

---

## Comment : After The Dust Settles In The Caucasus

Chris Weafer of Uralsib Capital  
business new europe / Germany - 22/8/2008

---

Although there is still plenty of scope for an escalation of events in the Caucasus, the most recent news does hold promise. Russia is starting to withdraw forces from Georgia and, although slowly, has promised to accelerate the process from this weekend. The tone of the rhetoric between Moscow, Nato and Western countries is tough and is likely to remain so, at least for the next several weeks, until Russia's military withdraw to the pre-war positions. This will foster a very nervous backdrop for investment sentiment towards Russia. Beyond this, the legacy of recent events is likely to lead to a more confrontational relationship with the US and EU through to the end of 2008 and maybe into 2009. This will keep the perception of investment risk in Russian assets high and, therefore, form a negative backdrop for asset valuations.

After the dust settles. Looking beyond the current headlines, when the dust settles the possible longer lasting effects can be viewed under a number of categories:

**Geo-Politics.** The heated exchange between Russia and the US was not unexpected, nor is it expected to result in any material change in Russia's status in important structures such as the G8. The fact that WTO entry and Russia's removal from the Jackson-Vanik list will likely be delayed is of no great consequence at the moment. The new Administration in the US from January 2009 will be important in terms of the tone of its relationship, but in reality the main action will be confined to rhetoric. It is, for example, not in Russia's interest to be seen to cause problems in the UN and its efforts to reach a deal with Iran over the nuclear issue, as developing a better political and trade relationship with countries in the Middle East is an important priority for Russia.

Opportunities delayed with the EU. The most important relationship, in terms of the investment case, is that with the EU. Currently, that relationship still remains pragmatically based. So long as Russia does withdraw its forces from Georgia, even if the process drags on, there should be no major negative impact. The core governments within the EU, especially the French as they now have the EU presidency, are expected to prevent any repeat of the friction caused by the smaller Eastern European countries in early 2007. But the main consequence might be the lost opportunity of advancing the trade and investment relationship during the French presidency. Now this period is likely to be taken up with diplomatic "fire-fighting" leaving the hoped for trade and investment deals on the table during the Czech Republic's tenure as head of the EU from next January. Given the controversial missile-shield issue and the history between Russia and the Czech Republic, the six-month presidency may well be very problematic and lead to even lengthier delays in concluding new trade and investment deals.

**Central Asia.** Despite the strong show of support for Georgia offered by western politicians, the fact is that Russia has sent a very strong message to the rest of the world that it regards Central Asia, covering both sides of the Caspian Sea, as its backyard and nobody else is welcome. Moscow has been rebuilding its relationships and influence in the region over the past few years via building political relationships, investment spending and energy deals, and its strong military action in the conflict with Georgia will help reinforce rather than hinder the process.

**Energy.** It is by no means clear how effective Ukraine's decision to order a reversal of the Odessa-Brody pipeline will be, as big questions remain over cost and availability of oil to fill the pipe. Moscow has been much more effective in securing energy deals in Central Asia and in agreeing pipeline routes. While the EU is again talking about the need to by-pass Russia the reality is that there are few alternative options available and recent events will not change that.

**Arctic.** Russia will likely to pursue its goals in the Arctic region and to establish territorial rights even more aggressively than previously.

**Gas-Opec.** Moscow is scheduled to host the inaugural formal meeting of the so-called Gas-Opec group this autumn. One of the consequences of the current stand-off with the West is that Russia will try to strengthen its position in the global energy market, by more actively promoting Gas-Opec, especially as Russia is central player in the emerging LNG market

**Ukraine.** The next major potential conflict facing Russia is a potential conflict with Ukraine, especially if the Kiev government attempts to block the return of the Russian navy to Sevastopol at the end of the month. However, Ukraine is unlikely to pursue any conflict with Russia in the face of objections from the EU. The issue of Transdniestria may also emerge as a contentious issue with Ukraine and the EU. Sharing a border with Ukraine, Transdniestria is formally part of Moldova, although it has declared independence and also hosts Russian peace keepers.

**Investment.** The main negative aspect of recent events for the investment case in Russia is likely to be a backdrop of tougher talking between Moscow and Western governments and frequent threats that may arise. This will likely result in a more volatile market and generally lower asset valuations as the perception of investment risk will remain higher than it was during 1H08. The Georgia conflict is of course only part of the reason for that. Prime Minister Vladimir Putin's Mechel comments, the ongoing TNK-BP dispute and the deterioration in some macro indicators are also contributing to the negative sentiment. There will likely be an increase in budgetary resources towards the defense industries, as Russia will want to modernize some parts of its land forces, previously a lower priority than the export market.

Bank of Georgia - not under our coverage - has been hammered as a result of the conflict. But we can expect to see increased financial aid to Georgia from both the US and the EU, partly to compensate for the lack of military or real political assistance in this conflict.

#### **Geopolitics: Heated exchanges**

Rhetoric is likely to remain tough. Right now Moscow is engaged in a war of words with several western countries and with NATO. Even as we expect that the tone of comments from each side will start to calm after the Russian military withdrawal, it will be a long time before we return to the previous more cordial relations. Russia is now stronger and more determined to push ahead with its political and regional priorities, old Cold War rhetoric is likely to be an issue in the US Presidential election campaign and the missile shields in the Czech Rep. and Poland will be a bone of contention with the E.U. Abkhazia, South Ossetia and perhaps Transdniestria might push for formal recognition of independence or greater autonomy, and undoubtedly Russia will cite the example of Kosovo to support these claims.

Negative backdrop. All of this suggests that normal relations are unlikely until well into 2009 and will provide a negative backdrop to the investment case in the meantime.

Russia and the US. The more important issues, such as Iran and cooperation on terrorism, are too important for both sides to be derailed by this event. Trade between the US and Russia is relatively small for both countries - less than 5% - but, again, it is important for both sides. For example, Russia's VSMPO-Avisma is the key supplier of titanium for Boeing and that cannot be easily sourced from elsewhere. Russia is the biggest buyer of US poultry and, again, this cannot be easily sourced in such volumes elsewhere. So, very little trade of this trade, while small, can be easily stopped.

Cold War rhetoric is more familiar. The conflict with Georgia, and the return to some of the old Cold War rhetoric, is now part of the US presidential campaign and that will prevent the issue from drifting away. If Senator John McCain wins then we can expect to have much cooler public relations than if Senator Barrack Obama wins. Either way, it is unlikely that the US Administration will be in any hurry to push for Russia's accession to the WTO or to remove it from the provisions of the Jackson-Vanik legislation. There will be threats to remove Russia from the G8 but, given Russia's energy importance, that is not expected to amount to anything other than the content of election speeches. The opportunity to focus on the familiar theme of Russia and the Cold War is no doubt a relief for the candidates in the forthcoming US election, as neither side can come up with any effective solution to Iraq or the issue of terrorism in general. However, Russia and the Cold War is relatively straightforward by comparison.

The EU. The Russia-EU relationship is important for both sides. Russia supplies 40% of the EU's imported gas (25% of the total usage) and a significant amount of other important materials. Russian coal, for example, fuels 15% of the UK's electricity generation. Over 50% of Russia's external trade is with the EU and over 50% of consumer and manufactured goods are bought from EU countries.

EU has not been able to secure energy elsewhere. The EU has so far tried in vain to secure energy supplies that circumvent Russia. The reality is that the EU will become even more reliant on Russian sourced, or controlled, energy in the future before any significant alternative sources can be found. The most likely alternative for the EU would be to tap into Iran's reserves. Meantime, Moscow has tied up supply deals with Turkmenistan and is the process of creating JV's with Algeria and Libya to channel their gas into Europe (see the Energy section below). The reality is that they need each other. The EU needs Russian energy and more of it. It also wants its energy companies to have a JV role with the likes of Gazprom and Rosneft, as they now plan to develop new hydrocarbon sources. For Moscow, access to EU markets with improved trade terms, plus the ability to increase the two-way flow of investment, which is an important part of the government's plan to expand and diversify the economy. A tougher, more belligerent relationship with the EU would slow this process and increase dependency/vulnerability to the oil price.

Lost opportunity. It was hoped that significant progress might be made in the process of bartering energy for trade during the French presidency of the EU. Instead, the danger is that the six month stint will be taken up with the aftermath of the Georgian conflict. This would delay the previous agenda until 2009, when the Czech Republic assumes the presidency. This would hardly be a positive backdrop given the rhetoric we have had already over the US missile-shield and will unlikely advance economic cooperation.

East Europe. Poland this week followed the Czech Republic and signed a deal with the US to host a site for the so-called missile shield. Relations between Moscow and the host countries will be more negative as a result. Several East European leaders visited Tbilisi to show solidarity with the Georgian government and, again, that will not endear them to Moscow. It is expected, however, that the core EU countries such as France and Germany,

will take more of a lead in dealing with Russia and it is unlikely that the smaller East European countries will be allowed to have the same influence that they had in late 2006 and the early part of 2007.

Ukraine may become a thorn in the side. The issue of Ukraine is likely to be more problematic. The Russian navy ships are expected back in Sevastopol by the end of the month and that could spark a row with the Kiev government. Ukraine and Russia have to negotiate a new gas contract this winter and that might also be problematic. There actually is little room for dispute this time, as Gazprom will simply look to pass on the well-publicized price deal with the Central Asian producers. President Yushchenko's order to reverse the Odessa-Brody pipeline flow will be an irritant to Russia, but only a minor one (see Energy below). For many observers, the non appearance of Prime Minister Yulia Tymoshenko in the debate is of greater curiosity and more of an issue for domestic Ukraine politics than the Russia-Ukraine relationship. But, given that she is to lead the gas negotiations with Russia it would of course be difficult for her to be openly critical ahead of that.

Nato. Despite the very public criticism of Russia by NATO and the support, or indications of support, for Georgian membership, it is unlikely that the organization will actually push forward the timetable to admit either Georgia or Ukraine. NATO would simply not have wanted to engage with Russia over such an issue and the Georgian actions will make them a lot more wary of admitting either. Support for membership will be endorsed by the McCain camp for sure, but Europe's member countries will be a lot more cautious for a very long time.

Middle East. While Russia's Foreign Minister Sergey Lavrov said that Moscow may review its stance in the UN action against Iran, the reality is that Moscow will likely be a lot more critical of US motives in the region but will not actually oppose any actions to push Iran towards a peaceful outcome. Building a stronger political and economic relationship with countries like Saudi Arabia, Qatar and the UAE is a priority for the government. Being accused of supporting a more belligerent Iran would not suit that purpose.

WTO. Membership of the WTO is not a high priority for Russia. It is more a "box to be ticked" rather than a critical piece of the immediate economic program. Yes, Russia wants to be a member of the trade body, but it is not a priority. The schedule to join was on track for later this year or early 2009; however, it looks likely to be delayed by six months, which is not of any great consequence.

### **Central Asia**

Moscow has rebuilt its position in the region. Moscow began rebuilding its influence in Central Asia during Putin's second presidential term and the recent military action in Georgia will actually help the process. Moscow has sent out a very powerful message that this is its backyard and that it is willing to defend its interests and those of its partner countries. Western support for Georgia, on the other hand, has amounted to little more than verbal attacks and threats against Moscow. In Central Asia, the military message will be by far the most important and influential.

Political ties are better. In recent years, Moscow has improved political ties with all Central Asian states, often, as in the case of Uzbekistan, taking advantage of western criticism of local politics to rebuild previously damaged ties. Governments across the region find it more comfortable to deal with an uncritical Moscow than with very critical western governments. Russia has also increased investment flows to the region by a much greater extent than those from the EU or the US.

Caspian Guard Initiative. Azerbaijan's reaction will be the most important over the medium term, as it is the possible source of increased energy flows to Europe via Georgia. But while the Baku government enjoys a good relationship with the EU, its relations with Russia have also improved markedly and during President Dmitry Medvedev's visit in early July both sides talked about increasing cooperation in energy projects. The US has been pushing Azerbaijan to agree to its Caspian Guard Initiative, which would see some US navy craft based near Baku to help defend the oil fields against possible attacks. Russia is very opposed to such a move, while Iran sees it as a direct threat.

Baku has its own priorities. In the aftermath of the Georgian War, the US will undoubtedly increase its efforts to establish a military presence in Azerbaijan, but the government there will likely adopt an even more cautious stance than before. President Aliyev is standing for re-election in October and in the past he has been criticized by both the US and the EU for slow democratic reforms. The opposition grouping of three parties, the Azadlig, has already said that it plans to boycott the October elections to protest the lack of political freedoms. Azerbaijan's priority is to regain control of Nagornokarabakh, the territory it lost to Armenian control in the 1990's. To achieve that, Baku will need to retain Moscow's support while any support by Moscow for an independent Nagorno-Karabakh would make the process much more difficult.

US base in Kyrgyzstan. We expect Moscow to cooperate with its partners in the Shanghai Cooperation Organization and to again press Kyrgyzstan for a date when the US airbase at Karshi-Khanabad is to be closed.

## **Energy**

Tied to deals in Central Asia. Moscow has been much more effective in agreeing energy cooperation deals with countries in Central Asia than has been the EU. Turkmenistan has agreed to increase its gas flow to Russia via the expansion of an existing pipeline northwards and is joining with Kazakhstan and Uzbekistan in building a new pipe to the eastern Urals region of Russia. While these agreements are not yet covered with signed contracts it is expected that they will go ahead as planned. Along with agreements already in place with China, it is most unlikely that Turkmenistan will have any significant spare volumes of gas to sell to the EU before 2015. This year the country plans to produce just over 80 bcm of gas from 72 bcm in 2007. But output for the first six months was actually down year on year.

Little spare oil. Azerbaijan plans to produce 1.0 mln barrels of crude this year and to raise that to 1.2 mln barrels next year. Most of that oil is promised for the Baku-Ceyhan pipeline so, again, there is very little spare oil or gas in the Caspian region to ship through either an increased capacity Georgian pipeline or to fill the Nabucco gas pipe.

Pipelines. The EU backed Nabucco pipeline has two main problems: the consortium needs to agree a transit deal with Turkey and it needs to find a source of gas. Turkey is expected to drive for improved trade access to EU markets in return for its participation in the Nabucco project; however, it is already known that some demands have met with a negative response from Brussels. Turkmenistan has a tentative agreement with the EU to supply 10 bcm of gas by 2009; however, if it also proceeds with the deals agreed with China and Russia, it simply will not have the gas to sell to the EU.

Odessa-Brody reversal. As regards Ukraine's plan to reverse the flow of oil in the Odessa-Brody pipeline later this year, it is not at all clear how this might be done. Ukraine convened a meeting of representatives from Poland, Lithuania, Ukraine, Georgia and Azerbaijan in Vilnius in October 2007. The result was the formation of a group called the Sarmartin Consortium with the

aim of bringing Azerbaijani oil via an expanded pipeline across Georgia, then to Odessa via tanker and then up to Brody. From Brody the plan is to build a new pipeline to Plock in Poland so that the oil can feed refineries in the region. But the plan has made no practical headway since October because there is no agreement on the sharing of the costs and no guarantee on the availability of enough oil to justify the project. The political will to proceed with the project is there (perhaps less so from Azerbaijan), but until the more practical issues of cost, etc are sorted then the project will not be a viable alternative. The Russian oil that will be displaced will likely feed the BTS-2, or Eastern, pipeline so the issue is one of inconvenience.

Arctic. Russia is expected to pursue its efforts to establish territorial rights over a large part of the Arctic with greater vigor, in its aim to increase the size of its energy bargaining chip with the west.

Gas-Opec formal structure expected. Moscow is already scheduled to host a meeting of the group of gas producing countries that have, until now, met informally as the Gas Producers Forum. At a meeting in early June the group agreed to create a more formal structure with a permanent Secretariat and Secretary General. The meeting to formalize this is expected to take place in Moscow in late September or in October. Moscow is now very likely to pursue that initiative much more aggressively, so as to ensure it remains at the center of the gas industry development, particularly in the area of LNG.

<http://businessneweurope.eu/storyf1213>

---