

Caspian disappointments

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Turkmenistan is on the wrong side of the Caspian, as someone put it. This makes the lack of export pipelines a problem shared by other US countries even more complicated. In addition, foreign investment has been slow in comparison with other republics of the region. And in the past few years, several companies have withdrawn from projects due to the unclear legal framework. But projects in the region, including important ones in Turkmenistan are now getting closer to being financed. On March 29 1999, Credit Suisse First Boston won the mandate to advise on the Trans-Caspian pipeline project, one of the most ambitious project for the export of the country's resources (see box).

Recent peace talks with Afghanistan raised hopes that the planned construction of a pipeline which will carry gas to Asia through Afghanistan could go forward. Unocal, which had been working on the project for a few years, dropped it in 1998. But one source says that other corporates are looking closely into the project.

According to a spokesman at US Exim, Turkmenistan's delay in paying its debt to foreign commercial banks could make it harder to obtain financing for the Trans-Caspian pipeline and other projects. The problem of payment arrears has been aggravated in the past 18 months because of a collapse of Turkmenistan's oil and cotton revenues, although the country paid in mid April four months late the \$13 million instalment of an outstanding debt with commercial banks. US Ex-Im will not go ahead with one of its projects in the country until the problem is resolved.

Adrian Skelt, new venture commercial manager at Monument in London, is bullish about Turkmenistan but he stresses the need for corporates to have a stronger local presence. "You won't get anywhere unless you visit Ashgabat and start negotiating," he said at the Moscow conference on Production Sharing Agreements (PSAs) in the CIS.

Monument is among the companies making considerable investments in the country. With Mobil, it has developed the Nebit Dag oilfield exploration and development project, which covers five fields for a total area of 2,000 square km, and the Garashsyzlyk, a PSA signed in July 1998, for the development of eight fields on a surface of 4,500 square km. In Turkmenistan, Monument is also involved in other activities, such as transporting and marketing Nebit Dag crude oil through several export routes and is studying the Turkmen oil export options on behalf of the government, in partnership with Malaysia's Petronas.

To get around the problem of a lack of export pipelines, Monument has put together swap deals with the National Iranian Oil Company through Iran. Company officials are also looking at the different routes for export pipelines. Speaking at the conference, Skelt defined the Nebit Dag project as "a groundbreaking agreement in many ways. It took ages to explain what it meant to do a PSA. Stamina is necessary, as anybody who works in the FSU knows," he said.

Falling confidence

But the combination of economic turmoil in Russia and inaccurate estimates of oil resources has dented investor confidence. For the first time projects have been postponed or cancelled.

A few years ago, many called the Caspian the future Middle East. Initial estimates suggested that, after the development

of a pipeline network in the Caspian region, oil production could have reached 3.9 million barrels a day by 2010. Production of a barrel of Caspian oil costs \$5 to \$7 ? compared with an average of \$1.50 a barrel in Saudi Arabia, and \$13 in the North Sea. But with low oil prices, international geopolitical issues and the absence of support from multilaterals and export credit agencies, why should investors carry on with plans to develop the Caspian Sea resources? By comparison, the Middle East continues to be more investor-friendly.

The legal status of the Caspian sea is one among many problems to be solved (see box). In addition, there are increasing fears about the financial stability of Kazakhstan. The tenge has been in freefall in 1999 and there are fears that the country might undergo the same crisis that hit Russia in August 1998.

Nor is the legal framework for the oil and gas sector in the CIS countries completely clear. Kazakhstan, Turkmenistan and Azerbaijan have no PSA legislation in place. According to Kairat Serikpaev, senior lawyer at Cameron McKenna in Almaty, Kazakhstan, though, PSAs have already been used in the northern Caspian. Unlike Russia, there is no law on PSAs in Kazakhstan. The matter is regulated by a law on subsoil resources and a law on oil.

Valentina Ferri, legal counsel at ENI in Milan, has worked on the Karachaganach project, which involves the development of a gas field near the city of Aksaj in north West Kazakhstan. Project sponsors are BG, Agip, Texaco and Lukoil. Speaking at the PSA conference in Moscow, Ferri pointed out that ENI has operated in Kazakhstan and will continue doing so, but she admits there have been problems. A stable legal framework, for example, is fundamental to the success of such long-term projects.

Olga Chenzova, senior partner in Aequitus law firm in Almaty, has advised the government on the drafting of several relevant laws. She says that while the situation in Kazakhstan is in no way comparable to that in Russia, there is a problem with ?conflict with local authorities, which can make things more complicated? during the negotiation for a project. ?But that depends on how foreign investor behave themselves,? she says. According to her, it depends who you deal with. Legislation is partly in place but the success of the transaction depends on the willingness of the single negotiator.

Project finance for PSAs

Delegates at the Moscow conference agree that PSAs will aid the development of projects in the oil and gas sector in this part of the world. But PSAs are still far from being standard contractual structures. Companies in Kazakhstan and Turkmenistan are starting to make more use of them. According to Kairat Serikpaev, a lawyer at Cameron McKenna in Almaty, Kazakhstan, one of the problems is that the negotiation of PSAs can be long and complicated. It is often tempting for parties to focus on financial and technical aspects at the expense of legal issues.

Speaking at the Moscow conference, Bruce Payne, head of CIS project finance advisory at Chase in London, said that oil companies investing in the CIS region are considering using non-recourse finance for their projects. There are some advantages. Sponsors that have project finance loans can use this as a leverage tool during negotiations with local governments to have the project regulated under UK or US law. This is what happened in the Sakhalin project in Russia. But the question is, which law governs the project? And when can international arbitration be used? For example, one of the issues is whether there is a possibility of international arbitration or not.

The need for multilaterals

According to Stuart Brown, director of global project finance at Citibank in London, in the Caspian Sea region ?investors have been reluctant to take the risky bet that the oil can be developed, produced and transported to safer shores without wars or government action getting in the way? (see Project Finance, February 1999, p48). According to Brown, despite the success of some ?pathfinding structuring deals? in the Caspian, multilateral and export credit agencies will be needed for deal in the region for a very long time.

One of the most interesting projects that have gone forward thanks to multilateral involvement is the Chirag early oil

project in Azerbaijan. The European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC) have each provided financing of up to \$200 million of which up to \$100 million will be syndicated. Citibank, Dresdner and SG are co-arrangers and providing \$25 million to the syndicated loans. Speaking at the Moscow conference, Vadim Voronin, deputy director of the World Bank in Moscow said that the bank is planning to extend to Kazakhstan and Azerbaijan its partial guarantee facility which has already been used for projects in Russia.

Political risk issues continue to influence the financing of oil and gas projects in the region. Low oil prices are hindering project development. But efforts are being made. Former Soviet republics in the Caucasus and central Asia have agreed, however, to set up cross-border organizations to operate pipelines carrying oil and gas to Western Europe. This will minimize financial and political risks and encourage investment. The deal aims to create a secure financial environment for potential financiers for pipeline projects in Uzbekistan and Turkmenistan. During Soviet times, departments of each federated republic were responsible for running energy networks. However, since the break up of the USSR there have been difficulties in establishing who will be responsible for investment risks for pipelines which cross international borders. The agreement was signed at a European Commission conference. According to European Union commissioner Hans van den Broek, this is a landmark umbrella agreement for financing oil and gas networks of the future. He says that a financial institution will not invest in a network if it is not totally clear who is managing it and under whose jurisdiction it falls.

Despite having 70 years of common history, the CIS countries are very different. As Jonathan Hines, international counsel at Debevoise & Plimpton in Moscow says, if one comparison can be drawn, it must be that Russia's oil industry, including the pipeline infrastructure, was a lot more developed during Soviet times. Strong links with Russia will last for decades, but CIS countries are slowly but steadily starting to go their own way.

How to slice the cake

?The Caspian sea has its own legal history,? says Iuri Mereshnikov, head of the working group of the Russian Federation on the Caspian sea. The demarcation of the Caspian Sea was regulated in the Soviet era by the treaties of 1921 and 1940 that established the right for the littoral states to exploit the resources on equal bases throughout its waters.

After the break-up of the Soviet Union, the new states met in Astrakhan and Tehran to discuss Caspian demarcation and other issues regarding the development of local resources, but since then they have struggled to find an agreement. Until 1998, Russia had maintained that the sea should be treated as joint property by all the bordering states. The Azeri government wants to divide it into economic zones. Both Iran and Russia have an interest in the first interpretation of the legal status of the Caspian.

A compromise arrangement was reached in November 1996, with Russia issuing a complex proposal that combined the notion of the states claiming national zones with the concept of a central zone to be exploited in common. In the summer of 1997, a dispute emerged on the Azeri-Chirag-Guneshli fields ? located 180km from Baku and only 100km from Turkmenistan ? that the country claims is part of its zone. In 1997, the president outlined his opposition to the July 4 signing of a \$1 billion agreement Rosneft-Lukoil (Azerbaijan's state oil company)-Socar on the joint exploration of the Kyapaz offshore field, that is claimed by Turkmenistan. Shortly afterwards, Rosneft pulled out of the deal.

In 1998, Russia and Kazakhstan signed a draft treaty that divides the seabed into national zones, but not the waters, to be used in common by all five states. A commission has also been conducting negotiations between Turkmenistan and Azerbaijan, with a first agreement reached on February 1998. The reasons for Russia's shift in position ranges from its need for a better relationship with the southern states to the pressure put on the country by its private oil companies.

Members of the working group will meet in Tehran in May 1999. Mereshnikov believes that Iran's political stance is becoming increasingly close to that of Russia. But a problem remains. In addition to the dispute between Azerbaijan and Turkmenistan there is a dispute between Iran and Azerbaijan. Iranian companies have started exploring an area which the Azeris believe is theirs.

According to Mereshnikov some time will have to pass before the issue will be resolved, but one positive result of recent talks is that nobody objects to the division of the sea and at least there is an idea of where the future delimitation will take place. According to Mereshnikov, the most important step has been the agreement between Russia and Kazakhstan on the northern Caspian seabed for mineral resources exploration. The construction of submarine pipelines will be regulated on the basis of this convention.

Trans-Caspian project ? background

?This will be one of the most important projects for the economic development of Turkmenistan and for fuel sources diversity in Turkey, and it is of vital economic and geo-political interest to every country in the Caspian sea region,? says Terry Newendorp, chairman and CEO of Taylor DeJong in Washington. Taylor DeJong is adviser to the Turkmen government. The firm will provide financial, legal and technical assistance in all aspects of the project.

A spokesperson at PSG International, the consortium comprising Bechtel and General Electric ? which will develop, finance, build and operate the natural gas pipeline ? expects the final contract on the \$2.5 billion financing to be in place by May 1999. Financing is expected to include 50% of equity. US Ex-Im and Jexim have indicated an interest in providing up to \$1 billion each. Opic may also provide additional funds and political risk insurance.

The pipeline will originate in the eastern gas fields of Turkmenistan and stretch 2,000km to Erzurum, Turkey. The gas is primarily intended as fuel for Turkey's power generation requirements for the next 20 years, but it will be in direct competition with the Blue Stream pipeline running under the Black Sea. Despite rapidly growing Turkish gas consumption, analysts says there is probably not going to be enough demand for both pipelines in the next few years.

A pricing mechanism has been agreed with Turkey's monopoly importer Botas, which according to Turkmen officials will guarantee cost recovery, but will also be capped at the level of competing supplies to Turkey. The Trans-Caspian project was presented at the fourth Turkmenistan International Oil and Gas conference (TIOGE) held in mid March in the Turkmen capital Ashgabat. Delegates at the conference expressed concern about the fact that there is no take-or-pay agreement, which will make financing more complicated. But according to Wallace Henderson, managing director of Credit Suisse First Boston in New York: ?The project presents a technically and financially viable Caspian pipeline solution and will attract strong support from the financial markets.?

Such display of officialdom and publicity for the project cannot shake off many doubts about its implementation. Iranian opposition to the project, voiced on several occasions by the Iranian foreign minister Khamal Kharrazi on the grounds of environmental concern over the future of the Caspian basin, is likely to be a political obstacle.

Edward Smith, CEO of PSG International, a member of the Trans-Caspian consortium, remains optimistic about the project saying that it will comply with environmental standards sufficient to satisfy Iranian concerns. He also emphasizes the support given by the US State and Energy departments. Smith adds that the Trans-Caspian pipeline will be a useful benchmark for other Caspian projects, such as the much-debated Baku-Ceyhan oil pipeline.

According to Mithat Rende, counsellor at the Turkish embassy in London, the Turkish government strongly supports the Trans-Caspian route and such a plan will not be in conflict with the Blue Stream project. The Trans-Caspian project will also have a positive effect on the future of the Baku-Ceyhan pipeline project as the main export pipeline. Turkish energy group Botas has held talks with Turkmen government officials over its involvement in the Trans-Caspian deal. Successful financing of this project will provide a benchmark for future deals.

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