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# BP fighting West's energy cold war in the Caucasus

By Frank Kane Emirates Business 24/7, United Arab Emirates - 23/8/2008

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If all goes according to BP's plan, crude will soon flow again through the Baku-Tbilisi-Ceyhan (BTC) pipeline, one of the most important geostrategic energy routes in the world. But it is unlikely that will be an end to the concerns that have dogged the British oil giant in the Caucasus, where its long-running confrontation with Russia has assumed all the dimensions of an energy cold war.

Last week, at the Azerbaijani oil terminal of Sangachal, 45km along the Caspian coast from the capital, Baku, oil was flowing, but in much reduced quantity, and ` from BP's point of view ` in the wrong direction. A suspected terrorist attack on the BTC in eastern Turkey, and Russia's military action against Georgia, meant that most of the limited amount of crude that was being shipped was going exactly where BP did not want it to go ` through the northern pipeline (NREP) that crosses the Azeri-Russian border before ending up at the Black Sea port of Novorossiysk.

That meant another victory in the Caucasus for the Russians, and a defeat for the West in the modern equivalent of the nineteenth century "Great Game" ` the struggle for control of the potentially enormous reserves of Azerbaijan, which dominates oil-production in the Caspian. The stakes are high. BP ` backed by European countries fearful of Russian control of their energy supplies ` wants to safeguard oil and gas flows from the Caspian region, and keep it out of Russian hands. Azerbaijan, the former Soviet republic, which on independence in 1991 found itself sitting on some of the most significant but strategically problematic oil reserves on the planet, wants to use the revenue for much-needed modernisation and economic development.

Azerbaijan has ambitions to join the club of sovereign wealth fund (SWF) countries like the UAE and Singapore, but finds itself in a delicate situation ` caught between the energy imperialism of its former Soviet "comrades" and the ambitions of Iran to the south. It will require delicate diplomatic choreography by the Azeris, who are acutely mindful of the fate of their neighbour, Georgia, invaded and occupied by Russian troops.

Oil has been a blessing , and a curse, to the region for millennia. Caspian oil was exported to central Asian and Europe throughout modern history and according to some analysts, by 1900 Azerbaijan accounted for more than half of the world's trade in crude oil.

Nazi Germany was aware of the potential difference Caspian oil would make to its war machine, and Hitler's armies were on their way to Baku before they were halted at Stalingrad in 1942. The Soviets plundered the region's oil reserves using obsolete technology and with no thought for the environmental consequences, leaving the Baku region with an ecological problem the Azeri government is still trying to deal with. Great swathes of land outside the city are heavily polluted, with ancient "nodding donkey" platforms dotting the landscape of abandoned facilities.

After independence, the Azeri government opened up the country to foreign investment, and Western oil companies brought in modern technology that could exploit huge reserves untouched by the Russians, out in the open sea. It is from this era that BP's involvement began, principally with the Azer-Chirag-Gunashli field in the Caspian, which provides most of the crude that now comes ashore at Sangachal. Azerbaijan is in the top 20 countries ranked according to oil reserves.

BP was aware, however, that it faced a massive logistical problem in shipping this crude out of the region. Already in 2002 there were concerns that Russia had a commanding grip on supplies in the region, despite the pipeline that went west from Baku to the Georgian Black Sea port of Suspa. (Supposedly safe from Russian interference, the reliability of Georgia as a supply route was exposed a couple of weeks ago as BP watched Russian warplanes dropping bombs near the Suspa pipeline. The Suspa route (WREP) was suspended on August 12.) BP, as lead and managing member of a consortium that included the Azeri government-owned oil company Socar, as well as some of the biggest corporate names in the international oil industry, saw the solution in a pipeline that avoided the Black Sea and went straight for the Turkish Mediterranean port of Ceyhan, and the BTC concept was born in 2002. Four years later, at a cost of \$4 billion (Dh14.7bn) to BP, the first crude flowed through the new 1,750km "East-West Pipeline", as BP proudly presented it.

The pipeline's route was determined as much by political and strategic considerations as environmental concerns. It skirted Armenia ` which had fought a three-year war with Azerbaijan in the early 1990s ` and had to be buried beneath towns and culturally-sensitive areas, especially in eastern Turkey.

When on August 5 a fire broke out at one of the pumping stations along this section of the pipeline, it was suspected that separatist Kurds were responsible, and the line was closed immediately for repair. However, it seems almost certain it would have halted a week later anyway, as Russian tanks came within striking distance of the BTC and planes dropped bombs dangerously nearby. The fragility of BP's grand strategy to bypass Russian influence in the region appeared to have been exposed.

BP officials in the company's Baku office last week could give no firm date for the resumption of supplies, but more recent reports from the United States said BP hoped to resume shipping from the terminal at Ceyhan next week, once the Turkish partner in the consortium had finished testing the repaired facilities and assuming there were "no further problems". Presumably these include possible fractures to the still-fragile ceasefire between Russia and Georgia. It cannot come a day too soon for Azerbaijan.

The 850,000 barrels per day that pass through the pipeline represent the country's biggest source of revenue, worth more than \$1bn a day at the current (relatively low) price of \$119 per barrel. The World Bank estimates that Azerbaijan could amass a sovereign wealth fund of about \$250bn out of the revenue from BTC, propelling the country into the SWF big league. The state investment company Sofaz is estimated to have \$3.34bn in reserves from energy revenue.

For a country still struggling with the legacy of Soviet neglect, this would represent a dramatic change in fortunes. Azerbaijan has topped the world league tables for growth in gross domestic product for the past couple of years, with 20 per cent-plus rates of growth, making the booming economies of China and India seem sluggish in comparison. However, all of this is due to oil revenue, and Azerbaijan faces serious challenges if it is to harness this growth for long-term development.

A recent report by ratings agency Moody's highlighted the "vibrant oil-driven growth" and the healthy state of public finances, but also pointed to high inflation (perhaps more than 20 per cent), a relatively undiversified economy, a rudimentary banking system, untested socio-economic systems and few managerial cadres. It also pointed to the culture of corruption endemic in the country.

The Azeri government led by President Ilham Aliyev "faces the difficulties of sheltering the economy from its current over-exposure to potential external shocks, whether they come in the form of lower energy prices, currency fluctuations, or even geopolitical problems," says Moody's. In particular, Azerbaijan will have to cope with "Dutch disease", the phenomenon that has blighted energy-dependent economies, forcing up inflation and straining investment in infrastructure and diversification. Deeper economic ties with the Gulf could also help Azerbaijan face these challenges, but ` after a flurry of trade missions and talks about free-trade agreements with the UAE a couple of years ago ` commercial opportunities with the region seem limited to high-profile advertising for Dubai property in the Azeri media. Azerbaijan seems to be looking firmly west, rather than south. For BP, there is much at risk in the Caspian. The company's long-running confrontation with its Russian partners in TNK is coming to some kind of denouement, with the decision by the head of BP's Russian business, Robert Dudley, to quit Moscow. Despite BP's stated commitment to carry on in Russia, there appears to be little hope of normal business being resumed between BP and Russia in the near future, if ever.

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