

HARVARD UNIVERSITY
JOHN F. KENNEDY SCHOOL OF GOVERNMENT
Caspian Studies Program



Mini-Case and Illustrative Paradigm

U.S. Policy on Caspian Energy Development and Exports

Graham Allison and Emily Van Buskirk

May 2001

Including student answers from a Kennedy School course,
International Security and Political Economy 202:
“Central Issues of American Foreign Policy,” taught by Graham Allison and Robert Blackwill

Preface

Energy policy has become a hot topic with President Bush's proposal of a "long-term, comprehensive" energy policy, California's rolling blackouts, and increasing prices at the gas pump. Vice President Cheney's *National Energy Policy* report proposes ways of increasing efficiency and diversifying supply, naming energy security a "priority of U.S. trade and foreign policy." Announcing his new policy, President Bush said, "Overdependence on any one source of energy, especially a foreign source, leaves us vulnerable to price shocks, supply interruptions, and in the worst case, blackmail."

Harvard's Caspian Studies Program conducts an ongoing study of energy policy and the development of Caspian basin energy resources, the largest untapped source of oil and gas reserves discovered since the North Sea. The Bush Administration, like its predecessor, has recognized the importance of Caspian energy and engaged in diplomatic efforts to develop export routes. The *National Energy Policy* advocates continuing and expanding these efforts, specifically recommending that the Administration "support the Baku-Tbilisi-Ceyhan oil pipeline as it demonstrates its commercial viability," "establish the commercial conditions that will allow oil companies operating in Kazakhstan the option of exporting their oil via the BTC pipeline," pursue other policies to develop gas transport systems, and create a stable business climate in the region. Recent changes in the U.S. Senate make prospects for increasing production by drilling inside the U.S. less likely, forcing greater attention on regions outside the U.S. such as the Caspian. Caspian resource development could also advance other goals of U.S. policy, promoting economic growth, independence, and stability in Central Asia and the Caucasus.

Drawing on the Program's ongoing research, my colleague Emily Van Buskirk and I prepared a case on U.S. policy on Caspian energy development and exports for a Kennedy School course I teach with Ambassador Robert Blackwill. Using the case, our sixty students examined central questions including: What is the most effective way to promote the development of Caspian energy resources? What is the proper role of government in large-scale capital projects? Where does the Caspian Basin rank in the hierarchy of U.S. national interests?

Our course attempts to introduce students to a dozen central issues on the American foreign policy agenda. Each week we enter a topic through the window of an operational assignment a student could actually have if she were working at the National Security Council. A mini-case like the one attached requires students to write a strategic options memo for the president identifying alternatives, pros and cons, and making a recommendation. Students' responses are then the subject of one class, followed by a second class where we widen the lens to the broader topic, in this case U.S. energy policy and the Caspian.

This case provoked a lively debate. Moreover, one week after their presentations, students had the opportunity to discuss the case and current U.S. Caspian policy with Ambassador Elizabeth Jones, Senior Advisor for Caspian Basin Energy Diplomacy (recently nominated to become Assistant Secretary of State for European Affairs) while the Ambassador was visiting the Kennedy School for a day of Caspian Studies Program events. A summary of her presentation at the School, "U.S. Caspian Energy Diplomacy: What Has Changed?" is available on our web site, www.ksg.harvard.edu/bcsia/sdi.

Ambassador Jones took great interest in the case, calling it both “realistic” and “difficult.”

With hopes that you will find it both useful and enjoyable, we attach this case. It starts with the real world today, accelerates developments to a fork in the road, and requires students to analyze and recommend. Specifically, in this hypothetical, the oil companies have completed their detailed engineering study of the Baku-Tbilisi-Ceyhan pipeline route, and concluded that the price for construction will be \$3 billion. Pledges from the companies and investors raise \$2.5 billion, leaving the project \$500 million short on the financing. Given U.S. government affirmations about the Baku-Tbilisi-Ceyhan pipeline as a U.S. priority, the companies seek assistance from the U.S. government. The question is: what to do?

If you know the answer, send us a note. For purposes of comparison you may be interested in the students’ answers, as well as our illustrative paradigm. For Caspian related studies, let me refer you again to our web site.

Yours Sincerely,

A handwritten signature in black ink, appearing to read "G. T. Allison". The signature is fluid and cursive, with a long, sweeping tail on the final letter.

Graham T. Allison
Chair, Caspian Studies Program
Director, Belfer Center for Science and International Affairs

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ISP 202: Central Issues of American Foreign Policy

Case #6: U.S. Policy on Caspian Energy Development and Exports

Distributed: March 19, 2001

Due: April 2, 2001

By Graham Allison and Emily Van Buskirk¹

The date is July 1, 2001. Real world history and trends occurred as they did through March 19, 2001—except for the hypothetical departures specified in the case below. Events after March 19 that are not specified in this case are assumed to be straight-line projections of events as they stand on March 19. Assume, for example, that sporadic violence continues in the Middle East at the current level of intensity; Britain and the U.S. are nearing the end of their review of UN sanctions against Iraq, and will soon make recommendations on refocusing the sanctions to make them “smarter”; as expected, Mohammad Khatami was reelected as President of Iran on June 8 with a mandate for continued reform; the price of oil is \$25/barrel; events in Chechnya and Ukraine, and negotiations over Nagorno-Karabagh will continue as before; etc.

1. Backdrop. Support for the construction of a new oil pipeline running from Baku, Azerbaijan through Tbilisi, Georgia, to the port of Ceyhan, Turkey, has been the centerpiece of U.S. policy towards the Caspian Region since 1997. “B-T-C (Baku-Tbilisi-Ceyhan) as the MEP (Main Export Pipeline)” has been the bumper sticker. As Bill Richardson, former Energy Secretary under Clinton, said: “This is not just another pipeline. It is a strategic framework that advances America’s national security interests. It is a strategic vision for the future of the Caspian Region.” Indeed, experts agree that Caspian oil (thus far out of OPEC’s reach) can enhance U.S. energy security by adding valuable, diverse marginal supply. Proven Caspian reserves are estimated at 25 billion barrels, comparable to those in the North Sea (17 billion barrels).

At the pipeline signing ceremony in Istanbul in November 1999, President Clinton remarked to the Presidents of Azerbaijan, Georgia, Kazakhstan, Turkey, and Turkmenistan, “These agreements which were just signed are truly historic. They will advance the prosperity and security of a region critical to the future of the entire world ... we will continue to support your efforts and our energy companies as they work with you. Our diplomats and energy experts will help to facilitate solutions that meet the needs of all the Caspian states and Turkey.” Secretary Richardson asserted that the Baku-Ceyhan pipeline would be commercially viable, and as an indication of this, “U.S. government and trade agencies, Ex-Im Bank and OPIC, stand ready to provide the necessary financing and insurance—on a commercial basis, of course—to help bring these projects to fruition.” At a press conference in Istanbul following the

¹ Graham Allison is Douglas Dillon Professor of Government at the Kennedy School, Director of the Belfer Center for Science and International Affairs, and Chair of the Caspian Studies Program at Harvard. Emily Van Buskirk is a Research Assistant at the Caspian Studies Program and Strengthening Democratic Institutions Project.

signing of agreements, Ambassador John Wolf, Special Advisor to the President and Secretary of State for Caspian Basin Energy Diplomacy, drew a timeline in the sand: “oil through the Baku-Ceyhan pipeline by the first quarter of 2004.”

This envisioned geopolitical pipeline serves a number of policy goals, specifically support for Turkey (a U.S. ally in the region and a member of NATO), whose Ceyhan port has suffered since 1991 as a result of the Gulf War and subsequent sanctions on Iraqi exports through Ceyhan; the pipeline would also serve Turkey’s interest in decreasing tanker traffic through the Bosphorus. Other states in the region (notably Azerbaijan) are attracted to the idea that the pipeline will help reestablish the old Silk Road for East-West trade and will guarantee their independence from Russia. Azerbaijani and Georgian officials and press have reacted strongly against occasional suggestions that the new Administration might abandon this policy, pointing out that their own pro-American stances have growing costs vis-à-vis Russia. Russia, which has all along opposed the East-West corridor, has increased its activity and influence in the Caspian under President Putin. Currently, the majority of operational pipelines in the Caspian Region go through Russia. In June, the Caspian Pipeline Consortium pipeline that runs from an oil field in Tengiz, Kazakhstan to the Black Sea Port of Novorossiysk, Russia came on stream.

2. During the election campaign, Bush and Cheney on many occasions criticized what they charged was the failure of the Clinton administration to “develop an energy policy.” During the vice-presidential debate Cheney argued, “My assessment is that there is no comprehensive energy policy today. That as a nation we are in trouble because the administration has not addressed these issues.”
3. As CEO of the oil services company Halliburton (which has operations in the Caspian), Cheney understood well the importance of Caspian energy supplies in general and of Azerbaijan in particular. Delivering an address at a U.S.-Azerbaijan Chamber of Commerce conference, Cheney stated, “Azerbaijan is of great significance not only to the future of the region, but to the future of a diversified and balanced global oil market . . . But the realization of this potential depends not only on commercial considerations, but also on politics, as the struggle to get these resources to market involves various countries with competing interests.”
4. On January 29, in the aftermath of the California energy crisis, President Bush appointed Vice President Cheney the head of his cabinet-level task force assigned, in Bush’s words, to devise ways to reduce America’s “reliance upon foreign oil” and to “encourage the development of pipelines and power-generating capacity in the country.” Bills concurrently circulating in Congress call for policies to bring U.S. dependence on foreign oil down from 56% to 50% (introduced by Alaskan Senator and Chair of the Energy and Natural Resources Committee Frank Murkowski) by opening up the Arctic National Wildlife Refuge (which contains about 3.2 billion barrels of economically recoverable oil).
5. In November 2000, the Center for Strategic and International Studies (CSIS), a Washington think tank, released the report of the Strategic Energy Initiative task

force, chaired by Sam Nunn and Jim Schlesinger. The report criticized “complacency among policymakers and the public about the need to incorporate long-term global energy concerns into near-term foreign policy decisions.” The report highlighted the importance of Caspian oil, faulting U.S. policy: “A policy approach that ties exports primarily to one pipeline route—with the goal of avoiding Iran and Russia as transit states—before the political and economic viability of the route is known may undercut the pace of energy development in the region, to the dismay of both producing states and potential transit states.”

6. In order to be financially viable, industry experts have calculated that the Baku-Tbilisi-Ceyhan pipeline must carry close to 100% of its 1 million barrels per day capacity (between 300-350 million barrels per year). Azerbaijan alone will not be producing these volumes within the next decade. President Nazarbayev of Kazakhstan has waffled on whether his country will commit the needed volumes to the pipeline; however, his most recent position (as he told it to Ambassador Elizabeth Jones, currently Senior Advisor for Caspian Basin Energy Diplomacy) seems to commit the first oil extracted from Kashagan (in the Western Caspian Sea, off Kazakhstan’s coast) to export through Baku-Tbilisi-Ceyhan.
7. A respected industry journal, the *Oil & Gas Journal*, reported that absence of assured routes is the central risk factor limiting production in the Caspian, “The reality is that the Azeri-Chirag-Guneshli project² will continue to slip all the time that the MEP [Baku-Tbilisi-Ceyhan] remains on hold, unless an alternative transportation route is found. ACG is only one of many projects that will face similar delays in the future.”
8. In a letter to President Nazarbayev in early March, President Bush urged his Kazakh counterpart to support the oil pipeline between Azerbaijan and Turkey, writing that the U.S. looks forward to increased cooperation with Kazakhstan in the economic and energy spheres (as well as in the fight against terrorism, weapons proliferation and drug smuggling). Meanwhile, Ambassador Beth Jones met with Nazarbayev to convince him to more firmly commit to transport the first oil from Kashagan along the Baku-Ceyhan route.
9. An intelligence report contained an interesting anecdote from a recent dinner: a sophisticated, well-informed U.S. government official expressed the view that Baku-Tbilisi-Ceyhan will go ahead now and become operational by the end of 2004, because as he explained, “all of this is linked to successful resolution of the conflict over Nagorno-Karabagh.” As this official said, “If the cost of resolving this bloody conflict is an extra \$1 billion for the pipeline, that will not be an insurmountable obstacle for the companies.” This individual also insisted that the Baku-Tbilisi-Ceyhan pipeline is and will be “commercially viable.”

² These are the three Caspian Sea fields involved in a 30-year, \$8 billion project signed by the Azerbaijan International Oil Consortium in 1994. The Azerbaijan International Operating Company (AIOC), an 11-member consortium, includes: BP (UK), Unocal (US), SOCAR (Azerbaijan), LUKOIL (Russia), ExxonMobil (US), Statoil (Norway), TPAO (Turkey), Pennzoil (US), ITOCHU (Japan) and Delta Hess (US/Saudi Arabia).

A representative of a major oil company who was at the same dinner table responded sharply: after using an expletive, she explained why from an oil company's perspective it was not only inconceivable, but also irresponsible to use shareholders' money to subsidize American foreign policy. The conversation ended with the sides agreeing to disagree.

10. A group of eight oil companies, known as the Group of Sponsors,³ has just completed a \$110 million Detailed Engineering study of the Baku-Tbilisi-Ceyhan pipeline route.⁴ The study and associated work concluded that construction of the pipeline would cost at least \$3 billion. Everything is now in place except the financing: government-to-government agreements, operating agreements, rights of way, and tariffs have already been finalized. After hard bargaining with both the oil companies that will ship oil through the pipeline and the many investment bankers involved, it has become clear that there is at least a \$500 million shortfall between the cost of the endeavor and the funds that companies and investors are prepared to commit now.
11. The head of the pipeline consortium met last week in Baku with U.S. Ambassador to Azerbaijan Ross Wilson and Ambassador Beth Jones to inform them of these facts. His message: unless the U.S. government can find the remaining \$500 million, the project will not happen now. He indicated that some members of the Sponsors' Group actually prefer that the decision be postponed for at least another year, though he personally strongly favors going ahead.
12. U.S. policy in the Caspian region has been on the medium priority list for a strategic review by the Bush Administration. Geographically, the Caspian abuts the Middle East on the one hand and Russia on the other, but it has become a separate topic as the "Caspian," given previous administration policy and the creation of a Special Advisor to the President and Secretary of State for Caspian Energy Issues in August of 1998. A multitude of problems—including regional conflicts, a history of U.S.-Russian rivalry in the region, and the Iran sanctions issue—complicate energy export decisions. Russia's new assertiveness in the area is a cause for concern; for example, in December, it temporarily cut off gas supplies to Georgia (where Moscow still maintains four military bases). Despite the fact that the new U.S. team is not fully in place, and the policy review is not completed, the administration will have to make a decision about the pipeline issue now, or let it pass.
13. A *New York Times* editorial published yesterday argued that if the U.S. does not help to make Baku-Tbilisi-Ceyhan a reality, not only will it be perceived as a failure of U.S. policy, but the U.S. will also "lose its friends and allies in the region." Meanwhile, a *Wall Street Journal* editorial put forth the opposite view, arguing that

³ Represented by the State Oil Company of Azerbaijan (SOCAR, charged with representing the interests of the Azerbaijani government in the project), BP (UK), UNOCAL (US), Statoil (Norway), TPAO (Turkey), Itochu (Japan), Ramco (Scotland), and the Delta Hess alliance (US/Saudi Arabia)

⁴ This hypothetical event represents a significant acceleration of real events. On the current timetable, the final commitment to invest will probably not occur before the 2nd quarter of 2002.

CASE: U.S. POLICY ON CASPIAN ENERGY DEVELOPMENT AND EXPORTS

“subsidizing” the pipeline would demonstrate a “misunderstanding of the proper role of government in energy markets.”

14. The President has called a National Security Council meeting to discuss the issues and determine how the U.S. should respond. You have been asked to prepare a memorandum that will serve as the basis for this meeting. As your notes of the assignment given to you by Dr. Rice (Assistant to the President for National Security Affairs) state, the President wants you to provide a background memo addressing the following:

- What national interests of the United States are involved in this issue? As Dr. Rice noted, the President likes our approach of framing deliberations in terms of national interests, but nonetheless he has asked that this memo not be overly abstract. As she observed, he knows from our last memo (and the one before that) that America’s number one vital interest is to avoid being attacked by Russian nuclear weapons. But the question is, what is the hierarchy among U.S. interests and objectives in the Caspian that are impacted by the issue at hand?
- Specifically, what are the short-term policy options for responding to this issue over the next several weeks? What are the pros and cons of each? If this involves U.S. government money, from where, and why?
- Which course of action do you recommend? Sketch a brief outline of how that course of action would be implemented: who would do what?
- As part of the context, she asks that you do a couple of paragraphs each on two related issues: What are the key considerations for the companies involved as they think about this issue? What is their checklist? Similarly, what are the key considerations for the countries that will be impacted (outline the considerations of at least Azerbaijan, Turkey, Iran, and Russia)? What are their respective checklists?

In addition to the memo (or presentation or outline), if you want to attach an appendix of no more than one half page identifying questions of fact or analysis that you do not know the answer to—but which you believe the individual writing the memo in the real world would be able to answer—and these would, you suspect, have a decisive influence on your analysis or recommendations, list such questions (with some indication of who or how or where they would likely be answered).

Assume the President knows all the facts of the case. Memos should be 3 pages in length. Group presentations are to be no longer than 15 minutes in length.

ISP 202 Central Issues of American Foreign Policy, Spring 2001

Graham Allison and Robert Blackwill

April 4, 2001

Illustrative Paradigm for Case #6: Caspian Energy Development and Exports

By Graham Allison and Emily Van Buskirk

I. Overview

Issue: How to respond to the BTC Sponsor Group's assertion that unless the U.S. government finds the \$500 million in the next several weeks, the MEP (Main Export Pipeline)—running from Baku, Azerbaijan through Tbilisi, Georgia, on to the Turkish port of Ceyhan—will not start construction now in order to be completed by the target date of 2004.

Recommendation: 3M: MEP= Main; Multiple; and Market-based Export Pipelines. Specifically (1) Reaffirm MEP as Main (for Azerbaijan's "main" oil, as compared to the smaller pipelines currently in use for "early" oil) but morph to a Multiple pipelines strategy and emphasize Market-based solutions; plus (2) make a serious effort to fill the \$500 million gap (and in the course of this to determine what the gap really amounts to), and even more importantly to appear to the countries, especially Turkey and Azerbaijan, and the key companies to have made a best faith effort—but (3) make no U.S. government appropriation. Reaffirm (reinterpret) commitment to emphasize "commercial viability" and that "market forces dictate the timetable."

If one judges the impact on Turkey and Azerbaijan too painful, and pent-up pressure on oil produced in the Caspian to flow through Iran (using swaps) too great; and if one judges any revision of U.S. policy towards Iran as unacceptable, then one would make a very serious effort to raise the money—pressing companies, countries (particularly Azerbaijan and Turkey, recognizing that Turkey is already committed to provide cost overruns on the Turkish portion for up to \$1.4 billion), and International Financial Institutions (IFIs) to make this feasible.

II. Background

- **Energy security:** The danger that the U.S. will face a nation-wide energy crisis in the near future reflects insufficient supply, distortions in distribution systems, and a growing demand. It is in the nation's interest to increase and diversify the world supply of oil in order to reduce dependence and vulnerability to disruption, especially Persian Gulf disruption. Reducing demand through technology and efficiency measures must also be part of a comprehensive national energy security policy.
- **The Caspian contribution:** The Caspian region holds the largest untapped reserves of oil to come on stream since the North Sea's 17 billion barrels, and it has much greater upside potential (proven oil reserves are estimated at 18-35 billion barrels, but unfolding discoveries could push the number much higher). The critical bottleneck

has been how to get the oil (and gas) out of the landlocked region to international markets at a reasonable cost that is profitable for investors.

- **Support for the Baku-Tbilisi-Ceyhan pipeline:** U.S. support for the Baku-Tbilisi-Ceyhan pipeline reflects a commitment to Turkey to compensate for Turkish losses incurred since Desert Storm as the result of the boycott of Iraqi oil exports through Ceyhan, and addresses Turkey's concerns about tanker traffic through the Bosphorus. The U.S. also wants to encourage Azerbaijan, Kazakhstan, and Central Asia generally to become more independent of Russian-controlled pipelines. Moreover, Baku-Tbilisi-Ceyhan would serve to relieve pressure on exports through Iran. (Oil companies have complained that the Ceyhan pipeline requires "oil to run uphill," since costs greatly exceed the Iranian alternative.)

Prior to 1997, the only major pipeline for Caspian oil went through Russia (Atyrau-Samara). Current oil from the Caspian Basin flows mostly through Russia to the port of Novorossiisk, with smaller amounts going through the Azerbaijan International Operating Company (AIOC) pipeline to Georgia's Black Sea port of Supsa. Oil from Novorossiisk and Supsa is shipped on tankers through the Bosphorus to international markets. The recently completed Caspian Pipeline Consortium (CPC) pipeline⁵ from Tengiz field (Kazakhstan)⁶ to Novorossiisk will be a major route in the future (with a peak capacity of 1.34 million barrels/day).

- **Oil companies' pipeline concerns:** Oil companies have become more enthusiastic about Baku-Tbilisi-Ceyhan as the discovery and production of oil in the Caspian has grown. Further oil discoveries are expected and could be very large, most notably at Kashagan, off Kazakhstan's western shore. Over the past year, the Sponsor's Group has spent \$135 million on engineering studies (\$25 million on the basic engineering, \$110 million on detailed engineering) to reach the point at which it is prepared to move forward. After several months of fundraising from the companies and international investors, the group asserts that it has only \$2.5 billion of the projected \$3 billion cost.

Oil companies' reservations about moving forward on this schedule and investors' hesitancy reflect (1) worry that U.S. policy towards Iran might change to allow sufficient oil swaps or even exports (through an existing pipeline that if reversed and retrofitted for less than \$1 billion could transport equivalent amounts of oil from northern Iran to the Persian Gulf); (2) uncertainty about whether Baku-Tbilisi-Ceyhan would have the necessary throughput by 2004 for the amounts of oil that will be produced, since some of the increased production can be transported by existing mechanisms or by expanding the current pipeline from Azerbaijan to Supsa (Georgia) from which ships carry oil through the Bosphorus (despite current crowding and

⁵ CPC Partners hold the following percentages: Russian Federation (24%), Kazakhstan (19%), Oman (7%), Chevron Caspian Pipeline Consortium Company (15%), LUKARCO BV (12.5%), Rosneft-Shell Caspian Ventures Limited (7.5%), Mobil Caspian Pipeline Company (7.5%), Agip International (NA) NV (2%), BG Overseas Holdings Limited (2%), Kazakhstan Pipeline Ventures LLC (1.75%), Oryx Caspian Pipeline LLC (1.75%).

⁶ The shareholders in TengizChevrOil (TCO), which supplies Tengiz crude, are: Chevron (50%), ExxonMobil (24%), Kazakoil (20%), and LUKARCO (5%). The final is a joint venture between LUKoil and ARCO (a U.S. company which is now owned by BP Amoco).

Turkish concern about environmental consequences of spills); (3) worry about U.S./global slowdown/recession impact on oil prices.

- **Turkey’s economic crisis:** Turkey is in a serious financial/economic crisis—at risk of a major default, political instability, and in the extreme case even a military takeover. [Note: this is the situation today. Per the hypothetical, a straight line extrapolation from the current situation would leave Turkey in deep crisis—by the July date of the hypothetical, Turkey may have defaulted, may have found a viable alternative, or may be in an even deeper crisis. In any case, this will be the dominant face of the issue for the Turks and for the U.S. relationship with Turkey.]
- **Financing:** Earlier commitments of maximum loans, loan guarantees and insurance provided by OPIC, Ex-Im Bank and TDA (Trade and Development Agency) have already been figured into the financing package before the Sponsor Group’s plea for U.S. assistance of \$500 million.

III. Possible U.S. Interests Involved

Canonical⁷

<p><u>Vital</u></p> <ul style="list-style-type: none">• Ensure the viability of global energy supplies;• Establish productive relations, consistent with American national interests, with Russia. <p><u>Extremely Important</u></p> <ul style="list-style-type: none">• Prevent the emergence of a regional hegemon in the Persian Gulf;• Prevent the regional proliferation of weapons of mass destruction and delivery systems: involves Iran;• Promote the well being of U.S. allies and friends: involves Turkey. <p><u>Important</u></p> <ul style="list-style-type: none">• Promote pluralism, freedom, and democracy in strategically important states as much as is feasible without destabilization;• If possible at low cost, end conflicts in strategically less significant geographic regions;• Promote international environmental policies consistent with long-term ecological requirements;• Increase and diversify supplies of oil from areas other than the Persian Gulf.

On the specific question asked about interests impacted by the threats and opportunities in the choice before you:

- Turkish security and well being as a U.S. NATO ally in its current financial/economic crisis and for whom the Ceyhan pipeline has great symbolic importance, as reflected by the commitment of two U.S. Presidents and their administrations in repeated statements.
- Azerbaijan as a new state defining its own identity in Central Asia independent of Russian domination by strengthening its relationship with the U.S., including

⁷ This “canonical” articulation of U.S. interests is adapted from *America’s National Interests*, from the Commission on America’s National Interests, July 2000. Graham T. Allison and Robert Blackwill were the lead authors of the report. Students in ISP 202 referred to the report for a list of national interests and a starting point for consideration of American foreign policy priorities.

specifically a pipeline independent of Russia running to Ceyhan, to which the U.S. has made commitments.

- Georgia, a struggling state (under increasing pressure from Russia) led by Shevardnadze [not necessary to say so but someone known to the President’s father and the former Secretary of State] through which Baku-Tbilisi (Georgia)–Ceyhan pipeline will flow and which is depending upon the U.S. commitment.
- Prevention of Iranian WMD ambitions and support of terrorism through policies that currently include sanctions prohibiting American companies from exporting oil through Iran—limitations that will be increasingly violated or come under pressure for reversal as oil is being produced in the Caspian with no other routes to international markets.
- Productive relations with Russia, which will suffer a modest negative hit if the U.S. commits money, but which also present an opportunity to engage, and to enlarge our role in a multiple pipeline system in which Russian companies can have a larger (though still junior) role and where the web of international contracts and dependence on income from oil and transit revenues integrates Russia in U.S. led global systems.
- The U.S. reputation as leader of the Western alliance and a dependent ally and friend whose commitments can be trusted.

IV. Possible Options

Policy Menu (different combinations are possible):

- 1) USG money or tax incentives;
- 2) USG fundraising from companies or countries;
- 3) If (2), who and which carrots and sticks;
- 4) Reaffirmation/reinterpretation/rejection of prior commitment to BTC.

Options:

1 Reject companies’ proposition and drop commitment to BTC in deference to “market decides.”

Pros

- Avoids U.S. taxpayer subsidy of a commercially questionable project and precedent.
- Can be spun as a concession to Russia.
- BTC is likely to still happen (60%), only later.

Cons

- Violates what Turkey, Azerbaijan, and Georgia have accepted as U.S. commitment.
- Undermines trust in U.S. leadership.
- Increases pressure for violation and reversal of Iranian sanctions.
- Risks environmental consequences in the Bosphorus.

2 Reaffirm commitment and fund through USG appropriations and/or tax incentives.

Pros

- Upholds commitment.
- Allows BTC to provide export for Caspian oil independent of Russia.
- A step in national energy policy aimed at diversifying and increasing supplies.

Cons

- Money and precedent.
- Struggle with Congress for authorization.
- Aggravation of U.S.-Russian relations.

3 3M: MEP= Main; Multiple; and Market-based Export Pipelines.

Specifically (1) Reaffirm MEP as Main (for Azerbaijan’s “main” oil, as compared to the smaller pipelines currently in use for “early” oil) but morph to a Multiple pipelines strategy and emphasize Market-based solutions; plus (2) make a serious effort to fill the \$500 million gap (and in the course of this to determine what the gap really amounts to), and even more importantly to be seen by the countries, especially Turkey and Azerbaijan, and the key companies to have made a best faith effort—but (3) make no U.S. government appropriation. Reaffirm (reinterpret) commitment to emphasize “commercial viability” and that “market forces dictate the timetable.”

If one judges the impact on Turkey and Azerbaijan too painful, and pent-up pressure on oil produced in the Caspian to flow through Iran (swaps) too great, and if one judges any revision of U.S. policy towards Iran unacceptable, then one would make a very serious effort to raise the money—pressing companies, countries (particularly Azerbaijan and Turkey, recognizing that Turkey is already committed to provide cost overruns on Turkish portion for up to \$1.4 billion), and IFIs to make this feasible. The person best able to assemble the widest array of sticks and carrots and to deploy them persuasively is the Vice President. The question: How scarce is his time given the many other demands upon him? One level down is the Secretary of Energy; and a step below that is the Senior Advisor for Caspian Basin Energy Diplomacy.

Pros:

- Moves U.S. policy to a sustainable basis.
- Aligns U.S. Caspian policy with market forces.
- Mobilizes IFIs and other funds.
- Demonstrates seriousness of effort in a campaign which engages actors with stakes.

Cons:

- Could delay the project.
- Perceptions in the region uncertain, depending on the outcome.
- Caspian states might sense this as a shift away from strong support of their independence.

V. Possible Considerations for Different Actors

<p>Oil Companies: ROI: invest only when ROI (return on investment) meets companies' hurdle rate; for producers: to have lowest cost and reliable transport for all the oil they can produce, but to "ship no oil before its time"; maintain faith and good relations with USG; maintain good relations with countries and lenders where they have economic stakes. Note: detailed analysis identifies differences among companies' interests.</p>
<p>Investors: ROI. Recall: At what point does an investor commit money? When greed overcomes fear.</p>
<p>Azerbaijan: Income for oil a.s.a.p. following production (so not to have capacity that can't be shipped); route independent of Russia; strengthen relations with U.S.; repeal of Section 907; favorable resolution of Nagorno-Karabagh.</p>
<p>Turkey: Income from Ceyhan construction, transit fees and associated activity in Caspian; assistance from U.S. in financial/economic crisis; limit risks of oil spill/environmental damage in Bosphorus.</p>
<p>Iran: Reverse U.S. sanctions beginning with restriction on transit of oil and exploration and development of oil and gas; strengthen role vis -à-vis neighbors; derail BTC.</p>
<p>Russia: Increase influence in Caspian Region; improve opportunities for Russian oil companies; derive economic benefits and political leverage from export of Caspian oil through Russia; derail BTC.</p>

VI. Key Factors/Questions/Assumptions to be Analyzed

- What is the hierarchy of U.S. interests impacted by the alternatives between which one is choosing?
- What are the alternative statements of operational objectives, alternative statements of options, alternative statements of strategy, alternative tactics and implementation, etc.?
- What are the proper roles of U.S. government and private companies, especially in large capital projects?
- What will delay of BTC mean in terms of Caspian oil production and transport? If the pipeline is finished in 2005 or 2006, how big a problem? For whom? What is the political, versus economic, impact of delay?
- Will this affect the Nagorno-Karabagh peace process?

July 1, 2001

(1) Summary

Recent events have created pressure for a policy decision on energy development in the Caspian basin. An industry consortium finding, that the Baku-Tbilisi-Ceyhan (BTC) pipeline requires a \$500m subsidy to be commercially viable, begs the question of if – and if so, how – the U.S. government will intervene to ensure the pipeline goes ahead. At the same time, the domestic constituency is alarmed by continued power outages in California and seeks reassurance that the administration has a sustainable, long-run energy policy.

(2) U.S. National interests at stake

The Caucasus are important to the U.S. for 2 reasons: 1) The region has extensive, underdeveloped energy resources, which if exploited could mean lower prices and more diversified supply for the U.S. in the long run; and 2) Russia is seeking to reassert its former power in this region, using various tactics to undermine the autonomy of the newly independent states. Russia's behavior has specific implications for U.S. energy sector, as above, but also threatens the spread of democracy, U.S. values, and economic development in general. U.S. interests therefore have two underlying dimensions that can be summarized as follows:

Short and medium term

1. Ensure the viability and stability of energy supplies to the U.S. (vital).
2. Ensure the survival and active cooperation of Central Asian and Caucasian states (vital, instrumental to #1).
3. Prevent the re-emergence of Russia as a dominant, hostile power in the region (vital).

Long term

4. Reduce and diversify U.S. dependence on the Middle East and on overseas energy exporters in general (extremely important, instrumental to #1).
5. Establish cooperative and productive relations with Russia (vital).

To some extent these national interests overlap with the political interests of the current administration, which needs to reassure the domestic audience that it has a comprehensive long-run energy policy. This requires that at least some parts of the Murkowski bill be passed, allowing drilling in Alaska and possibly also at other sites in the U.S. (Note that to some it would be inconsistent to drill in Alaska while foregoing the opportunity to export the larger reserves of the Caspian.)

See Appendix #1 for summary positions of the key regional actors.

(3) Short run policy options: the BTC pipeline

In the short run, the administration must make a decision about the BTC pipeline, and this decision will be taken as a signal of long-run energy policy for the Caspian region. There are three positions which could be taken, as follows:

A. Continue support for BTC + offer U.S. Government subsidy

Pros

- Ensures pipeline will go ahead (99% likely) and reduces Russian monopoly over export routes from the region
- Secures access to proven + unproven Caspian reserves
- Makes good on commitments to Azerbaijan, Georgia and Turkey; increases their trade links with the West
- Decision will be well received by energy industry

Cons

- Sets precedent of govt. finance in the lucrative energy sector, taxpayers subsidize private sector
- Expansionary budget move goes against 'tax cuts' rhetoric
- Russia will see U.S. decision as *tit-for-tat* response to their opening of the CPC pipeline to Novorossiisk
- Puts pressure on next step (Russia will step up efforts to open N-S route through Iran)

B. Withdraw support for BTC as Main Export Pipeline

Under this scenario, the U.S. could either (i) announce explicitly that BTC is not supported any more, or (ii) state that it will give equal consideration to all commercially viable proposals to facilitate energy exports from the region.

Pros

- Taxpayers do not finance oil company shareholders (Consistent with aim to reduce size of U.S. budget)
- Oil companies must select a route which is self-financing
- Reflects less antagonistic U.S. stance towards Russia
- Allows possibility of future involvement of U.S. companies in an Iranian pipeline project
- Marks a departure from Clinton-policy

Cons

- BTC will not go ahead (99% chance)
- BTC option may be lost forever if not pursued now – stakeholder states will strike other deals (e.g. with Russia) to keep precarious public budgets afloat
- Oil companies may be left with *no viable route* for a pipeline, at least as long as Iran remains under sanctions; government stance may be labeled a fantasy unless linked to sanctions reform

C. Continue support for BTC + promote efforts to meet financing gap through multilateral lending/subsidy

Under this option, the BTC pipeline project can move forward but without the (direct) use of taxpayers' money. The U.S. uses leverage at the World Bank (WB), the European Bank for Reconstruction and Development (EBRD) and possibly also the Asian Development Bank (ADB) to secure soft-terms financing for the pipeline project. (All three institutions have explicit arrangements in place through their "Private Sector Groups" to provide very low interest loans to commercial projects with significant development impacts, but that wouldn't be adequately financed through private investment banks.)

Pros

- High chance pipeline will eventually go ahead (80%+)
- Reduces Russian monopoly over regional exports and secures access to proven + unproven Caspian reserves
- Involves other national stakeholders (especially Britain, France, Japan, possibly Germany)
- Decision will be accepted by energy industry (some analysts think cautious timetable appropriate anyway)

Cons

- Securing loans from IFIs takes time: pipeline work unlikely to start for 12-18 months
- Other important U.S. proposals at the WB/EBRD/ADB may be lost in the horse-trading
- Non-supporting member countries (Russia, Iran, Armenia) will now have a vote in the process
- WB has bad experience of pipeline projects (West Africa & SE Asia) so may need inducements to support this one

Recommendation for BTC: Option C (Multilateral Finance for BTC)

Option A is possible, but not recommended – The U.S. should avoid the initiation of a regional "pipeline race" that would have significant effects on political and diplomatic stability in the region. Note, however, that the \$500m price tag would be low considering the project's considerable security benefits, so the option remains on the table.

Option B is rejected – It is inconsistent with domestic policy. The proposed policy of drilling in Alaska and expanding exploration in U.S. territory (Murkowski bill) only makes sense if the administration is also making every effort to expand and diversify the supply system abroad. Option B would also have long run, irreversible political costs in terms of lost good will amongst the stakeholder states in the region.

Option C is recommended – It offers to secure U.S. interests and to preserve relationships with U.S. allies in the region. This option also ties in other national governments with a stake in the East-West trading axis, and avoids the development of an increasingly adversarial and polarized confrontation between the U.S. and Russia. The main costs are delays (which the industry suggests would be tolerable), possible trading between other projects under IFI consideration, and the forced marriage of interests between Russia and Iran. (See Appendix #1.) *Option C must therefore be complemented by policies which aim to normalize*

relations with Iran, and planners must anticipate that – in the medium to long term – there may be several pipelines and multiple export routes from the region.

(3) Strategy and Program Design: How to Implement Option C

Operational Objectives

1. Energy development: Oil companies to begin construction of BTC pipeline within 18-24 months.
- 2a. Finance: Secure multilateral financing deals with IFIs within 12-18 months, ideally to cover the full \$500m shortfall.
[2b. Initiate financing discussions in Washington, London and Manila within one month.]
3. Diplomacy: Begin process of lifting sanctions on Iran within 6-12 months.

Strategy

The oil companies will almost definitely go ahead if financing is assured for the missing \$500m shortfall. If they need more persuasion, it may help to reassure them that the U.S. government gives this project full political backing. If companies still drop out, the U.S. can suggest that it will back the efforts of other industry players to complete this project (Russian companies may even be an option).

Problems are more likely to arise in securing *financing* through the IFIs. Here, there are five distinct types of strategy. First, the U.S. can trade support for BTC against support for other proposals (within the IFI budgets), which other member countries favor. Second, the U.S. can offer – indirectly – to increase or speed up its budgetary support for the banks, for example by creating a “U.S. Special Fund” for energy development (analogous to the Japan Special Fund held by the Asian Development Bank (ADB)). Third, if efforts to create a joint financing initiative fail, the U.S. could play the IFIs against each other, allowing the Banks to compete for what might turn out to be a high profile and prestigious development investment.

Fourth, if Russian opposition is overwhelming in the World Bank (WB) or EBRD, the ADB could provide an easier channel. The Caucasus are on the margins of the ADB remit, though some money has gone to Azerbaijan before. At any rate, the ADB can certainly channel money to the project via Central Asia, in particular through the Kazakh government. The project Terms of Reference would need to be adjusted to stress the importance of the pipeline for export-led growth in Kazakhstan, but the payoff is that Russia is relatively weak in the ADB. The lead voice is Japan, which shares the U.S. interest in developing alternative routes for energy exports which bypass the Strait of Hormuz.

Finally, the U.S. might trade other concessions – from outside the IFI system – for cooperation on this financial package. This is most relevant for Iran, which wants to see sanctions lifted as soon as possible. Some sanctions were eased last year, and more could be released in exchange for cooperation on this deal. This would make it hard for Russia, which is isolated in the IFI system, to block the deal (at the WB, EBRD or ADB).

We estimate the odds would be 90% in favor of at least one of the three Banks supporting the deal. However, if unsuccessful or if the Banks meet only part of the funding arrangements, we should investigate the possibility of financing the difference through USAID – a compromise between Options A and C, as described above.

Responsibilities for Implementation

1. *Elizabeth Jones, Sr. Advisor on Caspian Energy Diplomacy*
 - First duty: To welcome the Memorandum of Understanding (MoU) from BTC states and to affirm that the U.S. government continues to support this project – though it will not “bankroll the private sector”.
 - Ongoing responsibilities: To liaise with Natsios (USAID) and coordinate USG lobbying drive for multilateral financing; to maintain close involvement of the BTC states and Kazakh government; to synchronize with Cheney, Abraham & Powell over formulation of wider energy policy

2. *Spencer Abraham, Energy Secretary*
 - Rapidly completes comprehensive energy policy review and incorporates Caspian development within that framework. Confirms publicly that BTC policy is in line with domestic policy on exploration in Alaska and elsewhere, and that long run aim is to diversify and broaden the energy resources on which the U.S. relies.

3. *Colin Powell, Secretary of State*
 - Initiates independent review of sanctions policy toward Iran.

4. *President*
 - No direct involvement. If asked, he confirms his support for BTC, his confidence in broadening economic ties with the region and his hope that the IFIs will give the newly independent states all the financial backing they need at this important stage of their development.

Appendix #1: The key regional players and their interests

Russia has critical economic and political interests at stake. Economically, the BTC pipeline challenges the commercial viability of the CPC route to Novorossiisk, and of a possible future project to carry oil to the Persian Gulf through Iran. Politically, Russia resists the general development of an East-West trading and diplomatic axis, linking Central Asia and the Caucasian states to Western Europe via Turkey. This axis threatens to bypass Russian interests altogether and unsurprisingly Russia is working to develop an alternative North-South route. This would bind the Caucasus to Russia and Central Asia, possibly also to Iran in the south. Recent overtures to Khatami are part of this strategy, as is the new “strategic alliance” between the two countries.

The **Caucasian States** have mixed interests. All are keen to cement independence and avoid Russian dominance (Russia is cash poor and will negotiate export prices/transfer fees downwards if it has a monopoly over export routes). Georgia and Azerbaijan signed an MoU with Turkey and Kazakhstan in March, giving support for BTC – they clearly want to go ahead. Turkey looks forward to economic benefits and increased strategic importance possibly helping its bid for EU membership. Doesn’t want to be on the border of a new Russian pseudo-protectorate in the Caucasus. The closer links between Turkey and Azerbaijan will unsettle Armenia, and may push it in the direction of allegiance with Russia. Iran is already pursuing good relations with Russia, partly under pressure from U.S. sanctions and partly because of potential gains from the alternative pipeline route to the Persian Gulf.

The **oil companies** support BTC, if subsidies can make it profitable. In general they anticipate major discoveries in the area and will support proposals to facilitate exports from the region. Note that companies do not share the viewpoints of their national governments: some Russian companies support the BTC, some western companies would support an alternative pipeline through Iran. Their concerns are about costs, and therefore also about risk. Some companies would recommend a deferred decision on BTC, while others believe delays will have high costs in terms of lost opportunities to exploit Caspian reserves.

Table #1: Summary Interests in the Region

Country	BTC?	Interests?	Concerns?
<i>Russia</i>	Against	N-S trading axis; re-establishment of influence in the region.	E-W axis links region politically to U.S., reduces importance of CPC pipeline.
<i>Iran</i>	Against	Would benefit from N-S pipeline to Persian Gulf.	U.S. military sanctions force Iranians to pursue relations with Russia. Iran has some other shared interests with Russia, e.g. opposition to Taliban.
<i>Turkey</i>	For	Gain econ. benefits from trade, increase stake in oil trade, maximize strategic importance, which would make U.S. more likely to support EU entry.	Emergence of N-S axis from Russia to Iran would leave Turkey on the border with the new ‘Russian bloc’.

STUDENT MEMORANDA FROM ISP-202

<i>Georgia</i>	For	Autonomy (from Russian influence), transit fees, improved diplomatic links with the West.	Russian hostility: Moscow can apply pressure by cutting off current power supplies, imposing visa restrictions, etc.
<i>Azerbaijan</i>	For	Same as Georgia, plus links with Turkey and Georgia help to 'outflank' Armenians. U.S. may support claims to Karabagh.	As Georgia, but take note: Azerbaijan likely to reap some benefit from any or all pipeline schemes, due to centrality of Baku and drilling rights in Caspian Sea itself.
<i>Armenia</i>	Could be either, likely to be neutral?	Long run interest in becoming a member of the EU. Has powerful lobby in Washington, DC. Will have short run security concerns re. Azerbaijan, which might force it to turn to Russia for trade and security agreements.	Azerbaijan strengthens relations with Turkey and so pins Armenia down in the middle? Armenia makes no profit from the pipeline, while trading with Russia in other goods becomes more difficult.
<i>Kazakhstan</i>	For	Reduce dependence on Russia and Russian pipeline, improve links to West.	Pressure from BTC partners to provide steady stream of oil, though this may have political costs vis-à-vis Russia.
<i>Oil companies</i>	For, with subsidy	Western oil companies expect big business in the region. E.g. Chevron has 50% of Tengiz oilfield. Want to diversify export routes (65% of oil now goes through Straits of Hormuz). Could benefit from Iranian pipeline, but unlikely if Russia dominates.	Set-up costs of BTC pipeline are too high. Is Kazakh promise to ship supplies through this route reliable? What effect will falling oil prices have on profitability projections?

Appendix #2: Extra Questions

BTC pipeline

- Is there a precedent for government financing of the energy sector overseas?
- If so, was it a success? What was its reception on the stock market & amongst the media and public?

Multilateral financing

- What voting power does Russia have in EBRD, ADB and World Bank? What about Iran?
- How does this impact on what projects are chosen?
- What are the other projects the U.S. is negotiating through the IFIs? How are its contributions looking? Is it in a strong position to negotiate for this deal?
- What is the timing of the proposal process at WB/EBRD/ADB?

Iranian pipeline

- If this opens, is the BTC + subsidy a profitable project?
- What are the chances of U.S. involvement in this project, in the long run?

STUDENT MEMORANDA FROM ISP-202

TO: POTUS (President of the United States)
FROM: Jammie L. Himsl, National Security Council
RE: The Baku-Ceyhan Pipeline--U.S. Policy on Caspian Energy Development
DATE: 2 April 2001

Issue

After several years of planning and negotiations, the head of the Baku-Tbilisi-Ceyhan pipeline consortium has informed our Ambassadors in the region that everything is in place for the project to go forward except for a \$500 million shortfall in funding. Unless the U.S. can provide the remaining funds, the project will not go forward at this time. The BTC pipeline has been the cornerstone of U.S. policy towards Caspian energy development, as it advances the interests of Turkey, a key ally in the region, and FSU states Georgia and Azerbaijan, who see the success of the pipeline as a statement of independence from Russia. Despite its strategic importance, there is much doubt as to whether or not the pipeline would be politically and economically viable. While many parties within the Administration have an interest in seeing this project go forward, the Administration must view this current issue in the context of a broader National Energy Policy and avoid the temptation to commit public resources to the completion of a project with questionable prospects of long-term success.

U.S. Interests involved in the *Current Issue*

Vital

- Establish productive relations, consistent with American national interests, with Russia (*medium-high threat*).
- Ensure the viability and stability of global supplies of energy (*medium threat*).
- Ensure the cooperation and survival of U.S. allies in the Caspian, particularly Turkey (*low threat*).
- Ensure that Russia not launch any nuclear weapons against the U.S. (*low threat*).

Important

- Prevent the emergence of Russia as a regional hegemon in the Caspian region (*medium threat*).
- Reduce the U.S. dependence on foreign oil supplies (*low-medium threat*).

Operational Objectives

- Ensure the successful completion of multiple commercially and politically viable pipelines in the Caspian region by 2005.
- Avoid strategic competition with Russia in the region over control of pipeline routes.
- Limit traffic through the Bosphorus at current levels.
- Avoid the use of U.S. federal funds to subsidize pipeline projects in politically unstable countries.

Discussion

The development of Caspian energy reserves is a complicated issue involving many parties with diverse interests. "Baku-Tbilisi-Ceyhan as the Main Export Pipeline" was the cornerstone of U.S. policy in the region during the Clinton Administration. While meeting the needs of some parties, namely Azerbaijan, Georgia, and Turkey, this policy posture has directly challenged the interests of other parties, such as Russia and Iran. The current administration has an opportunity to reexamine the interests of all parties involved *and* to potentially reshape U.S. policy in the region. In the next few weeks, U.S. actions regarding the nearly complete BTC pipeline project should keep in mind the following interests of the various parties involved.

Interests of Oil Companies

- Construction and operation of a commercially viable pipeline.
- Commitments from oil suppliers to utilize the BTC pipeline, particularly the early shipments from Kazakhstan.
- Undisrupted flow of oil through the pipeline at near-100% capacity daily.
- Appropriate cost-sharing (risk-sharing) among initial financiers.

Interests of Azerbaijan

- Ensure the development of oil export options to match the projected increase in domestic oil production capability over the next decade.
- Ensure the creation of an export route that does not pass through Russian territory.
- Secure favorable resolution of the Nagorno-Karabagh conflict with Armenia.
- Seek repeal of Section 907 of 1992 U.S. Freedom Support Act.

Interests of Turkey

- Ensure the development of multiple non-Bosporus oil export routes through the region in order to reduce navigational & environmental hazards of excessive tanker traffic.
- Secure contract(s) for the construction of an export route through Ceyhan, in hopes of recovering revenues lost due to sanctions on Iraqi oil.

Interests of Iran

- Ensure the construction of multiple pipelines from the Caspian through Iran to the Persian Gulf, as the most attractive way to capitalize on the growing Asian demand for oil.
- Secure as many pipeline routes as possible without regional entanglements.
- Increase the confidence of foreign investors in Iranian development projects, in hopes of spurring foreign direct investment in domestic sectors other than energy.

Interests of Russia

- Maintain a decisive security posture and (ideally) a strong military presence in the Caspian region.
- Ensure as many pipeline routes as possible through Russian territory, in order to capitalize on desperately needed tax/tariff revenues.
- Block U.S. attempts to exert influence in the region.
- Prevent/suppress secessionist movements within the ethnically diverse areas of southern Russia bordering the Caspian states.
- Prevent Turkish attempts to restrict tanker traffic through the Bosporus.

The current political environment, as summarized in the above interests, suggests that a “single-pipeline” posture is not in U.S. interests, particularly when one considers the current low in U.S.-Russia relations and the likely impacts strategic competition in the Balkans might have on this relationship. As your top two national interests in this situation are to ensure the viability of global energy supplies and to establish production relations with Russia, the Administration must reshape the “single-pipeline” policy of the Clinton Administration.

Policy Alternatives for the Current Situation

Option 1: Provide \$500 million to the BTC pipeline commission from U.S. Treasury

Because of the extensive work that has gone into crafting the BTC proposal, and because of the interests of several domestic oil companies and our ally Turkey, there currently exists enough support to essentially subsidize the project with U.S. public funds. In addition, because of the geopolitical importance of the BTC route, failure of the project could be represented in the press as a broader failure of U.S. foreign policy in the region. The administration could go about accessing the funds in one of two ways: (1) by Congressional action, or (2) by direct release of funds from the U.S. Treasury. The second option is most appropriate in the short term (within 2 weeks); however, this approach is likely to ruffle feathers within Congress. Providing these funds indirectly, for example, as a loan to one of the host governments to directly give to the BTC commission, would be wiser approach.

Pros:

- Avoids perception of U.S. foreign policy failure.
- Advances the interests of key U.S. allies and friends in the region.
- Advances the interests of U.S. oil companies invested in the project.

Cons:

- Substantially aggravates already strained U.S.-Russia relations.

- Assumes that Fed will be willing to release necessary funds.
- Fails to consider the questionable future commercial and political viability of the BTC route.

Option 2: Allow market forces to determine pipeline routes—Do not provide U.S. loan

Resist the pressure to provide federal funding for the \$500 million financing shortfall for the BTC project. Encourage the investors to search for additional sources of private investment. If the commission manages to gather the necessary funding, the Administration can avoid some Russian criticism because the project will not utilize U.S. federal funds. Most likely, the commission will not be able to secure the additional funding. The Administration can mitigate the frustration of the interested parties by swiftly shifting to a policy, which supports multiple export routes through the region, including non-pipeline routes, such as rail routes. Specifically, support for the many proposals to prevent tanker traffic on the Bosphorus should be highlighted (Croatia-Transneft project; Ukraine & Romania proposals; Ceyhan Rail proposal). At the same time, the Administration should also pursue avenues to provide exemptions for several U.S. oil companies interested in investing in export routes through Iran. Such exemptions could be supported in Congress as a way to balance Russian hegemonic interests in the region, as well as to signal a potential normalization of relations with the moderate government (this could have later payoffs in dealing with Iraq). Finally, the BTC project should still be encouraged, but as part of a broader, multi-pipeline policy toward the region.

Pros:

- Diffuses the large potential for a direct clash with Russian interests in the region.
- Prevents the use of U.S. federal funds to subsidize a questionable project.
- Engages Iran in a meaningful, positive manner.
- Promotes the development of multiple oil export routes in the Caspian.

Cons:

- Risks the perceived foreign policy failure if BTC does not go through.
- Has potential to anger host states, particularly Turkey.
- Assumes Congressional support for broadening relations with Iran.

Recommended Action/Option 2

While there are many cases in which government intervention in a market is necessary to prevent market failure or to provide public goods, this is not such a case. The Administration needs to take a realistic view of the BTC project—the fact that the project has not been able to attract enough private investment from oil companies or from the host governments is an indicator of the high level of risk of the project. Coupled with substantial estimates that the BTC pipeline will not be commercially viable, this should send a clear signal to the Administration that the route would later be plagued with negative profits and potential supply disruptions. The best course of action here is for the Administration to shift to a multiple-pipeline policy and allow market forces to determine the pipeline routes.

**Ely Kahn
Chrissie Hart
Ran Liu**

April 2, 2001
ISP-202
Caspian Sea Oil Policy

Full Text of Presentation Slides

U.S. Interests

Vital

1. Ensure that in the short term, U.S. supplies are reliable and not subject to serious interruptions (low threat).
2. Ensure that in the long term supplies will be adequate to meet U.S. energy needs (low threat).
3. Ensure viability and stability of major global systems, particularly supplies of energy (low to medium threat).

Very Important

4. Maintain positive relationship with Turkey, an important U.S. ally (medium-high threat).

Important

5. Strengthen political and financial independence of CIS states against reemergence of Russia as regional hegemon (medium threat).
6. Promote an environmental policy in the Caspian consistent with long-term ecological requirements (medium-high threat-- Bosphorus).
7. Reduce regional and ethnic conflicts in the greater Caspian region (medium threat).

Opportunities

- Strengthen political and economic sovereignty and independence of the new states in the Caspian region, encouraging political and economic reform.
- Mitigate regional conflicts by creating economic linkages between the new states.
- Maximizing U.S. commercial opportunities in the Caspian region.
- Diversity of energy supplies.

Other Players' Interests and Objectives

Azerbaijan

- Full development of country's oil potential maximizing revenues.
- MEP originating in Baku.
- Generate economic and political ties with U.S.; avoid Russian assertions of political domination.
- Maintain good relationship with Turkey, an important ally.

Iran

- Demarcation of Caspian in manner favorable to Iran – lake not sea, prior treaties binding.
- Attract as much oil as possible through an Iranian route – perhaps through swaps.
- Delay decision on MEP route.
- Prevent U.S. economic hegemony in region.
- No trans-Caspian pipeline, no Bosphorus bypass.
- Push economics (distance, markets, existing infrastructure) as driving force because it aids Iran.

Russia

- Demarcation of Caspian in manner favorable to Russia – lake not sea, prior treaties binding.
- Prevent the development of Baku-Ceyhan pipeline as MEP.
- MEP through Russia.
- No trans-Caspian pipeline.
- Get Turkey to back down on Bosphorus issue.
- Prevent U.S. economic hegemony in region.
- Maintain/increase influence over CIS states.

Kazakhstan

- Full development of country's oil potential maximizing revenues.
- Ensure multiple and diverse outlets for country's hydrocarbon resources.
- Protect CPC pipeline (but flexible towards Baku-Ceyhan).
- Explore pipeline options to China.
- Generate economic and political ties with U.S.
- Avoid Russian assertions of political domination but maintain stable relations with Russia.

Western Oil Producers

- Maximize revenue generation from oil.
- A pipeline that reflects market forces; least expensive route with minimal political risks.
- Recognize need for compromise due to political realities.
- Pursue cooperation with regional governments.

Turkey

- Baku-Ceyhan pipeline a go.
- No Bosphorus bypass.
- Reduce environmental threat to Bosphorus.
- Remain active player in pipeline negotiations.
- Maintain good relations with U.S.
- Hold U.S. to framework agreement.

Operational Objectives

- That Baku-Ceyhan pipeline is the MEP.
- Prevent MEP through Russia or Iran.
- No major disruption of diplomatic relations with Turkey over pipeline issue.

Option 1 – Push for \$500 million to be raised now

- Get Ex-Im and OPIC to finance the remaining \$500 million, at request of U.S. companies which are part of the AIOC.

Pros:

- Operational Objectives 1 & 2 met.
- No perceived "failure" of U.S. policy – especially important to this Administration which has made energy a top priority.
- MEP gets underway giving the AIOC's Azeri-Chirag-Guneshli a boost.

Cons:

- Economically viable? Is it a sound investment for OPIC and Ex-Im to undertake now? Better to wait until to supply makes it viable? Presumably done on a project finance basis so future cash flows are source of repayment; so, if future cash flows are not there, not sound to finance it now.
- Plus, by forcing the project sooner than is economically feasible, the cost of financing is more expensive because of greater risk/delay of repayment.
- Nagorno-Karabagh conflict might interfere; memory of expensive Chechen by-pass to early oil pipeline.

Reactions:

- Turkey, Georgia and Azerbaijan support.
- Russia and Iran do not support.
- Possible negative U.S. public reaction to 'politicizing' oil by supporting non-economically feasible pipeline.
- Oil producers may have mixed reactions: some are happy to wait another year while some want to go ahead now.

Option 2 – Defer financing to Baku-Ceyhan, examine “incremental approach” to Baku-Ceyhan pipeline with Bosphorus by-pass (Recommended)

- The United States maintains that Baku-Ceyhan is the “best” route (in terms of stability, the environment, and strategic issues). However, it would not be cost efficient to build this pipeline before adequate oil production comes on-line. The U.S. and other parties must work with, and not against, market forces. Early financing for the Baku-Ceyhan pipeline is thus deferred.
- Instead, the pumping capacity of the Baku-Supsa pipeline would be increased to handle outflow until the construction of Baku-Ceyhan MEP is economically feasible. Financing (smaller amounts) is redirected towards the expansion of this pipeline’s capacities.
- To assuage Turkey’s environmental concerns a Bosphorus bypass pipeline would be constructed (calling their bluff in a sense).
- When Caspian Sea oil production levels reaches a preset “milestone production level,” the Baku-Supsa pipeline will be extended to Ceyhan. At this production level the Baku-Ceyhan pipeline becomes economically feasible (profitable).

Pro:

- Maintains support for Baku-Ceyhan pipeline (as opposed to Russian or Iranian proposals).
- Cost efficient and environmentally conscious solution.
- Balances Turkish desires with realistic economic approach.

Con:

- Turkey likely to be initially upset regarding altered U.S. policy.
- Must rework framework agreements.

Reactions:

- Turkey: Initial frustrations but strong likelihood of eventual acquiescence. With Bosphorus issue addressed, Turkey is now playing a rather weak hand.
- Russia: Against because MEP not through Russia.
- Iran: Against because MEP not through Iran.
- Azerbaijan and Georgia would support; Kazakhstan would probably support as well.

Option 3 – Back off from Baku-Ceyhan; Let market forces decide course entirely

Pros:

- Avoids the criticism of U.S. government’s over involvement in energy market.
- Likely to yield the most profitable, cost-efficient pipeline solution.
- Might be able to use this decision as a card with Russia on other U.S.-Russia issues.

Cons:

- U.S. –Turkey relationship will be damaged.
- Azerbaijan and Georgia will be upset as well.
- If the market force failed to construct a Baku-Ceyhan pipeline, it will be viewed as a failure of U.S. diplomacy.
 - May give Russia and Iran a chance of further expanding their influence in the region.
 - May be criticized as not enough effort for the pursuance of U.S. oil supply diversity

Reactions:

- Turkey, Azerbaijan and Georgia against.
- Oil companies may have mixed reaction; some want Baku-Ceyhan to go now, others may prefer market forces to determine best route.
- Russia and Iran would be happy about it.

Recommendation/Implementation

Short-term action

- Have Secretary Abraham begin dialogue with his counterpart in Turkey on revised plan immediately; stress to Turkey that U.S. still supports Baku-Ceyhan as MEP, but has to respond to

the financial realities; will get environmental and economic benefits from the Bosphorus by-pass both until MEP comes on-line and afterwards.

- Have Ambassador Beth Jones discuss plan with Azerbaijan and Georgian governments within a week.
- Over next several weeks, Secretary Abraham should put together a team to draft this proposal and distribute it to Caspian Sea oil producing countries and interested oil companies.
- Call a meeting among Framework Agreement participants to rework agreement.
- Begin discussions with oil companies on building Bosphorus bypass over next several months; note limited U.S. role.

Longer term action

- Continue to support publicly Baku-Ceyhan as MEP when financially feasible.

Strategy

- If Turkey gets angry, then point out 1) this plan still bring economic benefit to Turkey and 2) U.S. is still supporting Baku-Ceyhan as MEP.
- If oil companies refuse to sponsor Bosphorus bypass, then Turkey could impose stricter regulations and higher tariffs on Bosphorus oil traffic.
- If Caspian reserves prove unable to support ultimate Baku-Ceyhan MEP, then Turkey still has income from Bosphorus bypass (or Bosphorus tariffs).

Longer Term Interests/Opportunities

- Rework sanctions with Iran (more targeted).
- Rework U.S. energy policy (demand, efficiencies, and alternative energy sources).

Questions

- What does the current financing package look like? Where is \$2.5 billion coming from – World Bank Group (WB, IMF and Multilateral Investment Guarantee Agency); other countries' Ex-Im banks? Institutional investors?
- Assuming this is done on a project finance basis and so to get funds from other investors there must be studies showing project feasibility, that is, that anticipated cash flows are sufficient to repay investors, right?

**ISP 202 CASPIAN WEEK
READING LIST⁸**

World Energy Supply and Demand

1. *Maintaining Energy Security in a Global Context, A Report to the Trilateral Commission*, by William F. Martin, Ryukichi Imai, Helga Steeg. New York: The Trilateral Commission, 1996. Pp 6-12.
1. *BP Amoco Statistical Review of World Energy 2000* (oil related charts and figures through 1999), pp 4-11, 14-15, 19 (www.bpamoco.com/worldenergy/oil).
2. *International Energy Outlook 2000*, Table D1, World Oil Production Capacity by Region and Country. Energy Information Administration (www.eia.doe.gov).

United States Energy Policy

1. *Energy Security: How Valuable is Caspian Oil?* by Lucian Pugliaresi. Cambridge: Caspian Studies Program, January 2001.
2. *Comprehensive National Energy Strategy*, National Energy Policy Plan, April 1998, (www.hr.doe.gov/nesp/cnes.html).
3. “Executive Summary,” *The Geopolitics of Energy into the 21st Century, A Report of the CSIS Strategic Energy Initiative*. Washington: CSIS Press, November 2000.
4. “A Narrow Energy Bill,” Editorial Desk, *The New York Times*, March 5, 2001.
5. “The Energy Equation,” Editorial, *The Washington Post*, February 5, 2001.

Caspian Energy: Background Information, Environmental Issues, Regional Conflict

1. *Caspian Sea Region*. United States Energy Information Administration, June 2000 (including Caspian tables and map) (www.eia.doe.gov).
2. *Caspian Sea Oil and Natural Gas Export Routes*. United States Energy Information Administration, June 2000 (www.eia.doe.gov).
3. *Caspian Regional Conflict*. United States Energy Information Administration, June 2000 (www.eia.doe.gov).

⁸ This is the reading list for the Caspian week in ISP 202, April 2-4. A packet of current press concerning pipeline developments was handed out in class. One obvious addition that has been published since would be President Bush’s *National Energy Policy*, a Report of the National Energy Policy Development Group, May 2001, particularly Chapter Eight “Global Alliances—Enhancing National Energy Security and Global Relationships” (<http://www.whitehouse.gov/energy/National-Energy-Policy.pdf>).

READING LIST

4. *Caspian—Bosporus/Black Sea Issues*. United States Energy Information Administration, June 2000 (www.eia.doe.gov).

Industry Report

1. “Special Report: Caspian Sea Activity,” by Hilary McCutcheon and Richard Osbon. *Oil & Gas Journal*. PennWell Corp., August 2000, pp. 52-59.

U.S. Caspian Policy

1. *Address to CERA Conference*, Ambassador Richard Morningstar, Special Advisor to the President and Secretary of State for Caspian Basin Energy Diplomacy. Foreign Affairs Network, U.S. Department of State, December 7, 1998.
2. *State of the Field Report: Energy and Politics in Central Asia and the Caucasus*, Laurent Ruseckas. NBR Publications: Access Asia Review: Vol.1, No.2: Essay 2.
3. *Testimony Of J. Robinson West, Chairman, The Petroleum Finance Company, On Caspian Sea Infrastructure Projects Before The Senate Foreign Relations Committee*. Subcommittee On International Economic Policy, Export And Trade Promotion, April 12, 2000.
4. *Remarks by Ambassador John S. Wolf*, Baku, Azerbaijan. November 9, 2000.
5. “Problems in the South: the Myth of ‘the Great Game,’ *An Agenda for Renewal: U.S.-Russian Relations*. A Report by the Russian and Eurasian Program of the Carnegie Endowment for International Peace, 2000.
6. *The Great Game, Round 2: Washington’s Misguided Support for the Baku-Ceyhan Oil Pipeline*, by Stanley Kober, CATO Institute Report No. 63, October 31, 2000.

Optional Readings

World Energy “Areas to Watch.” Energy Information Administration, August 2000.

Non-OPEC Fact Sheet. Energy Information Administration, June 2000.

OPEC Revenues Fact Sheet. Energy Information Administration, October 2000.

Tables: Petroleum Imports, OECD Total Net Imports, 1960-1999. Energy Information Administration, Energy Overview, 1999.

Testimony of Daniel Yergin, Phil Sharp, and Jay Hakes, Oversight Hearing National Energy Policy: Ensuring Adequate Supply of Natural Gas and Crude Oil, Subcommittee on Energy & Power, May 24, 2000.

EIA Country Pages: Azerbaijan, Iran, Kazakhstan, Russia, Turkey, Turkmenistan, Energy Information Administration, www.eia.doe.gov.