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Special Perspective

Caspian Energy: The Great Game Redux

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CASPIAN ENERGY: THE GREAT GAME REDUX



This report was prepared by analysts in the Office of Transnational Issues and the Office of Russian and European Analysis. Comments and queries are welcome and may be directed to the Issue Manager

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GEOPOLITICS AND US INTERESTS IN THE CASPIAN

The competition for the rich energy resources in the Caspian region, heralded as a major oil and gas supplier for the 21st century, is moving toward a day of reckoning as energy development timelines create pressure for decisions on major export projects from this landlocked region. Some of these decisions will determine the path and security of future energy flows, the Caspian states' sovereignty and financial stability, and the US role in a region where Russia, Iran, Turkey, and China also vie for influence.

Despite the intense political attention, oil companies so far have largely determined the pace and nature of the region's energy development. Caspian oil production is expanding slowly, restrained by logistic difficulties—especially a shortage of offshore rigs—and a 15-month decline in oil prices through March of this year that reinforced company reluctance to invest in large-scale pipelines.

At the same time, divergent national objectives and rivalries among Caspian states are hindering progress on US-supported export projects such as the pipeline from Baku, Azerbaijan to Ceyhan, Turkey, and the Trans-Caspian gas pipeline.

(See map)

- Azerbaijan, the likely geographic hub of an east-west pipeline route, so far has shunned a regional leadership role.
- Kazakhstan has played a waiting game, despite having the region's largest oil reserves and a strong desire for a non-Russian export outlet.
- Turkmenistan President Niyazov's desire to be treated as an equal player in the Caspian has kept him from making compromises that might advance pipeline development.

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ALTERNATIVE SCENARIOS FOR THE GREAT GAME

The Caspian could produce different scenarios depending in large part on regional stability, good governance, and the success of US efforts to push for pipelines that would link the region to Turkey and the West.

- East-west export routes would help establish secure outlets for Caspian energy and position these countries to make the most of their energy wealth, but such routes also would provoke a backlash from Iran and Russia and would leave the US vulnerable to blame if energy revenue falls short of expectations.
- A failure to develop east-west outlets could enable Iran and Russia to dominate Caspian energy flows, adding to global energy dependence on these two suppliers and diminishing the benefits from energy wealth to the Caspian states.
- A breakdown in order in the Caspian countries could disrupt oil and gas development, especially if combined with a lifting of sanctions against Iraq and low oil prices. This would undercut global and US energy security and leave the region more vulnerable to intervention by Russia and Iran.

Even if the OSCE Summit in Istanbul this week advances the east-west pipelines, the three scenarios will remain in play. US diplomatic efforts will continue to have a direct bearing on their probabilities.

CASPIAN ENERGY POTENTIAL LARGE BUT NOT A RIVAL TO THE PERSIAN GULF

Early claims that Caspian energy resources rival those of the Persian Gulf are exaggerated. The Caspian region probably holds at least 65 billion barrels of recoverable oil, similar to the original resource base of the North Sea but only about one-tenth of current reserves in the Persian Gulf. (CNR)

Many industry observers remain optimistic about the region's resources despite some recent disappointing exploration results offshore Azerbaijan.

The Caspian is one of the best places in the world to find oil and gas, and that 15 to 20 large fields could be discovered over the next decade. In addition, companies say they have found greater reserves than expected in existing projects, such as Tengizchevroil in Kazakhstan and fields operated by the Azerbaijan International Operating Company.

A CIA baseline estimate of Caspian oil potential—developed with the support of industry experts—indicates that regional production could rise from about 1 million barrels per day this year to more than 4 million by 2015 if current investment trends continue. Gas production potential in the Caspian region is likely to parallel oil production, rising from about 40 billion cubic meters (bcm) per year in 1999 to up to 160 bcm by 2015, based on existing reserve levels and export proposals.

- These oil and gas output levels are similar in magnitude to supplies from the North Sea, which have been a major factor in preventing energy prices from rising during the past 20 years.

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SCENARIO 1: US-BACKED EAST-WEST ROUTES ARE DEVELOPED

KEY DEVELOPMENTS: Azerbaijan, Kazakhstan, and Turkmenistan cooperate to build the large oil and gas pipelines the US is promoting. The Baku-Ceyhan main export pipeline is financed and built by the US-backed target date of 2004, as oil companies combine oil volumes from projects in Kazakhstan with production in Azerbaijan. Turkey follows through on its commitments to make the pipeline commercially attractive to the oil companies and provides purchase agreements for the Trans-Caspian gas pipeline. Instead of seeking separate pipelines, Azerbaijan and Turkmenistan put aside their offshore boundary dispute and agree to share access to the Turkish gas market in the interests of building the gas pipeline.

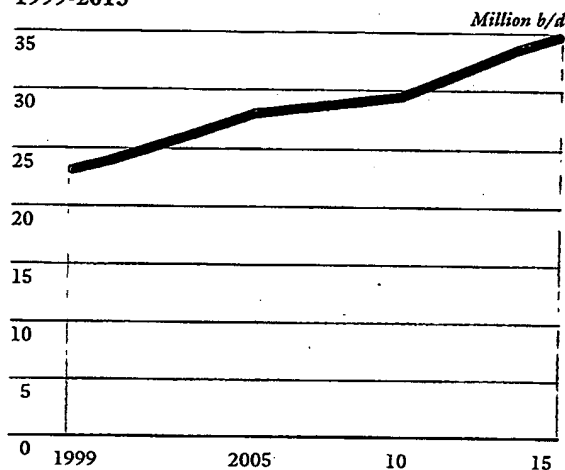
OUTCOME: Completion of the Baku-Ceyhan oil pipeline and the Trans-Caspian gas pipeline from Turkmenistan to Turkey creates a major transportation corridor linking the two sides of the Caspian to Turkey and other western markets. Growing volumes of oil and gas from the Caspian states are shipped through this corridor because expansion generally is more cost effective than developing new routes.

- The success of a gas pipeline from Turkmenistan to Azerbaijan encourages a Trans-Caspian oil pipeline to ship increasing volumes of oil from Kazakhstan and Turkmenistan to Azerbaijan and on to Ceyhan.

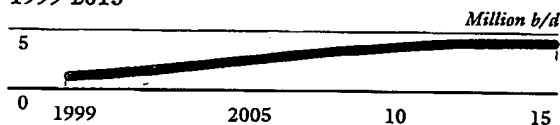
REGIONAL OIL PRODUCTION COMPARISONS

Historical North Sea production, not Persian Gulf, is a good model for forecasted Caspian oil output.

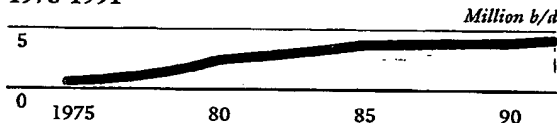
PROJECTED PERSIAN GULF 1999-2015



PROJECTED CASPIAN REGION 1999-2015



HISTORICAL NORTH SEA 1975-1991



Sources: US Energy Information Administration and CIA projections.

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- Russia completes the Caspian Pipeline Consortium's (CPC) pipeline from Kazakhstan, but most other east Caspian oil is exported across the Caspian Sea.
- Iran remains a bit player in the Caspian, importing relatively small volumes of oil and gas into its northern territory.

IMPLICATIONS: US and Turkish links and influence in the Caspian are strengthened, fueling expectations of future support and perceptions that the US bears some credit or blame for the competence of Caspian regimes.

- Turkey is pleased that the Baku-Ceyhan pipeline relieves some pressure from the Bosphorus for shipping Caspian oil.
- Russia's perceptions of US infringement on its sphere of influence are increased.
- Iran's sense of Western encirclement is heightened as it loses ground in competition for Caspian exports and the Turkish gas market.
- Caspian states are less dependent on Russia and more strongly linked to Turkey and Europe. Increasing orientation toward the West encourages Caspian governments to implement economic and political reform.

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SCENARIO 2: SUPPORT FOR EAST-WEST ROUTES FALLS APART

KEY DEVELOPMENTS: US efforts to facilitate cooperative efforts fail as Azerbaijan, Kazakhstan, and Turkmenistan stick to their "me first" export strategies. Iran uses the advantage provided by its infrastructure to attract Caspian energy exports and gains more foreign investment after the Iran-Libya Sanctions Act (ILSA) expires in August 2001.

- Russia makes a stronger bid for Caspian exports by pushing completion of the CPC pipeline and using a "carrot-and-stick" approach to attract Azerbaijani oil at the same time it is destabilizing Georgia to undermine its role as a transit state.
- Oil companies decline to pool their oil volumes and to cooperate on large-capacity export projects, except for the CPC pipeline project from Kazakhstan through Russia.
- Turkey fails to support any of the gas export projects competing for its market but continues to resist growing oil traffic through the Bosphorus.

OUTCOME: Commercial negotiations on the Baku-Ceyhan oil pipeline break down as Azerbaijan and Kazakhstan decline to cooperate and oil companies balk at Turkey's terms for the project. Bickering between Azerbaijan and Turkmenistan kills the Trans-Caspian gas pipeline. Iran becomes a major conduit for Caspian oil and gas by expanding its infrastructure. Russia completes and expands the CPC pipeline and builds a pipeline to bypass Chechnya to handle oil exports from Azerbaijan. Azerbaijan increases oil exports through Russia and Iran as Moscow's meddling in Georgia makes oil flows

there unsecure. As tanker traffic through the Bosphorus mounts, Turkey carries out its longstanding threat to restrict flows, making additional oil exports through Iran even more attractive. With help from European institutions, oil pipelines through Ukraine and the Balkans are established to deliver oil to Europe and ease shipments of Caspian oil through the Bosphorus. Azerbaijan decides to send gas to Turkey on its own.

IMPLICATIONS: Iran becomes a major transit state for Caspian oil and gas, earning large revenues and extending its political and economic influence into the Caspian.

- Russia also attracts larger volumes of exports and uses its economic leverage to increase its political influence.
- US and Turkish influence wanes, and the Turks' sense of betrayal by Azerbaijan weakens their backing for Baku on the Nagorno-Karabakh dispute, increasing risks of renewed conflict between Armenia and Azerbaijan. Turkey's dependence on Russia and Iran for gas supplies grows, increasing the Turks' strategic exposure.
- The Caspian states and Georgia are more dependent on Iran and, to a lesser extent, Russia for economic survival, reducing their political independence. Turkmenistan suffers serious economic difficulties and defaults on its international loans, especially if the Iranians were to cut off its access to the Turkish gas market. Georgia is weakened by the loss of potential revenues from failed east-west routes.

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MAJOR CASPIAN EXPORT PIPELINES

| EXISTING OIL | OWNERSHIP | LENGTH (km) | CAPACITY |
|---|--|-----------------|---------------------|
| Baku-Supsa Western Early Oil Pipeline | AIOC: BP/Amoco, Unocal, Lukoil, SOCAR, Statoil, Exxon, TPAO, Pennzenergy, Itochu, Ramco, Delta-Hess | 814 | 115,000 b/d |
| Atyrau-Samara Pipeline | Transneft, KazTransOil | 750 | 180,000 b/d |
| Baku-Novorossiysk Northern Early Oil Pipeline | Transneft, SOCAR | 1,350 | 130,000 b/d |
| PLANNED/PROPOSED | | | |
| OIL | | | |
| Baku-Ceyhan Main Export Pipeline (MBP) | Undetermined | 1,750- 2,000 | 1.1 million b/d |
| Caspian Pipeline Consortium (CPC) Project | Russia, Kazakhstan, Chevron, LUKArco, Mobil, Rosneft-Shell, Oman, Agip, British Gas, KazakhOil/ BP-Amoco, Oryx | 1,500 | 1.34 million b/d |
| Neka-Tehran Pipeline | Iran | 300 | 100,000 b/d |
| GAS | | | |
| Blue Stream Pipeline | Gazprom, ENI | 1,200 | 16 bcm/yr |
| Trans Caspian Pipeline (TCP) | PSG, Shell | 2,000 | 16 bcm/yr |
| Iran-Turkey Pipeline | Iran, Turkey | 530 | 10-22 bcm/yr |

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SCENARIO 3: CASPIAN INSTABILITY DISRUPTS ENERGY DEVELOPMENTS

KEY DEVELOPMENTS: The Caspian states suffer a breakdown in order triggered by political succession and ethnic conflict and aggravated by continuing corruption, inept governance, growing inequalities, and subversion by Russia and Iran. Oil companies perceive much greater risk to investment in the Caspian. An end to UN sanctions on Iraq coupled with an opening by Saudi Arabia and Kuwait to more foreign energy participation exerts downward pressure on oil prices and diverts investment by oil companies to the Persian Gulf. Turkey is too preoccupied with internal politics to help stabilize the Caspian or implement a coherent policy on pipelines. ☐

OUTCOME: Oil company investment is drawn away from the Caspian, slowing petroleum development there. Mistrust, weak regimes, and corruption hinder alliances or cooperation among Caspian governments. Oil companies are reluctant to honor their Caspian investment commitments, except for the few projects already generating revenues. Oil and gas continue to bleed out of the region in all directions, but major US-backed oil and gas export projects are delayed indefinitely.

- The lifting of UN sanctions on Baghdad also enables Iraqi gas to beat Caspian gas to the Turkish market, further impoverishing the Caspian states and leaving them with few financial means to deal with domestic problems.

CASPIAN OIL BLEEDING OUT BUT NATURAL GAS STILL STRANDED ☐

Caspian oil output has risen by more than 250,000 barrels per day (b/d) since 1995 to nearly 1 million b/d this year. Exports have surged to 650,000 b/d—nearly double the 1995 rate—and are bleeding out of the region in all directions.

- The largest volumes of oil are exported from Kazakhstan through existing pipelines that transit Russia.
- Additional routes that rely heavily on existing infrastructure include the frequently disrupted pipeline from Azerbaijan through Chechnya, several rail routes from Kazakhstan to Black Sea and Baltic ports, and small tanker traffic from the east Caspian to Iran for transshipment to Iranian refineries, or to Azerbaijan and on through Georgia via rail.
- The one new oil export pipeline and the first to exclude Russia currently delivers 115,000 b/d of crude from Azerbaijan to the Black Sea port at Sup'sa. A second new route, the Caspian Pipeline Consortium project from Kazakhstan through Russia, is under construction. ☐

Caspian production and exports of natural gas have fallen over the same period. Turkmenistan has one of the world's largest natural gas resource bases and was a major gas producer and exporter until the mid-1990s. Turkmenistan relies on Russian pipelines for most of its gas exports, and in the early 1990s Russia started locking out Turkmen gas from customers who could pay hard cash. Turkmenistan's gas exports plummeted to small volumes sent to its Central Asian neighbors and Iran. ☐

Turkmenistan has signed agreements to sell gas to Turkey, but it lacks a pipeline link. A US-supported pipeline project crossing the Caspian and the Caucasus is competing with projects to deliver Russian and Iranian gas to Turkey and also may have to compete with gas from Azerbaijan. ☐

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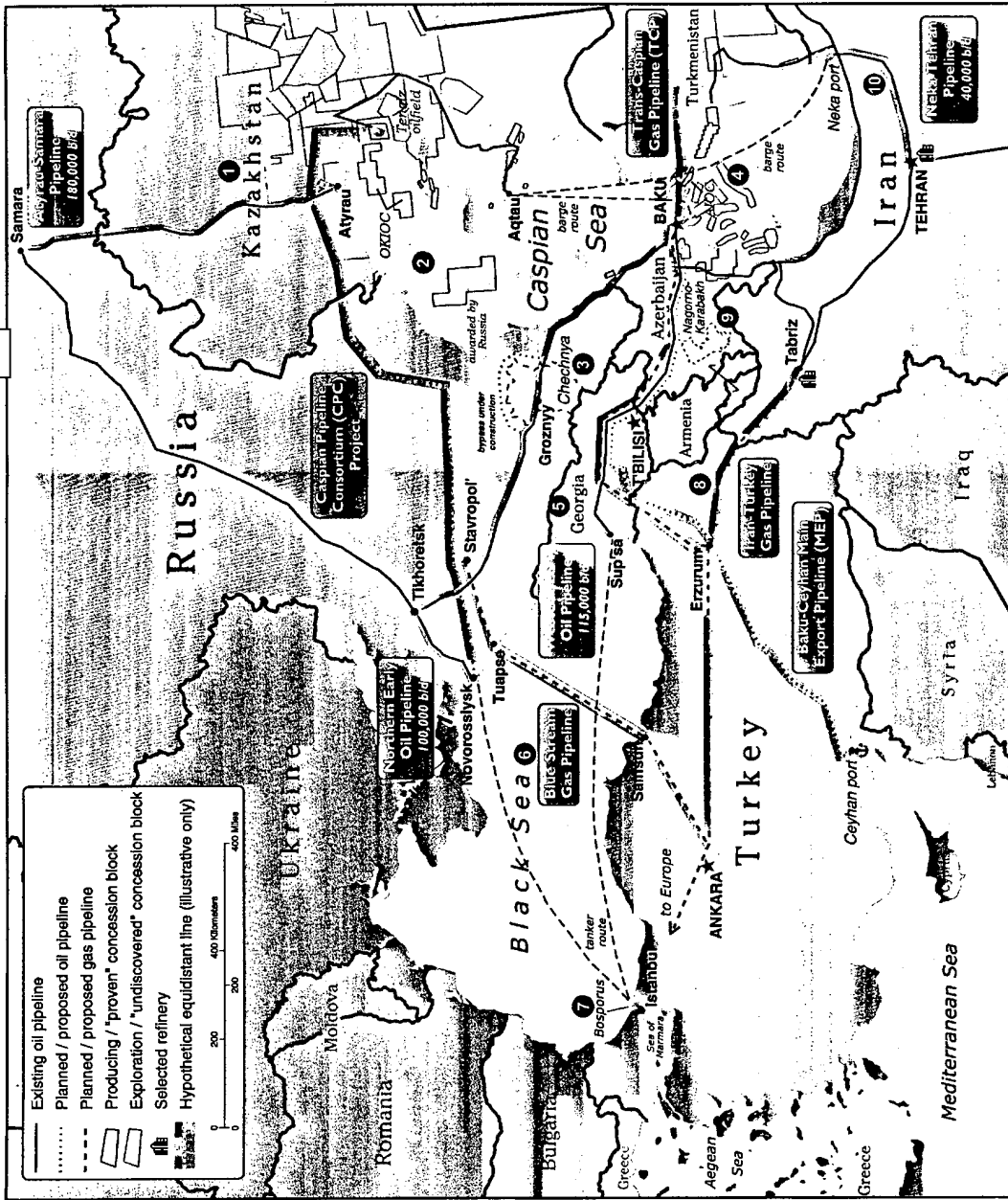
- Russia and Iran exploit Caspian governments' ineffectiveness to expand their roles in exporting Caspian energy.

IMPLICATIONS: The world economy is denied a major new source of oil and gas supplies that could enhance global and US energy security by diversifying supply. Caspian states still look to the US to play a stabilizing role and may overestimate US willingness to intervene and put troops in harm's way in response to regional conflict.

- Turkish influence is reduced as ineffective governance in the Caspian and the collapse of pipeline projects transiting Turkey eliminates useful levers. Turkish dependence on Russian and Iranian gas increases.
- Russia becomes bolder and more heavyhanded in trying to regain influence in the region, especially the Caucasus.
- Iran benefits from the collapse of east-west oil and gas export routes by expanding oil swaps and providing a growing market for Turkmen gas exports.
- The Caspian states evolve toward autocratic and corrupt governments that finance their rule with unlawful activities such as the smuggling of narcotics, people, and perhaps even weapons of mass destruction.

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CASPIAN ENERGY EXPORT ROUTES AND POTENTIAL FLASHPOINTS



- Key Points of Tension and Potential Conflict**
(numbers are cross ref'd to map)
- 1 Kazakhstan is seeking a non-Russian oil export route. Kazakhstan's support and oil are critical to making Baku-Ceyhan pipeline commercially attractive.
 - 2 Littoral states disagree on division of the Caspian Sea.
 - 3 Conflict in Chechnya has slowed pipeline operation from Azerbaijan.
 - 4 Azerbaijan and Turkmenistan offshore boundary dispute threatens to stymie Trans-Caspian Gas Pipeline (TCP).
 - 5 Russia is threatening to cut off gas supplies to Georgia for supporting Caspian gas export schemes.
 - 6 Russia's Blue Stream gas pipeline threatens to shut Turkmen gas out of the Turkish market.
 - 7 Turkey strongly objects to increased flows of Caspian oil through the Bosphorus.
 - 8 Iran-Turkey gas export pipeline is nearly complete. Iranian gas is competing with Caspian gas.
 - 9 Armenia and Azerbaijan dispute over Nagorno-Karabakh poses threat to regional security.
 - 10 Iran's plans to expand Neka-Tehran oil export pipeline threaten to delay Baku-Ceyhan oil export project by providing a cheaper alternative for Caspian exports.