THE JAMES A. BAKER III
INSTITUTE FOR PUBLIC POLICY
OF
RICE UNIVERSITY

UNLOCKING THE ASSETS: ENERGY AND THE FUTURE OF CENTRAL ASIA AND THE CAUCASUS: WORKING PAPERS

KEY CONSTRAINTS TO CASPIAN PIPELINE DEVELOPMENT:

STATUS, SIGNIFICANCE AND OUTLOOK

SHEILA N. HESLIN

FORMER US NATIONAL SECURITY COUNCIL DIRECTOR

FOR RUSSIA UKRAINE AND EURASIAN AFFAIRS

PREPARED BY THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY

RICE UNIVERSITY – APRIL 1998

Introduction

The emergence of independent states in the South Caucasus and Central Asia (SCCA) region has created a new environment of great importance to the United States. The region's geo-political position between Europe, the Persian Gulf, and Asia, its vast natural resources, and its unresolved regional conflicts have made it both a magnet and potential flashpoint for its neighbors, including Russia, Turkey, Iran, China, Pakistan and India. As the SCCA states have asserted their independence, they have sought international support to help protect their sovereignty, resolve regional conflicts, and link their land-locked Caspian energy reserves with global markets through diversified infrastructure corridors. In return, they continue to offer access to their vast resources to those who are able and willing to help them advance their independence and economic development. As a result, the Caspian region's vast energy reserves have made the region a highly competitive commercial environment for companies from the U.S., Europe, Russia, the Persian Gulf and Asia and have positioned it to become an important new player in the global energy market.

Despite the region's energy reserves and intense competition for influence, there are a number of issues that need to be addressed to assist the region before it can begin to realize its full potential. Development of export pipelines for this land-locked region is at the top of the list. As the SCCA states move toward a major decision on main oil and gas export pipelines, therefore, this paper looks at the key political constraints affecting prospects for Caspian pipeline development and routing. The constraints are complex and interlinked, serving both as levers and long-term challenges to the South Caucasus and Central Asian states, regional powers, Western, Gulf and Asian countries, and foreign oil companies that are parties to the pipeline negotiations currently underway.

The paper first sets out the broader context of developments in the region and the various pipeline plans under consideration or construction. Next, the paper describes the status and significance of political constraints facing pipeline development, including regional conflicts, disputed property rights, sanctions, transport bottlenecks, and the dynamics of multiparty negotiations. Where appropriate, the paper makes recommendations regarding potential solutions or approaches to minimizing these risks. Finally, the paper identifies the route with the best prospect for meeting the key strategic objective for Caspian pipeline development in the coming five to seven years. Overall, the paper takes an optimistic view concerning the potential for Caspian pipeline development, including the eventual construction of multiple pipelines.

Context/Framework

In the early 1990s, many skeptics regarded the South Caucasus and Central Asian region as too backward, too unstable and commercially unattractive compared with potential oil ventures in Russia to warrant development of Caspian reserves. The situation today has reversed itself completely. Russia, for its part, is perceived as having discouraged international investment in its energy sector.

Meanwhile, the Caspian Sea states, having survived the first harsh years of independence, are seen as being fully committed to developing their resources in partnership with international energy companies in order to solidify their sovereignty and secure their future as fully independent and prosperous states, at peace with their neighbors and integrated into the global economy. Substantial political and commercial risks notwithstanding, therefore, foreign oil companies have come to regard Caspian development as the bellwether for energy investment in the former Soviet Union.

Today, companies are competing fiercely to sign production sharing agreements for the remaining Caspian fields and comply with tight deadlines for exploration and development. The continued lack of transportation capacity looms large as the single most important constraint to Caspian energy development.

The Strategic and Commercial Rationale Behind Multiple Pipelines

The South Caucasus and Central Asian states, regional powers, foreign oil companies and major investor nations all favor the development of multiple pipelines from the Caspian region, albeit for different reasons. In fact, most observers agree that multiple pipelines will be needed to carry Caspian Sea energy to world markets. Based on volumes alone, Caspian Sea energy reserves amount to at least those that have been found in the North Sea, which was brought to market via a network of five oil and nine gas pipelines. Like the Persian gulf, the Caspian Sea is an area characterized by high political but low geological risk, motivating companies to pursue multiple pipelines so as to minimize their exposure to supply disruptions and local conflicts.

The Caspian states view multiple pipelines as key to their efforts to ensure that no regional power can exercise strategic control over energy routes and their broader economic and political ties to western, Mediterranean, and Asian partners.

Russia, for its part, has opposed multiple pipelines, reflecting a strong desire to retain control over strategic resources and infrastructure networks. However, when deals have been struck, Russia has grudgingly gone along and encouraged some stake in these developments for Russian companies. This approach typifies a more general pattern of Russian relations toward the South Caucasus and Central Asia region, which remains characterized by deep ambivalence about the changed political, economic and military realities ushered in by the collapse of the Soviet Union. Russia has been bogged down in a divisive internal debate on whether to advance its interests vis-a-vis its newly independent neighbors through confrontation, obstruction or cooperation.

Some groups in Russia, primarily in the foreign policy and military establishment, maintain as their stated objective the integration of the South Caucasus and Central Asia into a common space which, by sheer weight alone, would be dominated by Russia. From an SCCA standpoint, Russia's direct or tacit participation in regional conflicts, its control over pipeline networks and its role in the unresolved status of the Caspian Sea's legal regime are seen as levers used by Russia to extract political concessions, obtain basing rights, maintain control over CIS borders and acquire resources cheaply while deterring foreign investment in the Caspian region.

In contrast, some of Russia's emerging business class views the establishment of more normal relations with the South Caucasus and Central Asia as the sine qua non for access to the vast resources of the region. Russian business interests have been lobbying for expanded commercial relations and preferential trade agreements as the basis for a policy of engagement with its neighbors. These groups see clear benefits in a stable investment environment and open lines of transportation to the Caspian region; thus, they support a constructive Russian approach to achieve early resolution of regional conflicts. Likewise, they favor a more transparent operation of pipelines in Russia itself to ensure lasting access for Russian and Caspian energy to foreign markets. In line with this commercial strategy, these groups also want access to pipelines that will be built elsewhere--even outside Russia--to increase their overall market share in energy exports to global markets. Still, even these groups are willing to resort to crude political levers to advance their commercial interests in the Caspian Sea region.

Thus, Russia continues to pursue conflicting policies in the SCCA region. At one extreme, Russia has tended to lean heavily on its neighbors. In the energy area, Russia has used its pipeline monopoly as a foreign policy tool to thwart Caspian energy development. This clumsy tactic has helped the SCCA states unify and accelerate their efforts to find export solutions outside Russia. In contrast, when Russia has sought to engage constructively along commercial lines, its presence has been welcomed by its neighbors and resulted in deepened cooperation. In the end, Russia's conflicting policies have undermined its otherwise natural position as the preferred transit country for Caspian energy and stiffened the resolve of SCCA states to find diplomatic and commercial partners who will help them develop multiple pipelines.

Meanwhile, the other regional powers--Turkey, Iran, China, Pakistan and India--emboldened by Russia's loss in Chechnya, see an opportunity to expand their influence in the SCCA region and gain access to its cheap natural resources. Constrained by limited resources and military reach, they are focusing their efforts, for now, on building pipeline and transport corridors across their territories to expand their access and deepen their ties to the region. In the process, they have become active proponents in the push toward multiple pipelines. Over the longer term, such efforts are seen as part of a broader strategy by regional powers seeking to advance their geopolitical aspirations in this resource-rich yet sparsely populated space, lay claim to the region's valuable resources, manage their own restive borders and, in the process, limit the influence of their neighboring rivals.

U.S., European, Middle Eastern and Asian energy companies, for their part, favor multiple pipelines to ensure reliable market access and a predictable commercial regime so as to avoid being squeezed by excessive transit fees set by a monopolistic pipeline operator. Under the terms of their PSAs, companies are under mounting pressure to arrive at a solution soon. Most are required to complete appraisal and begin production over the next six years or so, leaving no margin for delay in the development of export pipelines.

Still, multiple pipelines can only emerge over the long-term. The underlying tension arises from the fact that there will be insufficient oil supply and demand over the next ten to fifteen years to justify all these proposals for main export pipelines in northern, southern, southwestern, western and eastern direction. Instead, it is more likely that multiple pipelines will be built in phases, in line with the gradual expansion of Caspian energy production and external demand. Intense competition over the routing of the first generation of pipelines has emerged, in part, because all parties are aware that the sequencing of pipeline development will influence the political and economic orientation of the SCCA region for the next decade.

Developments on the Ground

Already, multiple pipeline routes are being utilized, albeit on a small scale, by SCCA governments and international energy companies, without much fanfare. For instance, Russian pipelines are being used to transport Kazakh and Azeri crude to ports in the Baltic and Novorossysk as well as Turkmen gas, primarily to NIS markets. Chevron is shipping Tengizchevroil (TCO) crude north through Russia by pipeline, rail and barge. Chevron is also utilizing western routes, shipping oil across the Caspian to Baku by barge and onward by rail to Batumi on the Black Sea; Chevron also has plans to construct a parallel pipeline along this route to transport expanded volumes of crude. And, Chevron has just begun shipping TCO crude east by rail to China. AIOC, for its part, recently began shipping oil north through Russia. In addition, it is scheduled to complete construction of an oil pipeline from Baku to the Georgian port of Supsa in the first quarter of 1999, that with expansion of capacity could be capable of moving upwards of 200,000 barrels per day. Kazakhstan has been engaged in crude oil swaps with Iran for more than a year, with a near-term target level of 60,000 barrels per day. Turkmenistan has recently completed construction of a very small scale pipeline to Iran, which allows the shipment of 2 bcm of gas to Northern Iran, with a planned increase to 8 bcm over the next several years.

A second dimension of multiple pipeline development is the intense competition now underway to lock-in the first generation of main export pipelines. In fact, every conceivable option for main oil and gas export pipelines has been put on the table by different groups of investors, operators, and governments.

Two main oil pipelines will be built and brought on line to serve the region up to 2010. As for gas, it is likely that only one major line will be constructed during the next decade, connecting the Caspian with the Turkish market. At this point, the only pipeline that has reached the final stages of negotiation is the Caspian Pipeline Consortium (CPC) pipeline for oil from Kazakhstan to the Russian port of Novorossysk. Competing proposals for the other two first generation pipelines are at various stages of negotiation. The potential routes include:

· To the north, a main oil export pipeline across Daghestan and Chechnya to Russia's port of Novorossysk, with an eventual Bosphorous bypass envisioned to absorb additional volumes of oil or the extension of the Druzhba pipeline into Europe. In addition, Russia and Turkey are discussing the potential for an underwater gas pipeline from southern Russia to Turkey.

· To the east, there is a proposal to build an oil pipeline from eastern Kazakhstan's Uzen field to western China as part of an overall $9.5 billion deal supported by China's state oil company CNPC.

· To the southwest, oil and gas pipelines originating in Turkmenistan are envisioned transiting either Afghanistan or Tajikistan to ports on the Arabian Sea and locations in Pakistan and, possibly India.

· To the south, an oil and gas pipeline from the SCCA states across Iran, respectively to Kharg Island or to a new port on the Gulf of Oman for oil and to Turkey for gas. And,

· To the west, oil and gas pipelines transiting from Baku to Ceyhan with links to cross-Caspian lines from oil and gas fields in Kazakhstan and Turkmenistan.

All of these pipeline options are technically possible; most are commercially feasible at some volume; and competition over which route will prevail intense.

Constraints

Actual and potential constraints affecting Caspian pipeline development range from regional conflicts to disputed property rights, transport bottlenecks and sanctions to the underlying dynamics of multiparty negotiations. These constraints merit special attention in two respects. First, they are being used as tactical levers to influence the bargaining process now underway. Second, most of these political constraints represent long-term problems that must be addressed if a stable pipeline regime is to be established. As the debate between proponents and opponents of each route intensifies, the question arises to what extent individual routes may be affected by different types of constraints.

Regional Instability

Since their independence, the Caspian states have struggled to overcome the legacy of ethnic conflict, economic dislocation, weak government institutions, porous borders and an aggressive Russian security policy and have sought to become independent states, capable of asserting sovereign control over their territories. Over the past six years, the SCCA states have survived these crises and emerged strongly committed to their independence. Now, they are well on their way to forming national identities and articulating their national interests.

Still, regional conflicts have left the South Caucasus and Central Asia in a state of "frozen instability" that reinforces the region's immature political development and poses a considerable risk premium for Caspian energy development and its transportation to global markets. This instability holds the potential to slow Caspian energy and pipeline development and to pose ongoing security risks for regional powers and the West.

Broadly speaking, the region's conflicts have a negative impact on pipeline development in three ways. First, conflicts zones have served as transshipment points and breeding grounds for arms and drug trafficking throughout the region; such lucrative activity tends to reinforce local mafia structures and create powerful interest groups committed to maintaining the status quo. As a result, these smoldering conflicts stand in the way of foreign direct investment, including investment directed toward the development of a broad-based transport corridor alongside the pipeline routes.

Second, they tend to hinder the development of normal patterns of regional cooperation, while reinforcing historic animosities. For instance, conflicts in Georgia block Russia from advancing a land-based pipeline and transport corridor to the Mediterranean, limiting Russia's ability to expand export links with its largest trading partner, Turkey. Similarly, the Nagorno-Karabakh conflict directly impedes the development of an Azeri-Armenian-Turkish pipeline route at the economic expense of all three states.

Third, latent conflict zones in the South Caucasus and Central Asia have been used as launching pads for regional powers seeking to expand their influence or control over their own restive hinterlands. For instance, there is a strong perception throughout the SCCA that Russian security forces exploited local ethnic strife in 1992-1994 to solidify control over CIS borders and extract long-term basing agreements.

Security Risks Along Potential Pipeline Corridors

Most pipeline routes from the Caspian region are affected by actual or latent conflict situations. It is worthwhile to look at each briefly to consider their significance for the development of pipelines along the five principal corridors.

The northern routes from Baku and Tengiz through Russia will continue to be subject to frequent disruption due to disagreements between Russia's central and regional authorities over the distribution of transit fees, instability in the north Caucasus, Russian use of pipelines as a political lever, as well as poor weather conditions and overcrowded port facilities at Novorossysk. Already, the early oil pipeline from Baku to Novorossysk has been disrupted several times as a result of such disagreements between Russian and Chechen authorities under the guise of mechanical and administrative difficulties. Likewise, final completion of the Caspian Pipeline Consortium agreement has been held hostage to disagreements between federal and local authorities regarding the distribution of transit rents. Similar problems can be expected if a bypass is built through Dagestan, with the added potential for sabotage from Chechnya should Russia seek to use the bypass as a replacement for the Chechen pipeline. Broader instability throughout Russia's Caucasus regions could also affect current and future routes. However, despite frequent disruptions, ensuring that northern pipelines will continue to be utilized for Caspian exports with some level of Russian involvement has strong industry and official support.

Various western routes under construction or negotiation could become targets should war be resumed in the region. The Nagorno-Karabakh conflict represents the most serious threat to a western route. Despite threatening statements by hardline Armenians in the region and abroad that Azerbaijani crude will not reach western markets, up to now Armenia's leadership has been careful not to push its war-weary population and struggling economy beyond current ceasefire lines. In Georgia, considerable progress has been made toward establishing a federal structure far more acceptable to the country's ethnic minorities, thereby stabilizing the country and allowing pipeline development to move forward. The prospects of broad autonomy within a federal structure for Ossetia and Abkhazia contain the formula for an eventual settlement. In a worst case scenario, renewed hostilities could result in periodic guerrilla attacks against the Baku-Supsa pipeline but would not threaten the integrity of the overall pipeline system. Finally, while Kurdish separatists in Turkey represent a continued security risk for a Ceyhan pipeline, it is instructive to recall that the Iraqi-Turkish pipeline which passes through some of the most contested territory has never been disrupted by ethnic conflict. Thus, although the western routes involve significant security risks, from an industry perspective, these appear manageable.

The south-Asian routes will remain blocked until the now intertwined civil wars in Tajikistan and Afghanistan are settled conclusively. While a fragile peace settlement has been agreed upon in Tajikistan, under considerable pressure from Russia's former Prime Minister Chernomyrdin, prospects for building a stable government remain weak. For now, the ongoing fragility of the Tajik situation prevents Gazprom from pursuing its pipeline plans. Meanwhile, the Unocal consortium, intent on building a pipeline through Afghanistan, will have difficulty attracting the necessary financing until Afghanistan's civil war is wound down and a government acceptable to the country's many ethnic group is established.

The southern routes from the Caspian states via Iran and the eastern routes from Kazakstan via China to Asia face no acute hostilities. However, the Caspian states, concerned about the imbalance in terms of sheer size, population and military strength between themselves and their surrounding neighbors, look to these routing proposals as a means for strengthening their bargaining position in the short term and mitigating against risks of outside domination in the long terms. With ethnic groups spanning the spaces between SCCA states and neighboring powers, there is a potential for future cross-border conflicts which could undermine stability in the region and complicate pipeline development. Two examples are northern Iran, which is home to more ethnic Azeris than Azerbaijan itself and the Uighur province in Western China, where Uighur nationalists have called for a revival of an independent Turkestan which could threaten both Kazakstan and China.

Building Pipelines in an Uncertain Environment

Over the past several years, Caspian energy pipeline development has moved forward in spite of the region's instability. Several factors have helped. First, the growing sovereignty and stability of the SCCA states have allowed the successful development of early oil routes, establishing facts on the ground and building confidence in prospects for the development of main export routes. Regional leaders view the development of their vast resources as key to independence and have been determined to work closely with those companies willing to take risks to ensure progress. Western companies, for their part, have been able to offer technical solutions for extracting Caspian energy while at the same time enlisting the active support of their respective governments to manage the region's high political risks. As a result, strong partnerships have emerged between the SCCA states, international energy companies and major Western, Asian and regional powers in favor of developing Caspian energy and diversifying pipeline networks.

Equally important, most players--both inside and just beyond the borders of the region--have developed a better appreciation for the high and often unpredictable costs of conflict. Compared with the 1992-94 period, when conflicts exploded throughout the SCCA region, greater caution is prevailing now on all sides. For the past three years, therefore, ceasefires have mostly held and a state of "no war, no peace" has emerged, particularly in the Caucasus.

Typically, the mere presence of low-level conflict at the local level does not stop profitable energy and pipeline development from going forward. The energy industry has ample international experience in minimizing direct collateral damage to its infrastructure assets caused by local and regional conflicts. Pipelines and pumping stations can be repaired quickly; storage tanks can help minimize the costs of disruption. Equally important, companies are aiming to build an overlapping web of fields, transport systems and shipping contracts to reduce political risk and reinforce the tendency towards regional cooperation and stability.

Finally, many SCCA leaders are acting on the recognition that a window of opportunity exists to resolve these conflicts, form cooperative regional arrangements and share the expected energy windfalls rather than continue on a path of obstruction. Indeed, the growing trend toward cooperation across the full range of political, economic and security issues on both sides of the Caspian is seen as a positive development, capable of building an interlocking web of mutual interests among SCCA states thereby reinforcing the region's overall stability.

Toward Regional Stability and Security

Still, it is likely that regional instability will remain a negative factor for Caspian pipeline development in the foreseeable future. It would be imprudent to dismiss the region's multiple conflicts and classify them as "manageable." First, it will take time to build up the security of multiple routes, rendering the first generation of pipelines relatively more susceptible to regional conflicts than when a diversified network exists. Second, leadership successions will occur in most SCCA states over the coming decade, with the prospect of a younger generation of nationalists emerging and, with them, the potential for renewed instability. Third, once Caspian energy begins to flow in sizable quantities, the prospect of a mounting divide between the haves and have nots may fuel local discontent and heighten the potential for outside meddling in new conflicts. Thus, even as pipeline development moves forward apace, now is the time for governments to promote a set of policies that brings about the resolution of the region's festering conflicts and encourages stability through political and economic participation as well as regional cooperation.

Promoting Regional Security

The SCCA states, with support from regional powers and the West, need to address overarching regional security issues to help promote an environment that reinforces stability and increases prospects for the development of strong and democratic states at peace with each other. The goal should be to promote the development of the region as one that is open to the commercial involvement of neighboring powers and the West, but dominated by none. While energy companies have a comparative advantage to advance a web of commercial agreements and infrastructure projects that undergird regional cooperation, governments serious about long-term commitment to Caspian energy development must take primary responsibility for promoting overall regional security.

Toward this end, three issues must be given political priority. First, far more must be done to promote regional arms control in the SCCA states, breakaway enclaves and Russia's north Caucasus. Senior political commitment, buttressed by thoughtful analysis, will be required to advance an arms control process that allows individual SCCA states to build up the national forces required to defend against invasion while at the same time reducing destabilizing offensive arms build-ups, proliferation of mercenaries and foreign military presence in the region. In the absence of such preventive efforts, there is a strong likelihood that future energy windfalls could be used to finance a destabilizing regional arms race over the next decade.

Second, the U.S. should expand considerably its ongoing efforts, bilaterally and through multilateral institutions such as NATO's Partnership for Peace program, to help all SCCA states build up the capacity to protect critical infrastructure assets and control their own borders. In this, the U.S. has a direct interest to reduce the potential for arms proliferation through what can currently be described as a wide-open region bordering Iran. Beyond this, such capabilities will bolster SCCA sovereignty and reduce the temptation for outside powers to meddle, in turn, bolstering regional stability.

Third, a region-based security dialogue involving the SCCA states should be established. Regional powers and key western states could be accorded observer status. Similar to ASEAN, such an organization is needed to address the region's security vacuum. In turn, a structured dialogue could help reinforce SCCA security cooperation and serve as an important transparency and confidence building effort in the region, among regional powers, and in the West.

Taken together, these three concrete steps would help establish a more stable environment to foster regional stability through conflict resolution, a goal that the SCCA states, the U.S. and Russia have each identified as a core aspect of their policies in the region.

Promoting Regional Economic Cooperation: A Role for Business Partnerships?

In principle, the region's characteristics--a relatively small population (70 million) with a vast resource base--favor a wide sharing of wealth within states and among producing and pipeline transit countries. Obviously, any sharing arrangement presupposes resolution of conflicts and cooperation arrangements between national governments and local enclave authorities as well as between SCCA states themselves, reinforced by lasting commercial engagement of regional powers and the West.

Before energy exports begin to take off in large volumes, it would be useful for Caspian governments, local authorities, the energy industry, and international financial institutions to assess prospects for the establishment of social equity funds and business partnerships. Both instruments could be part of a broader strategy to strengthen the internal cohesion of states through internal wealth redistribution and conflict resolution, promote interstate cooperation and encourage long-term stability.

Indeed, key representatives of SCCA governments, breakaway enclaves, the business community and non-governmental organizations share strong interests in exploring prospects for the establishment of mutually beneficial business partnerships. National governments could make effective use of a policy instrument that could help improve prospects for peaceful settlement and overall stability. Local authorities could strengthen their cooperation with national governments but can do so within the context of an expanding resource envelope. Companies, for their part, could support federal arrangements as they consider the potential for innovative business partnerships involving the enclaves. In this way, they would have the prospect of building their stature in the community while mitigating their exposure to the political risks in the region.

Notwithstanding the promise of social equity funds and business partnerships, it is important to keep in mind that ensuring the effective use of windfalls for economic development and social stability will require governments throughout the region to deepen reform. Likewise, partnerships are not a panacea for conflict resolution: where parties remain entrenched or conflicts active, it will be difficult for such mechanisms to be effective.

Putting Principles into Practice: Three Examples

Each conflict situation is unique and will require tailor-made approaches for resolution. Even though energy and pipeline rents alone will not bring peace, they could play a reinforcing role. While a detailed discussion of the history, status and prospects for settlement of each of the region's conflicts is beyond the scope of this paper, a brief look at three representative examples may help to highlight the range of the region's conflict situations in their inherent complexity and outline some steps to help minimize their negative impact on regional stability and energy development.

Nagorno-Karabakh. The conflict between Armenia and Azerbaijan over Nagorno-Karabakh is deeply entrenched. Once again, it defied settlement despite engagement by senior policymakers in Russia, France and the United States under the auspices of OSCE's Minsk Group and the potential for significant economic gain for both Armenia and Azerbaijan should a settlement be concluded.

In the most recent round of negotiations, both Azerbaijani President Aliyev and former Armenian President Ter-Petrossian signed on to the OSCE Minsk Group peace plan that envisioned a step-by-step settlement. President Levon Ter-Petrossian's efforts to move his nation toward compromise, however, failed when his support for the plan precipitated strong opposition from hardline groups and vested economic interests, forcing his resignation. The recent setback comes as no surprise: Armenians in the region and diaspora have rejected both step-by-step and comprehensive peace plans over the past two years despite being elevated to senior political levels in Armenia, Azerbaijan, Russia, France and the United States. At this stage, it is unclear whether Armenia's newly elected President Kocharian will have the political courage or desire to lead Armenians toward peace, making Armenia's role in the region and its own future economic prospects less certain.

Several factors help explain the entrenched opposition to a settlement of this conflict. First, for both Armenia and Azerbaijan, the fight for independence became intertwined with the conflict around Nagorno-Karabakh. Second, influential war lobbies opposed to compromise exist in both countries. In Azerbaijan, the large-scale refugee population lends a human face to demands that these lands remain a part of Azerbaijan. In Armenia, the war lobby arguably has more power: those who won the war over Nagorno-Karabakh are national heroes; they are opposed to ceding hard-won ground and have pursued a massive arms build up, importing more than $1 billion of weapons from Russia since

1996 to establish an offensive force in and around Nagorno-Karabakh. Third, unrealistic public expectations in Armenia that the status quo represents a basis for peace and economic cooperation with Azerbaijan have been reinforced by a diaspora that reassures Armenians of continued external assistance and insists on Nagorno-Karabakh annexation or full independence. Finally, the co-chairs of the Minsk Group have inadvertently reinforced these attitudes insofar as bilateral policies toward Armenia and Azerbaijan tend to be influenced by domestic lobbies that favor Armenia. For instance, Russia has forged its closest defense relationship with Armenia and the U.S. has kept Armenia as a top recipient of bilateral assistance regardless of Armenian policies.

Despite successive rounds of negotiations having failed over the past three years, it is time to renew international efforts to advance a peace settlement for Nagorno-Karabakh. No time should be lost searching for yet another negotiating framework: all key players are familiar with the already well developed substance of both step-by-step and comprehensive approaches to settlement; at this stage, Armenia needs to be encouraged to firmly commit itself to one approach and then be held to it.

A complementary strategy needs to be put in place that proceeds in parallel to the confidential peace talks as a counterweight to those factors that have contributed to the entrenched status quo. Three elements are crucial:

First, the Minsk Group co-chairs must establish clear incentives and penalties for the parties to the conflict, so that public opinion in the region begins to associate action with consequence. To that end, the U.S. should reward steps toward peace while attaching deterrents to those threatening hostilities in the region and meaningful costs to those that undertake hostilities in the region. The Administration has concrete levers at its disposal to address the range of situations, if it can muster the political will to deploy them. Specifically, the Administration should waive Section 907 of the Freedom Support Act, to reward Azerbaijan for its steps toward peace, without prejudice to Armenia's bilateral assistance. Indeed, it is important at this stage not to isolate Armenia while, at the same time, bringing about more realistic public attitudes in Armenia through an even handed approach. Still, Minsk Group co-chairs should jointly warn Armenia's newly elected

President that renewal of hostilities would come at a very high cost, threatening Armenia's international standing and large-scale western assistance. The U.S. government should be prepared to back up that threat by withholding Armenia's assistance should Armenian nationalists undertake hostilities against Azerbaijan or Georgia.

Second, urgent efforts should be made to accelerate regional arms control, including in the enclaves, building on the process envisioned in the CFE flank deal.

Third, a public debate should be launched in the region as well as with the Armenian diaspora to explore the likely economic implications resulting from the status quo and, alternatively, from peace settlement. Clarifying the economic benefits and costs of each option would be timely. The U.S. should work closely with Azerbaijan and Georgia as well as energy companies to define fully the potential gains from business partnerships and downstream infrastructure development, both for Armenia, a Nagorno-Karabakh enjoying the broadest possible autonomy within Azerbaijan in the event of peace, and Georgia's southern Javakheti region. Such a debate will not resolve the conflict but might help Armenians make a more informed decision when the next proposed peace settlement emerges from the Minsk Group.

Abkhazia: The Abkhazian conflict also has its roots in a Soviet regime that relied on policies to divide and conquer different ethnic groups. The resulting legacy of bitterness led to inter-ethnic strife during the glasnost era and full scale war as the Soviet center collapsed and independence movements spread at national and sub-national levels. As with the Nagorno-Karabakh conflict, peace has been elusive due to the deep historical animosities and localized nature of the disputes; massive inflows of illicit weapons that help freeze the conflict situation in a tenuous balance; and the ambitions of regional powers.

But, prospects toward peace may be better for a number of reasons. Abkhazia's external political and economic support, while not insubstantial to date, is more likely to decline while prospects for the emergence of a democratic, federal and prosperous Georgia are steadily rising. Specifically, Russian military support, which played a critical role in Abkhazia's wartime gains, has become more muted because Russia wants to avoid any negative precedents its continued support might have for Chechen's independence; also, the Russian military, having more or less achieved its goal of reestablishing extensive basing rights in Georgia, faces significant logistics and supply problems until an Abkhaz settlement is forged and Russia's rail and road links through Abkhazia are linked to the broader Georgian transport network. Economically, an Abkhazian enclave in its current form will face a poor economic future. Shut off from Georgia, Abkhazia enjoys limited external economic support and is allied with an illegal, declining support base which relies on its ports for transshipment by the military and mafia. Thus, Abkhazia's leaders increasingly will have to choose between an alliance of partners with diverging political goals and declining economic prospects versus an alternative future linked to the region's energy and transport windfalls.

In the Abkhaz case, prospects for an alternative future rest on the ability of the Georgian government, local Abkhaz authorities and the energy industry to develop innovative business partnerships financed by shared transit rents and consideration of Abkhazia's incorporation into the broader Eurasian transit corridor of infrastructure and transportation networks. Obviously, such steps presupposes an arrangement that envisions broad autonomy for Abkhazia within the Georgian federal state.

Ajaria: Georgia's region, Ajaria, represents a case where potential separatism under the leadership of a regional strongman closely aligned with Russian military did not develop into armed conflict, but rather mutually beneficial cooperation.

So far, the national government has worked closely with Ajaria to ensure broad autonomy in managing local affairs within Georgia's federal structure. This has allowed Tbilisi to break the cycle of instability which plagued Georgia through 1994. Ajaria, for its part, has been able to compete as a prospective pipeline transit port in the broader scenario of a Eurasian Transport Corridor that will traverse Georgia. Building on economic cooperation already underway, business partnerships, worked out together with Tbilisi and Batumi, could reinforce the region's attractiveness and bolster local interest in maintaining a stable and peaceful relationship within Georgia.

Despite the promise of such economic cooperation, a broader process is still needed to reduce the potentially destabilizing military build-up in this region as well. In the unlikely event that separatist conflict were to break out in Ajaria, it would affect routes to Batumi without undermining the central Baku-Supsa pipeline, an eventual Baku-Ceyhan line or prospects for Georgia's continued recovery. While each region has its own challenges, requiring unique solutions, lessons drawn from the Ajarian case may be usefully applied to potential flashpoints in Georgia's Javakheti region as well as Azerbaijan's Lezgin provinces.

Disputed Property Rights

Resolution of the legal status of the Caspian Sea is an important issue affecting the sovereignty of the Caspian states, the pace of private sector investment in Caspian energy development and prospects for cross-Caspian pipeline development.

Conventional international practice is to draw a boundary at a median line equidistant between coast lines of littoral states, irrespective of whether the body of water is classified as a sea or a lake. In other words, international law generally does not favor the establishment of a condominium regime based on joint ownership and management for landlocked seas or lakes. Since the collapse of the Soviet Union, however, boundaries for the Caspian Sea--both subsea resources and the water column--have yet to be demarcated.

Over the past four years, diplomatic negotiations and developments on the ground have centered on three issues. First, should the Caspian Sea be delineated into national sectors, drawn equidistant from coast lines, or alternatively, be subject to a condominium arrangement (joint management)? Second, should this rule be applied to each country's entire national sector or be limited to subsea resources, with joint management governing the water column (i.e., fishing, navigation and environment)? Related to this, how should environmental protection measures be undertaken to address both current and future pollution of the Sea and protect fisheries? Third, should any littoral state have the right to exercise veto powers over the development of the Caspian Sea or the construction of subsea pipelines outside its respective national sectors?

The stakes are high: without an agreement on national sectors for subsea resources, international financiers and multilateral development banks could withhold financing on grounds that property rights are in dispute. In contrast, establishment of national sectors for subsea resources would spur rapid energy development and a network of pipelines to export rising production. Likewise, investors will seek clear delineation of the water column so that they can manage the costly environmental liability issues associated with developing subsea pipelines. Thus, if a joint management regime for the Caspian Sea's water column were to emerge, it could threaten prospects for cross-Caspian pipelines.

Status:

At the outset of negotiations, Russia's and Iran's official positions favored a condominium approach to subsea resources, thereby pitting them against the three Caspian littoral states with substantial seabed energy reserves -- Azerbaijan, Kazakstan and Turkmenistan -- which supported the principle of establishing equidistant national sectors. Likewise, Russia and Iran have sought agreement on the establishment of a joint regime for the management of Caspian navigation, fisheries, and environmental issues on grounds that the Caspian represents a closed sea with a particularly precarious ecological balance that must be safeguarded. Kazakstan and Turkmenistan have taken a middle ground, stating their willingness to negotiate on a joint regime in return for national sectors for subsea resources and the ability to transport energy freely across the Caspian. Azerbaijan, for its part, has argued that the UN Law of the Sea Convention should apply to the Caspian Sea, requiring the establishment of full maritime boundaries.

Recently, Russia and Kazakstan started work on a draft treaty that, on the one hand, promotes division of the subsea reserves along national sectors in the Caspian and, on the other hand, envisions joint management of the Caspian Sea's waters by all five littoral states.

Russia's recent shift on subsea resources represents an important step forward. It can be attributed to the widespread recognition that a de facto regime for exploitation of subsea resources had already emerged, consistent with international practice. Several factors played a role. First, the energy-rich Caspian states and western oil companies were sufficiently assured of international practice to conclude legally-binding production sharing agreements and begin development. Second, both parties have managed to minimize their risk by including a broad cross-section of G-7 and Russian oil companies in the various consortia. Finally, the Russian government effectively recognized the existence of national sectors in late 1995 by signing a government-to-government agreement with Azerbaijan in a bid to become a transporter for crude from Azerbaijan's offshore shelf. More recently, all former Soviet Caspian states, including Russia, have held tenders for their respective blocks in the Caspian, further reinforcing the de facto regime.

Despite recent progress, several impediments to resolution of the legal status of the Caspian Sea remain. With regard to subsea resources, two outstanding issues must still be resolved. The first involves Iran's insistence on joint ownership of seabed resources. It is likely that Iran will maintain its position on joint ownership as a lever in the negotiations and a bargaining chip for participation in western oil consortia. So far, Iran is relatively well positioned to extract concessions, as it has been careful to ensure that neither the Government nor the state-owned company, NIOC, enter into legal agreements recognizing national sectors.

A second issue revolves around Azerbaijan and Turkmenistan, which have yet to agree on where to draw the boundary between their respective sectors. The disagreement emerged last summer when Russian and Azeri companies announced their decision to develop the Kapaz field, which is thought to be particularly resource rich. Turkmenistan disputes Azerbaijan's interpretation of the median line, putting in question the ownership of the Kapaz field. This dispute has arisen in large part due to the rising sea level, which has affected the location of the median line. Nonetheless, both states share a strong interest in resolving the dispute early and in a manner that reinforces national sectors and regional cooperation. The foreign ministers of both states are actively negotiating a settlement.

The most problematic issue to be resolved concerns the management of the Caspian Sea's water resources. So far, little movement has occurred in the negotiating positions of the parties. Although joint mechanisms among littoral states are not unusual elsewhere, in light of the recent history of the Caspian region and the uneven military strength between the energy "haves" (Azerbaijan, Kazakstan and Turkmenistan) and "have nots" (Russia and Iran), there is concern that a joint management regime could be used to veto cross-Caspian pipelines and interfere in the affairs of otherwise sovereign nations. Indeed, such concerns are not far-fetched. On February 25, 1998, the foreign ministers of Russia and Iran issued a joint statement, stating their opposition to construction of any cross-Caspian pipelines due to concerns about the Caspian's sensitive ecological balance.

Equally important, in the absence of clear maritime boundaries, liability concerns on the part of western energy companies would complicate any prospects for financing cross-Caspian pipelines. In contrast to industry willingness to develop specific Caspian fields as a means to reinforce de facto national sectors, shippers would not want to take on liability for a spill in another part of the Caspian. This is particularly so in the absence of an agreed Caspian regime regulating navigation or environmental issues. In other words, prospects for building a cross-Caspian pipeline by joining two pipelines secured under the law of individual national sectors are not good. The management of the Caspian water column will need to be resolved and considerable progress made on regulation of navigation and environmental issues before cross-Caspian pipelines are built.

Outlook and Recommendations:

The legal status of the Caspian Sea is likely to remain in dispute for some time, particularly with respect to the management of the sea column. Despite Iran's stance, momentum toward national sectors will probably continue, building on existing legal precedents and the ongoing tendering of concessions throughout the Caspian. Still, development will proceed more slowly until property rights are completely clarified.

Prospects for resolution of sea column issues and related cross-Caspian pipelines are more problematic. So far, there has been little movement on the ground to help set up a de facto regime, even for navigation or environmental management of Caspian sea resources. Although the SCCA states seek cross-Caspian pipelines, they have not yet recognized their common interest in national management of the water column or the potential impact a joint regime could have on achieving their goal. Finally, the issue has received little attention from western governments and energy companies, which have been preoccupied with the delineation of national sectors for subsea resources.

The U.S., as a major investor nation, can play a constructive role by clarifying its own position and quietly providing information to littoral states on best practices in this area without, however, attempting to intervene in the negotiation itself.

The U.S., in close consultation with energy companies, needs to develop a better understanding of best practices in regarding the management of water columns. A position that, on the one hand, proves most effective in safeguarding the Caspian Sea's ecological balance and, on the other hand, provides sufficient clarity on navigation and environmental management for energy companies to manage liability concerns and build cross-Caspian pipelines would be desirable.

The best outcome would be one that combines strong national programs for navigation, fisheries and the environment with regional mechanisms to share information on the Caspian's overall ecological status. Typically, national programs are more likely to attract external funding support, including from energy companies, and result in concrete to measures to safeguard and rehabilitate the Caspian Sea. If SCCA governments were inclined to do so, the U.S. could help them to take concrete steps, in partnership with energy companies, to establish such programs and begin to share information regionally. In contrast, joint environmental programs tend to be difficult launch and are typically poorly funded. Whatever regime is ultimately agreed among littoral states, it should preclude any littoral state from using environmental issues as a pretext for obstructing the development of cross-Caspian pipelines.

Transport Bottlenecks

Physical bottlenecks--in Russia's extensive pipeline system and along Turkey's Bosphorous Straits--hinder the easy transport of Caspian Sea energy. Over the past five years, these two bottlenecks also have emerged as political bargaining levers in the negotiations over Caspian development and future pipeline routes.

The existing Russian pipeline network for oil and gas, designed to transport energy from Siberian fields to Soviet and European markets, can neither meet the capacity requirements arising from new field development in the Caspian nor reach growth markets in Turkey and Asia. In the first generation of Caspian development, the system's physical bottleneck could be addressed by financing new extensions to take pressure off Novorossiysk. Prospects for developing new pipeline capacity cheaply are slim; despite its technical competitiveness, the deep-seated problems associated with the management of Russia's pipeline network make it one of the most expensive options available to shippers. Neither Transneft nor Gazprom have a reputation as reliable and efficient operators with access to necessary financing sources to maintain, let alone expand, the current pipeline network and meet the challenges required by new field development. More troubling, under Transneft's and Gazprom's management, the current network has become much more susceptible to disruption and graft. Gazprom, in particular, has frequently resorted to a strategy of squeezing out monopoly rents by limiting open access, prohibiting new entry of competitive producers and shippers, and delaying new investments in additional pipeline capacity. In sum, neither Transneft nor Gazprom can provide sufficient certainty to make them the first or only choice for any producer (including from Russia itself) seeking to export Caspian oil and gas to new markets.

Turkey remains committed to the 1936 Montreux Convention, which allows free shipping through the Bosphorous Straits but points to tightening physical and political constraints due to increased shipping activity on the Bosphorous. In the wake of the collapse of the Soviet Union, the sharply higher shipping accidents, mounting public safety and environmental concerns in Turkey's historic and most densely populated city, Istanbul, now represent important political problems for Turkey. As a result, producers cannot rely on the status quo: the probability of a serious tanker accident at some future point is high; were such an accident to occur before a land route could absorb Caspian crude, oil export could be seriously disrupted.

Significance for Pipeline Development:

The widespread perception among foreign oil companies and SCCA states alike that Russia employs existing bottlenecks as a political lever to slow Caspian development and extract large rents has engendered a growing distrust toward Russia and, ironically, hurt its long-term prospects as a major transit country.

Turkey, for its part, gets a mixed reviews concerning its record of cooperation on the Bosphorous. Some parties see Turkey as a responsible and cooperative partner that is actively managing a difficult political situation. This group places a premium on a first generation Turkish land route at Ceyhan, both to ensure Turkish cooperation in the short-run and mitigate the risks associated with a major tanker accident in the medium to long-run. Others, particularly in the business sector, perceive Turkey as employing a weak stick in the Bosphorous, particularly given the potential for rising Black Sea demand and low additional volumes early on. For this group, the combination of continued political turmoil in Turkey and its perceived willingness to use the Bosphorous as a political lever tends to make Black Sea outlets look better in the short-run.

Outlook and Recommendations:

Overall, the bottlenecks in Russia's pipeline system and Turkey's Bosphorous straits are long-term problems that will require structural solutions. The temptation to use these constraints as sticks to achieve political and economic undermine their prospects as major transport corridors. Cooperative approaches, stability and reliability will be key to securing a long-term position as a major Caspian transporter. Specific solutions are already well known but will require political will and strong commercial partnerships to achieve success.

Russia's pipeline authorities need to move towards a reform and adopt a modern regulatory system that ensures the reliable and competitive operation of Russia's pipeline network. As a first step, Russia's pipeline operators should strive to meet the basic standards set out in the Energy Charter Treaty.

Turkey, for its part, should do all it can to demonstrate its willingness to cooperate with Black Sea states and Caspian shippers on the Bosphorous. Early installation of a vessel tracking system on the Bosphorous is an essential confidence building measure that has long been delayed. Ultimately, if relieving pressure on the Bosphorous is a priority for Turkey, then it has a window now to do so by securing a Baku-Ceyhan main export pipeline. Securing this outcome cannot be achieved with using the Bosphorous bargaining chip alone; political reassurance and commercial concessions will be required. Politically, to the extent that the Bosphorous was seen as a secure outlet, several potential blocking governments, particularly Russia, would probably be more willing to risk expanded commercial cooperation and participation in a pipeline to Ceyhan. Likewise, commercial companies will be looking at the actual prospects for building a commercially viable pipeline given the continued drop in world oil prices.

Sanctions

U.S. sanctions policy directly affects Caspian pipeline development, notably through the Iran-Libya Sanctions Act (ILSA). The goal of the 1996 law is to press for a change in Iran's foreign policy, which was widely criticized as being supportive of terrorism and weapons proliferation as well as undermining the Middle East peace process. In practical terms, ILSA prohibits foreign direct investment in Iran's energy capability and infrastructure and applies to U.S. business as well as third parties, although there is little provision for international coordination or enforcement.

Today, an expectation has emerged that ILSA may soon be irrelevant. A number of factors have contributed to this impression: President Khatami is perceived as a harbinger of a more moderate Iranian policy; Europe and Russia have signaled their intent to move ahead with the South Pars deal in spite of ILSA; the widespread perception that the U.S.

Government will do little, if anything, to sanction third country investors in that sanctionable deal; and, former senior U.S. policymakers as well as members of the business community arguing for rapprochement with Iran and an end to ILSA.

However, the lifting of ILSA any time soon is unlikely. ILSA's well-organized defenders will argue that it is too early to tell if the forces of moderation now emerging in Iran will prevail. As in similar cases before, the overall U.S.- Iran relationship will have to be put on a normal footing before ILSA is significantly diluted or repealed. That broader process appears to have begun, albeit very cautiously on both sides. In sum, having been signed into law, ILSA will remain in place for the foreseeable future, despite promising developments in Iran.

Meanwhile, ILSA has emerged as a divisive issue in U.S. policy toward the Caspian Sea. Setting aside discussion of the sanction law itself, it is timely to assess ILSA as a constraint on Caspian development. Two issues are central: first, to what extent does ILSA negatively affect the pace of Caspian energy development and export? Related to this, do such costs represent a reasonable trade-off that helps advance U.S. policy goals vis-a-vis Iran through ILSA? Second, absent ILSA, would Iran be the preferred export route for SCCA states and commercial interests?

Status: ILSA and the Early Phase of Caspian Development

Despite a recognition that ILSA could have an adverse impact on Caspian Energy development, an implicit trade-off was made in favor of containing Iran. However, the U.S. Government sought to soften the adverse impact of the sanctions regime on the early phase of Caspian development. Specifically, the USG gave a nod to the need to boost Caspian energy production early on in order for independent main export pipelines to be developed. In theory, provisions were made for licensing small-scale, short-term swaps of Caspian crude with Iran as a means to expand Caspian exports and circumvent exporting constraints imposed by Russia's pipeline monopolies, Transneft and Gazprom.

In practice, however, the U.S. Government has successfully discouraged U.S. companies from applying for licenses to swap crude so as to avoid domestic criticism. Meanwhile, Kazakstan and Turkmenistan, working with European and Asian partners, have resorted to small-scale oil swaps and gas shipments to Iran to maintain and boost their production. In contrast, U.S. companies, particularly recent entrants, are faced with blocked export avenues and growing problems to remain competitive as key Caspian producing states seek to partner with companies that can move product, albeit in relatively small volumes, with Iran.

In this context, two other issues have emerged that have an impact on Caspian energy development itself. First, there is a serious lack of drilling rigs which is slowing down field development. Although companies have come up with a detailed, though not ideal rig sharing agreement, later entrants will be even further disadvantaged. This shortage could be addressed if excess drilling equipment located in AbuDhabi were trucked through Iran to Azerbaijan Despite the small benefit Iranian truckers would derive from such transshipment, the USG has discouraged companies from applying for a license to move such equipment. A second issue relates to the ILSA requirement that US companies not participate in Caspian development that also involves Iranian participation. Initially, this rule worked as intended: Azerbaijan, Turkmenistan, and Kazakstan responded to U.S. pressure to exclude Iran from Caspian energy development. More recently, however, the energy-rich Caspian states, and particularly Azerbaijan and Turkmenistan which each share a long border with Iran, have sought to include Iran in some of the key consortia now being established; that trend is expected to increase, leaving American companies increasingly on the sidelines.

Under current conditions, Caspian energy development during this critical early phase will be adversely affected by ILSA, without, however, achieving the stated goal of isolating Iran, particularly in the Caspian Basin. Caspian production will ramp up more slowly than necessary absent licensing for transshipment of equipment from the Middle East across Iran and allowance for moderate levels of swaps prior to development of main export pipelines. Likewise, the expectation in industry circles is that the trend to grant Iran minority participation in Caspian consortia will accelerate. Caspian countries are motivated to seek political accommodation with their large southern neighbor as well as a bargaining lever to change Iran's position favoring condominium ownership for the legal status of the Caspian Sea. It is not without irony that ILSA could turn out to be the lever by which Iran manages to significantly curtail U.S. presence (and influence) in Caspian development-- an outcome in direct contrast to official U.S. government policy in the region. In turn, that would affect U.S. influence over the direction and sequencing of routes. Increasingly, it appears that the narrow case of ILSA may prove the general rule: failed sanctions actually tend to strengthen the other side.

Significance for Main Export Pipelines:

The picture is more complex concerning Iran's position as a main export transit state. Proponents of an Iranian pipeline corridor argue that, were ILSA removed, Iran could become the quickest and surest way to counterbalance Russia, securing Caspian development and SCCA independence. To date, several main export pipeline options through Iran are under consideration. Most notably, China has stated its intention to build oil and gas pipelines along the western border of Kazakstan and Turkmenistan to Iran. But the Asian economic crisis is likely to sideline that investment for now. In addition, Shell has initialed a pipeline deal to ship Turkmen gas to Turkey via Iran. Supporters of ILSA would be right in pointing out that the strong U.S. opposition to the Shell deal could become an impediment to its ultimate construction. ILSA may not be enough to stop the Shell deal given initial U.S. support to the project and expectation of symbolic sanctions concerning South Pars. Rather, if Shell moves away from this deal, other factors less acknowledged are probably decisive. In sum, the prospects for main export pipelines from the Caspian through Iran are clouded in confusion; ILSA is an impediment but not the only or best reason for Iran pipelines to fall behind other options.

At the broadest level, irrespective of Iran's troubled relationship with the U.S., Iran like Russia, is and will remain an energy competitor with the Caspian Basin. Simply put, if Iran and Russia can control the region's access to western and Asian markets for the next ten years, they would be well positioned to remain importers of cheap Caspian product (discounted due to lack of global access) and expand further into export markets in Europe and Asia. In other words, beyond low volumes, the interests of the two existing producers, Russia and Iran, diverge with those of the new producers, the Caspian states. It is in the interests of the key Caspian producers to cooperate with Russia and Iran but to develop independent routes, particularly in the first generation of pipeline development.

SCCA policy appears to bear this observation out. In fact, Iran has not been the preferred route for main export pipelines by any of the SCCA states. In large part, this can be attributed to the widespread perception among SCCA elites of Iran as a threat. For instance, Iran took a negative position on the legal status of the Caspian Sea before ILSA and has maintained its stance after Russia dropped its position on a condominium approach to subsea resources. It also helps explain why, even prior to the enactment of ILSA, Azerbaijan, Kazakhstan and Turkmenistan each put priority on non-Iranian routes. More recently, all key SCCA producing and transit states reaffirmed their commitment to east-west pipelines that avoid both Russia and Iran. Perhaps that explains why even as Shell pursues an Iranian transit route for Turkmen gas, it is also actively working on a cross-Caspian route.

From a strictly commercial perspective, main export pipelines through Iran are not necessarily the top choice either. Many U.S. companies looking at Europe as the target market for the first generation of incremental oil from the Caspian have found that ports on the Mediterranean can easily compete with Kharg Island. Further increasing the already high dependence of oil companies on Gulf outlets would raise political risk and prompt a search for alternatives. In fact, companies quietly admit that the symbolic attraction of having the Iran option for main export pipelines may be greater than the actual commercial advantage.

Recommendations:

Above all, the US needs to understand and actively reduce the negative impact of Iran sanctions on Caspian development. Several principles should guide U.S. action: boosting Caspian production, ensuring robust U.S. commercial involvement, and protecting American companies against undue discrimination vis-a-vis their European and Asian counterparts due to ILSA. Specifically, the Administration should consider licensing those activities that give an early boost to Caspian production, particularly transshipment of rig equipment across Iran and oil swaps across Iran. With regard to the latter, the Administration would have to make a judgment on appropriate volumes and timeframe of contracts; ideally, while significant leeway might be granted in the short-term, the Administration would need to ensure that such contracts do not reach a volume or extend over a long-enough time period as to undermine prospects for the overarching goal of constructing main export pipelines across the Caspian to Ceyhan.

Equally important, the U.S. should take steps, together with Congress, to ensure robust U.S. participation in Caspian development. U.S. interests could be best advanced by allowing American companies to invest in Caspian fields, even if an Iranian company holds a minority share. Strong U.S. presence will increase the likelihood that cross-Caspian and Baku-Ceyhan pipelines will be achieved and will tend to solidify rather than split a U.S.-European-Asian commercial partnership.

E. In Search of a Stable Pipeline Regime: The Dynamics of Multiparty Negotiations

Despite a strong predisposition in favor of developing east-west pipelines shared among SCCA governments, the U.S. Government (USG), Turkey, and many private companies, no stable coalition has emerged in support of this outcome, or for that matter, any other. This can be attributed in large part to the complex negotiation dynamics currently underway regarding Caspian energy pipeline development. These negotiations are characterized by multiple routing options with multiple time paths, pursued by multiple coalitions of governments and commercial investors without, however, a strong center geared to promote convergence of corporate executives, PSA signers and regional governments behind a regional pipeline.

The First Round of Negotiations for Caspian Pipelines:

To understand the underlying complexities of these negotiations, it helps to draw a comparison with the first round of pipeline negotiations that took place in 1995-1996. At the time, the SCCA region was just emerging from several years of costly civil wars. Minimal commercial activity was taking place in the region. In the energy sector, American commercial interests were concentrated in two consortia, with the former seeking the conclusion of early oil pipeline deals within and beyond Russia and the latter a restructuring of CPC to ensure a commercially viable project. In general, there was little acceptance of commercial principles. Neighboring regional powers were stuck in escalating geopolitical rhetoric concerning control over pipelines rather than engaging in commercial dialogue. Russia, for its part, was strongly opposed to western involvement in Caspian energy development and diversification of pipeline networks outside Russia. In this context, prospects for Caspian pipeline development, particularly outside Russia, were considered slim. U.S. energy companies saw consistent, high level USG support in the Caspian region and with Turkey and Russia as critical to any prospects for success.

Establishing Principle-Based Diplomacy:

The USG identified as its broad interests rapid Caspian energy development and the construction of multiple pipelines. Consistent with overarching U.S. foreign policy, the USG saw its primary role as one of ensuring a normal business environment that emphasized commercial principles over geopolitics; at the same time, policymakers believed that the difficult post-Soviet commercial environment would require intensified USG efforts to achieve that end. Three principles underpinned USG efforts regarding Caspian Sea energy. First, that energy and pipeline projects should adhere to international commercial norms, consistent with standards typically required by international financial institutions. Second, that such projects meet the test of commercial viability. And, third, that Caspian energy and pipeline deals were transparent.

The U.S. actively supported all steps that advanced U.S. interests in rapid Caspian energy development and multiple pipelines, consistent with commercial principles. This principle-based diplomacy served a number of purposes. First, it helped create the necessary political space for the SCCA states to negotiate a western pipeline deal despite intense Russian pressures. Second, this approach highlighted the potential for win-win commercial outcomes thereby avoiding the perception of a win-lose proposition between the rest of the world and Russia. Third, it established a basis for U.S. companies to rebuff proposals by regional actors seeking commercially unprofitable deals.

Applying Principles to Promote Facts on the Ground:

Efforts focused on establishing facts on the ground consistent with these principles. With key regional players having staked out positions on future AIOC routes and the CPC project, the U.S. could position itself as an impartial moderator, pushing for convergence toward win-win outcomes for all concerned governments. On the early oil pipelines from Azerbaijan, for instance, these principles allowed each company to enter into a coalition favoring multiple early oil pipelines while still pursuing their individual commercial interest. Meanwhile, on CPC, the U.S. was able to use commercial principles to push "blocking governments" toward compromise without, however, prejudicing other American commercial interests that sought late entrance into a restructured commercial deal.

In each case, a clear line was established between the respective roles of government and business. Governments set a broad framework and sought to promote a secure environment for U.S. companies but did not interfere with routing, contractual terms or timing of decisions. Business, for its part, was prepared to finance commercial deals despite the high risks involved in the region. Strict adherence to these roles, it was hoped, would serve as a model in the Caspian region and Russia, reinforcing commercial principles and bringing closer the day when the U.S. Government could phase out its highly activist role to one more typical of efforts in other regions of the world.

As a result, by the end of 1996, a stable foundation had been established in favor of multiple export pipelines from the Caspian. AIOC had closed deals with entities in Russia and Georgia establishing multiple early oil pipelines and the CPC was well on its way to being restructured as a commercially viable main oil export project through Russia. Thus, strong precedents had by then been established favoring main export pipelines from the Caspian through Russia as well as westward across the Caucasus.

The Second Round of Pipeline Negotiations

Commercial Principles Increasingly Accepted...

At the outset of the second round of negotiations, the environment for development of main export pipelines from the Caspian Sea region had improved significantly and commercial principles increasingly accepted as the basis for pipeline negotiations.

The key producing and transit states in the SCCA region, for their part, emerged as more secure, coordinated, and experienced than in the first round. One indication is the joint public statement they recently issued at Istanbul favoring cross-Caspian and Baku-Ceyhan pipelines. Generally, they recognize their strong mutual interests and are banding together to achieve an east-west pipeline outcome.

Meanwhile, regional powers increasingly compete for pipeline routes in commercial terms. In Russia's case, its official ambivalence toward Caspian development appears to be diminishing and Russia's energy companies are proactively pursuing joint ventures consistent with a Baku-Ceyhan pipeline as well as routes through Southern Russian to Turkey. Turkey, for its part, highlighted its maximum flexibility by opening the door to all possible routes, including from Russia. Both have attempted to reduce the kind of zero-sum rhetoric that characterized the opening round, recognizing the potential for deepening their own mutually beneficial commercial cooperation along a Ceyhan pipeline corridor.

Finally, in this round, the number of interested private consortia increased, each seeking to advance a number of deals along several routes, in search of the best possible terms from potential transit states.

...But Convergence Undermined by Intense Competition...

Paradoxically, the very progress toward a competitive, commercial environment and the emergence of multiparty, multilevel negotiations significantly complicated prospects for an early or readily predictable outcome on main export pipelines.

In this round, pipeline routing options are possible in virtually every direction; most are commercially feasible; and, all neighboring regional powers are engaged in an intense competition to promote a route through their own country.

Compounding the competition over routes, competing commercial consortia have entered the competition for the same routes and markets in this second round, each pursuing a "winner-take-all" strategy for control over pipeline routes. This is so even though the construction of cross-Caspian and Baku-Ceyhan pipelines would ideally accommodate a broad coalition of current and future producers, consortia and independents alike.

The SCCA states, for their part, have made clear their preference for the Western route but nevertheless remain in a constant negotiating mode in order to balance competing interests and relieve intense pressure from their powerful neighbors, gain support from external powers, and position themselves to take advantage of the best commercial deal. However, at times, their statements are discounted amidst the noise generated by the flurry of new pipeline proposals. At the same time, these governments have not been able to impose binding terms or deadlines for the negotiations, in part because of past concessions granted to competing players who have sought exclusive rights and, in part, because their expectations outpace normal commercial practices.

More generally, transit states are attempting to counteract the resulting downward pressure on tariffs by attracting competing commercial proposals on their favored route. For instance, Turkey has sought to strengthen its negotiating position in this round by signaling strong interest in all pipeline proposals. It has done so irrespective of its ability to support all of them or to manage the potential fallout for the regional distribution of gains and losses. Turkey's tactics have had several unintended side effects. First, there is considerable confusion generated by the multiplicity of options, adding to the lack of convergence. Second, this dynamic has allowed investors and external governments to second guess statements of support for a Baku-Ceyhan pipeline by SCCA governments jointly with Turkey. Overall, it has been difficult for all parties to the negotiation to distinguish between short-term tactics and actual strategies.

Neighboring regional powers have every interest in keeping the debate going, be it to bargain for additional shares in new Caspian fields or to press for their preferred routing proposal. To this end, Russia has kept alive the prospect of a blocking coalition through its shared position with Iran in opposition to cross Caspian pipelines. Iran, for its part, has emerged as a savvy negotiator. For now, its primary objective is to become a major transit country for Caspian oil and gas and to ensure access to cheap energy, particularly in its northern provinces. Thus, it continues to bargain for shares in Caspian consortia, using its opposition to national sectors for sub-sea resources as a bargaining lever. Iran also has been aggressive in positioning itself as a transit state by encouraging southern routes to Kargh Island for oil and most notably a gas pipeline from Turkmenistan to Turkey across its northern territory. An important side benefit for Iran has been to attract western foreign direct investment and to splinter the US-sponsored sanction regime. Meanwhile, Iran has voiced strong opposition to cross-Caspian pipelines, consistent with its role as an energy competitor with the Caspian region. Overall, it would appear that Iran is pursuing a well-devised divide-and-conquer strategy, using Moscow to block cross-Caspian pipelines, while presenting itself as the only viable alternative--an approach that resonates very effectively with European governments and some U.S. energy companies.

Overall, these dynamics present real obstacles to a speedy conclusion and stable settlement on the first generation of pipeline development.

...And the Absence of a Strong Center

The USG, for its part, began the second round well positioned to play a key role. It was widely perceived as an impartial arbiter that could help to maintain the commercial rules of the game and support the development of multiple pipelines, including a western pipeline, while assuring win-win outcomes for Russia.

However, the USG was slow to recognize the fundamentally changed negotiating environment or to adjust its implementing strategy accordingly. As a result, it has made a number of important missteps. In the process, the USG has had to cede its role as an impartial arbitrator and instead become a player with a narrow set of interests, eclipsing the effectiveness of the broader commercial principles that underpinned its earlier strategy, exacerbating confusion among the parties to the negotiation and intensifying the strong tendency toward zero-sum competition at the expense of convergence. The upshot is a greater likelihood for suboptimal outcomes on Caspian pipeline development. The following issues are instructive:

At the outset of this round, the USG committed itself at the highest political levels to the accelerated development of a cross-Caspian pipeline linked to a Baku-Ceyhan route to the exclusion of alternative routes. In large part, this early public effort emerged as a defense against the perceived threat of a main export pipeline corridor developing through Iran. Explicitly narrowing the scope of potential commercial routes so early in the bargaining process had a number of unintended consequences. This directly undercut the ability of commercial companies to negotiate a commercially viable pipeline deal. Equally important, there were immediate downsides insofar as it focused Russian-Iranian opposition on cross-Caspian lines, thereby increasing their leverage against that outcome.

Secretary of Energy Pena traveled to the region not only to explain USG commitment to deliver a cross-Caspian deal and finance plan but also to request that SCCA governments put a moratorium on their ongoing pipeline negotiations with Iran and wait out most of 1998 for the USG to deliver. This step blurred the line between government and business, effectively eclipsing the commercial-led approach and the commercial principles underpinning U.S. policy that had up to then characterized Caspian pipeline development. Because key regional players like Turkey expect the USG to deliver on its stated policy, the negotiating room for U.S. companies was further reduced, undermining prospects for the companies to obtain the terms they believe they require to ensure a commercially viable east-west pipeline.

Simultaneously, the USG effort to accelerate progress on a trans-Caspian-Baku-Ceyhan pipeline raised unrealistic expectations among U.S. companies and within the region about what the USG would be prepared to do to ensure a successful outcome. In particular, U.S. energy companies came to believe that once the USG had established Baku-Ceyhan and trans-Caspian routes as a strategic priority, it was no longer simply a commercial deal; it followed that joint cost sharing was considered appropriate and companies incorporated the concept of large-scale U.S. subsidies into their negotiating efforts. Unfortunately, it took the USG took more than six months to definitively turn down requests for subsidies, with distrust growing on both sides. In the process, American companies believe they lost time and further negotiating leverage in the region, particularly in Turkey, which is perceived to have hardened its stance subsequently.

Finally, the USG decision to set an October 1998 deadline for project completion and the concomitant signal that the USG would work specially with those commercial interests that could deliver a cross-Caspian-Baku-Ceyhan also had some serious negative effects. To begin, it gave late but aggressive entrants a leg up in the pipeline negotiation, even those that lacked production. The prospect that current producers (AIOC and TCO) or future shippers (current PSA signers) could face either a lack of transportation or be required to pay significant rents to regional pipeline operators (as they had in the North Sea), intensified the push toward exclusive pipeline arrangements. The resulting efforts by small groups seeking to obtain exclusive rights over pipelines has tended to splinter oil supply and preclude the formation of a broad coalition behind a preferred outcome, slowing and potentially thwarting early agreement on the first generation of main export pipelines.

Equally important, in the search to secure accelerated pipeline development, the USG shifted its attention from oil to gas and back again, creating considerable uncertainty among companies and exposing the USG to potential perceptions of conflicts of interest in favoring certain consortia over others. Finally, absence of a meaningful dialogue with industry has impeded the USG ability to forge a broad, stable coalition of commercial interests moving on a similar path. Company tactics are frequently mistaken for strategy; close cooperation between government and business has become more difficult to achieve; and, pipeline negotiations have become a source of misunderstanding and mistrust.

Paradoxically, these developments could result in making the preferred option too expensive, particularly as oil prices drop.

Significance for Pipeline Development:

Over the last year, there is mounting evidence that these competitive negotiations have had a number of downsides which require careful attention lest the dynamics of the negotiation itself become an important constraint to Caspian pipeline development.

The negotiating dynamics stand in the way of consensus building between corporate executives, PSA signers and regional governments in favor of one approach. Those parties that for a variety of domestic reasons are pressing for an early settlement, including Azerbaijan, Georgia, Kazakstan, Turkmenistan, as well as the U.S., are disadvantaged, while those parties that gain from postponing an early settlement, notably Russia, Iran and Armenia, have every incentive to hold out.

Furthermore, the negotiations, which are proceeding without moderator or clear rules, are rife with misunderstanding between governments and private companies. The lack of trust makes it more difficult for key western governments to define a path that would promote both their national interest in the emergence of an east-west pipeline and accommodate broad industry interests. In this environment, SCCA governments will be more likely to agree with multiple small transportation ventures, rather than waiting for agreement on a region-wide solution. Likewise, there is a danger that companies will be more likely to proceed on separate, rather than joint tracks, thereby increasing the chances for suboptimal outcomes.

Outlook and Recommendations:

Multiparty negotiations are often complex but not, per se, unmanageable. To be sure, in this case, it has raised the international understanding of the region's potential and provides all actors with ample opportunities to participate. Likewise, by ensuring a broad regional debate, it has expanded the scope for regional cooperation. Nonetheless, government and corporate decisionmakers should consider several steps to minimize future downsides of these multiparty negotiations.

The USG still stands alone in its ability to reinforce the commercial rules of the game for SCCA and international oil companies and raise the costs to would-be blockers. It is critical, however, that the U.S. return quickly to first principles, focusing government efforts on ensuring an environment conducive to broad industry interests while putting companies back into the drivers seat to conduct the commercial negotiation. Specifically, the USG should:

· Return to its earlier focus on underlying principles, notably that projects must meet international commercial norms, be commercially viable and transparent. These principles should be augmented by two new ones. First, negotiating parties should be encouraged to work toward greater inclusivity so that, at a minimum, all SCCA states become involved early enough to gain an appreciation for the potential benefits of inclusion as well as the costs of sitting out. Second, the USG should channel the increased competition over pipelines into non-exclusive pipeline projects so as to promote the bundling of current production and future capacity and accelerate convergence toward a preferred outcome.

· Encourage best practices and establish facts on the ground on emerging issues. In particular, efforts should be made to encourage IFI involvement in establishing regulatory regimes the reduce political risk of cross-border transit.

· Reduce the region's high political risk by shifting increased attention to promoting regional stability.

Commercial companies, for their part, should strongly consider how best to establish a broad alliance comprising of corporate executives, PSA signers and regional governments to support a Baku-Ceyhan and transCaspian pipeline system. To do so, most companies will have to go outside existing operating agreements and PSAs to forge a mutually beneficial and cooperative regional transportation effort. In view of the intense commercial competition and constraints faced by the USG, it would be best if corporate executives took the initiative to jumpstart such an alliance; key producers and transit states have already made their intention clear and likely would join were such an alliance formed. In turn, this would establish a basis for the USG to engage directly in support of the effort.

Conclusion

In view of the numerous feasible proposals on the table, it would be unwise to declare a Baku-Ceyhan pipeline outcome, or for that matter any other pipeline, a fait accompli. Along the way, key political constraints will have to be overcome. In fact, as the analysis above indicates, most political constraints to Caspian pipeline development can be overcome, if not immediately, certainly over time. Of course, much will depend on the actions of individual actors. Nonetheless, as the debate over pipeline pros and cons grows louder over the coming year, and negotiating positions sharpen, it will be worthwhile to keep in mind the key strategic considerations that will shape the selection of main export pipeline routes.

The logic of configuring pipeline networks is deceptively simple: First, pipelines connect the most promising fields with markets where growth prospects are best, leaving little room for administrative fiat on routing and capacity. Second, for pipelines to be built, there must be strong market demand and commercial viability. In addition, pipeline management must be sufficiently transparent and predictable so as to justify the high risks and large-scale investment required for full field development. In situations where pipeline operation and ownership are not directly controlled by producers, they tend to favor multiple outlets for their energy products so as to ensure secure and low-cost access to markets. Third, in a region with high political risk like the Caspian, it would be ideal to establish an interlocking web of fields, pipelines and shipment contracts that binds all parties together while minimizing opportunities for disruption. In other words, pipeline routing should reinforce regional cooperation and stability, while discouraging monopolistic or winner take all behavior by neighboring countries or external investors.

Most analysts agree that the incremental demand for Caspian energy is in Europe and Asia. But, with the downturn in Asian markets in the short to medium-term, together with the expense involved getting there, regional energy producers increasingly view Asia as a second generation prospect for Caspian energy. As a result, most Caspian producers are targeting the Turkish, Black Sea and European markets for first generation Caspian energy.

From the perspective of commercial viability, pipeline management and predictability, a Baku-Ceyhan route may be the most costly to construct but possibly the most profitable route for main oil export, positioning companies well to meet incremental demand in Turkey, the Black Sea region and Europe, while minimizing political risks from future accidents in the Bosphorous Straits. Still, much will depend on the ability and willingness of regional governments to avoid the kind of cost escalation currently experienced by energy companies on early oil routes. Technically, Russian routes are commercially attractive, but extra handling at Novorossysk, the requirement for a bypass as volumes rise, and a highly unpredictable and intransparent management regime diminish and possibly reverse the overall commercial viability of these lines. Similarly, Iranian routes are also considered commercially viable based on desktop studies and Iran's history of good market behavior. But, the significant political risks associated with sharp internal divisions in Iran's government, the potential for regional war to affect the already heavily utilized Straits of Hormuz, U.S. sanctions policy and the current slump in Asian demand make it more competitive as a second generation route. A pipeline through China would not be commercially viable unless China decided to subsidize it based on broader strategic interests. Likewise, routes through Afghanistan will not become commercially financeable until a coalition government is put in place that is acceptable to all of Afghanistan's diverse ethnic groups. Thus, in this case as well, producers view pipelines from the Caspian to outlets on the Black Sea and Ceyhan and, to a lesser extent, Russia or Kharg Island as the best prospects for the coming decade. The combination of lower world oil prices and the prospect of significant cost increases along a Baku-Ceyhan route, however, makes Baku-Ceyhan less commercially viable than previously thought, particularly in the absence of commercial incentives by key transit states.

The timing and sequencing of pipeline routes will play a critical role in the geopolitical evolution and economic development of the region. The continued development of northern routes to the exclusion of others would reinforce Russia's monopoly shipping position vis-a-vis the Caspian region and private energy companies, with all of the associated management problems. A southern route through Iran would tend to reinforce the current marriage of convenience between Russia-Iran geared to limit outside competition and dominate energy exports by compelling Caspian countries to sell cheaply into Russian and Iranian markets, while positioning themselves to boost their own exports to regional markets, particularly Turkey and Pakistan. In contrast, in the second generation, with an independent Caspian region route already established, a southern (or SouthAsian route) would serve to reinforce diversification. A western route is the only route that delivers commercial viability and meets the political requirements of Caspian producing and transit states to reinforce their independence, cement regional cooperation among the key South Caucasus and Central Asian states, create carrots for regional conflict resolution, and relieve pressures from transport bottlenecks while holding out the prospect of new commercial corridors for energy transport between Russia, the Caucasus and Turkey.

From a strategic perspective, the first generation of pipeline development should proceed along a western route, notably the Baku-Ceyhan route. The challenge lies in putting together the broad alliance of governments and commercial entities that can secure that outcome.