraction of the supply market, its actions would cause only a temporary spike in world prices until alternative

sources filled the gap. For now, Russia could not even implement such an embargo. Saudi Arabia's reserves are so large and, because of low infrastructure costs, its ability to control its pumping volume so great that it can be a "swing" producer, filling any global gaps that arise. Russia lacks this flexibility; its own oil production costs are high, making changes in pumping or storage volume expensive. Furthermore, Russia's current economic health and growth remain dependent on oil exports.

That said, in the past the Soviet Union did suspend oil deliveries to clients several times in order to punish them, and Russia might try something similar. Controlling Kazakhstan's oil exports could allow Russia to become the sole alternate supply state for regional markets - including Western Europe or East Asia - if a crisis in the Persian Gulf or the chokepoint Straits of Hormuz or Malacca were to block the exports of members of the Organization of Petroleum Exporting Countries (OPEC). Kazakhstan's oil could help stabilize regional supplies and, hence, global prices; withholding it could further aggravate the disruption.

Finally, the sum of Kazakhstan's proven and probable reserves is less than half the size of Russia's, but greater than those of Norway and the United Kingdom combined and double those of its westward-leaning Caspian Sea neighbor Azerbaijan. Furthermore, Russia's major fields have been overexploited for short-term gain, with inadequate concern given to investment in future production. Kazakhstan's fields, by contrast, have only recently been opened to production or are still awaiting development. This means they will benefit from the high-tech and more environmentally sound methods used by international oil companies today. Assuming world oil prices remain elevated and Kazakhstan's foreign investment climate remains friendly, Russia could simply wait until Western oil companies finish initial development of Kazakhstan's fields, and then swoop in to take the associated production profits.

How Russia Could Get Control

Russia cannot cajole Kazakhstan back into its fold immediately. Kazakh President Nursultan Nazarbayev's major goal is to maintain a balance among the outside powers involved in the region: Russia, China, the United States, and perhaps Iran. His foreign policy is designed to ensure that the country does not fall into the orbit of any one state. As an old bumper sticker in the country reads, "Happiness is multiple pipelines."

Kazakhstan is a stable country, and even in the absence of free elections it is generally accepted that Nazarbayev enjoys a high degree of popular support. Yet Nazarbayev's term as president ends in 2012, and it remains uncertain whether his successors will maintain his policy of balance. Two high-profile political assassinations, alongside very public infighting among the president's daughters and sons-in-law, foreshadow a difficult succession struggle. This conflict provides an inroad for influence peddling by other states. While commentators in the post-Soviet region often express fear about U.S. interference in regional elections, it is Russia which could, in this case, work behind the scenes to back a successor sympathetic to Moscow's interests, trading favors now for exclusive oil access rights later.

The Caspian Pipeline Consortium

Moscow is also using legal methods to try to gain control of Kazakhstan's oil exports. For example, Russia is trying to renegotiate the Caspian Pipeline Consortium (CPC) contract, whereby oil from Kazakhstan's giant Tengiz field is piped to the Black Sea by a consortium of western and Russian firms and the Kazakh and Russian governments (Oman is also a small shareholder). The pipeline was financed and built by the international oil companies that are members of the CPC and which are also part of the Tengiz oilfield production consortium.

The CPC is based on an international treaty, and is seen by many as a symbol of liberal Western inroads against Russia's sole domination of Kazakhstan. Russia is now trying to reinterpret that contract, turning it into two bilateral agreements between consortium members and the separate Russian and Kazakh states. If Moscow succeeds, Transneft will likely take control over the pipeline that crosses Russian territory, allowing its Russian state owners to veto CPC prices and policies.

The Kumkol Case

Russian efforts are directed not only against western firms, as the struggle over the Kumkol oilfield in west-central Kazakhstan shows. Kumkol is the primary local supply source for a new pipeline, built by Beijing, connecting Kazakhstan to western China. The pipeline currently operates below capacity and therefore must be filled with oil originating in Russia that merely transits Kazakhstani territory via a Transneft pipeline.

Russia's largest private oil firm, Lukoil, owns half of the North Kumkol oilfield in a joint venture called Turgai Petroleum. The joint venture was originally signed by the Kazakh government; but then Kazakhstan sold its share to a Canadian private firm, Hurricane (which changed its name to PetroKazakhstan in 2002). Kazakhstan simultaneously sold the neighboring South Kumkol field to Hurricane, leaving Lukoil with what amounted to a 25 percent stake in a single underground oilfield with adjoining surface areas. By 2005, PetroKazakhstan faced bankruptcy stemming from legal disputes with both the Kazakh government and Lukoil. The Canadian firm sold out to the Chinese National Petroleum Corporation (CNPC), making Beijing Lukoil's new Turgai partner.

Since Lukoil is a privately owned firm, it may seem odd to argue that it represents the Russian state. Twenty percent of Lukoil is owned by ConocoPhillips. Yet the vast majority of Lukoil shares are held by Russian citizens, and Lukoil's actions, at least in part, reflect Moscow's bidding. Lukoil chairman and part-owner Vagit Alekperov, a multibillionaire, cherry-picked the oilfields he wanted as the last deputy energy minister of the Soviet Union. He remains unusually close to the Kremlin, saying in an interview, "Our interests are the same. What's good for Russia is good for the company."

When it was a publicly traded Canadian company, PetroKazakhstan fell afoul of the Kazakh government. Kazakhstan accused the firm of price fixing and began prosecuting its management after the firm bought a controlling stake in the nearby Shymkent refinery. Kazakhstan also singled out PetroKazakhstan for harsh enforcement

of environmental regulations.

These legal actions followed an unsuccessful hostile takeover bid by one of PetroKazakhstan's minority shareholders, an arm of the huge KazKommertsbank banking conglomerate headed by Timur Kulibayev. Earlier, KazKommertsbank had been the majority owner of Shymkent – the same owner that Hurricane/PetroKazakhstan bought out when it acquired the refinery. At about the same time that Kulibayev lodged the hostile takeover bid against PetroKazakhstan, he was named vice president of the newly integrated KazMunaiGaz (KMG) state petroleum company. Kulibayev is one of President Nazarbayev's sons-in-law, and a leading contender in the post-Nazarbayev succession struggle.

As this was all happening, PetroKazakhstan's relations with Lukoil soured. Lukoil began to pump its share of North Kumkol oil through the CPC, of which it is a shareholder via its Lukarco joint venture. Yet PetroKazakhstan's attempt to gain similar CPC access was blocked. Lukoil also launched a series of lawsuits against PetroKazakhstan totaling nearly a billion dollars, accusing the Canadian company of unfair drilling practices and trying to force it to provide Lukoil preferential access to its own refining and transit assets.

When PetroKazakhstan went up for sale in 2005, Lukoil unsuccessfully sued in Canadian court to prevent CNPC from buying the firm, arguing that its own stake in the Turgai joint venture gave it the right of first refusal on the purchase and offering to buy the Chinese shares for the same price CNPC had paid. Although it lost the Canadian suit, Lukoil continued to pursue legal actions in Kazakh courts against the company's new Chinese owners and won an initial \$200 million judgment in early 2006. In September 2006 Kazakh courts redistributed another \$60 million of PetroKazakhstan's South Kumkol assets to the Turgai joint venture in North Kumkol. Lukoil's regional director Boris Zilbermints has announced his intention to use international arbitration courts to take full ownership of Turgai. Despite cooperation between China and Lukoil in other contexts, their relationship in Kazakhstan remains tense.

The timing of the legal attacks by the Kazakh government and Lukoil made them appear coordinated. It is also noteworthy that Lukoil's offices then were located inside the KMG Building in Kazakhstan's capital city of Astana – the same building that serves as the headquarters for both Kazakhstan's Ministry of Energy and the Kulibayev-led petroleum company. In 2006 Lukoil held its annual board of directors meeting in Astana, and Alekperov gave a well-publicized speech lauding his company's strong working relationship with the Kazakh government. Meanwhile, after PetroKazakhstan was sold to China, KMG won the right to buy back one-third of those shares against the wishes of CNPC, after the Ministry of Energy intervened on KMG's behalf. In other words, KMG joined Lukoil as a Kumkol partner by reducing China's shares, thereby enhancing the impression of collusion. Lukoil's eventual goal may be to direct as much high-quality Kumkol oil as possible through the CPC pipeline, leaving China's new pipeline dependent on Russia's Ural crude.

U.S. Policy Recommendations

The United States must encourage the retention of multiple pipeline owners in Kazakhstan in order to prevent Russia from gaining physical control over Kazakhstan's oil. While Washington has limited ability to affect policy choices in the region, three main tactics are key.

First, Washington should retain good relations with Nazarbayev, despite his shaky human rights record on political and media freedom issues. Nazarbayev is popular at home because he is adept at sharing Kazakhstan's oil wealth. He is probably not responsible for this past year's political assassinations, even though several U.S. pundits (notably not regional specialists) have accused him of it. Nor is Kazakhstan likely to produce a liberal democratic successor to Nazarbayev. Nazarbayev's policy of balancing remains preferable to the probable alternatives.

Second, Washington must recognize that Nazarbayev will not last forever, and construct enduring economic relationships now in order to encourage his successors to opt for a similar balancing policy. The more Kazakhstan's economy is diversified beyond the oil sector and integrated with western trading and investment partners, the less likely that a future government would risk disruption by retreating into Moscow's narrow orbit. Pursuing the possible new Baku-Tbilisi-Ceyhan pipeline extension from Kazakhstan through Azerbaijan may help the western integration effort, but it will only have lasting political impact if it is profitable for Astana – something that remains doubtful at present.

Finally, Washington should keep a low profile within Kazakhstan, so as not to aggravate pro-Moscow interests that would like to disrupt Nazarbayev's balancing act. Establishing a military base in the country could be disastrous, for example, as experience around the world proves that bases in relatively well-to-do countries – where base-related jobs are not vital for economic health – often become a political irritant. Given Moscow's strong economic ties to Kazakhstan, and the large number of ethnic Russians in the country, Washington, too, must play a balancing game.