



Economic Pragmatism Prevails. Destinations of Gas Trade Following the Financial Crisis

*Azerbaijan Today's interview with Peter Kaznacheev,
Managing Partner of Khaznah Strategies Ltd*

AT: *Can you tell us about Khaznah Strategies Ltd. and the work that it does?*

P.K.: Khaznah Strategies is a boutique consulting firm that specializes in business development and investment advisory services in the Caspian region and the CIS. Khaznah Strategies is a relatively new company – it was established in London in June 2009. We help companies to identify and evaluate business opportunities in the CIS and build strategic partnerships with private and public players in the region. Our primary area of focus is the extractive industries, namely oil and gas, mining, and some related fields, such as petrochemicals and hydrocarbon transportation. At the same time, we also use our expertise and contacts to open business opportunities in other sectors.

AT: *In the beginning of June at the Caspian Oil & Gas Conference in Baku you made a presentation. One of the terms that you used was EM2EM – investment activity between emerging markets. Does your*

company consider this to be an area of future growth?

P.K.: An important element of what we are trying to achieve is facilitating co-operation between businesses in emerging markets. For example, investors from the Middle East and Asia looking for partners or investment prospects in Russia, Azerbaijan or Central Asia. Because we think that business co-operation between various emerging markets will be one of the driving forces of economic recovery from the financial crisis in the former Soviet Union and in the world in general. I also think that over the next few years, business activity between emerging markets, such as the CIS, the Middle East and Asia will play a more significant role than today and replace the reliance on the East – West economic axis that has dominated the last decades.

AT: *At that conference you also started a discussion by arguing that Azerbaijani gas may some day go East rather than West to Europe or North to Russia. Do you still think it is a real possibility?*

P.K.: Well in fact, I was not the one who first argued it. SOCAR representatives caused an outbreak of media speculations when they argued an eastwards option for Azeri gas back a couple years ago. Back then it sounded like complete utopia. But things have changed a lot. Today this doesn't sound so improbable any more.

AT: *What exactly has changed, in your opinion?*

P.K.: Well first of all, it's the supply-demand balance that has changed. Following the financial crisis, demand for gas in Europe has dropped quite significantly. According to analysts, it is not likely to go back to the pre-crisis level before 2015. At the same time demand for gas from countries in Asia and some in the Middle East is steadily growing despite the crisis. So the entire equation for exporters like Azerbaijan has changed. Secondly, the pipeline situation has changed as well. A new transportation route eastward has emerged recently. The Turkmenistan-China pipeline was inaugurated in the end of 2009: the first 20 bcm string was completed, with the second to follow next year. A capacity of 40 bcm annually is expected in 2013-2014. Currently, the main supply sources for this pipeline are in Turkmenistan, in the Bagtiarlyk Area and the giant South Iolotan field. This new pipeline changes the status quo as it allows gas from the Caspian region to go East. A regional pipeline connecting the Eastern and Western parts of Turkmenistan is currently underway. So on principle, if Caspian delimitation issues were resolved and a Trans-Caspian pipeline were ever built, it could carry gas in either direction.

AT: *What about the prospects Azeri-Russian gas trade? of incremental gas export from Azerbaijan to Russia? Up until 2006, Azerbaijan was importing about 4 bcm annually from Russia, and since this year gas started going in the other direction – from Azerbaijan to Northern Caucasus. Gazprom's chief Alexei Miller said earlier this year that Russia would be willing to buy as much Azeri gas as Azerbaijan could offer.*

P.K.: I think that these statements reflect the situation not today but in the past - before things changed so much under the influence of the financial crisis. The reality today is that Gazprom's own gas production has fallen as a result of decreased demand in Europe and also in Russia. Look at what happened in Turkmenistan – Russia's imports of Turkmen gas have fallen to below 10 bcma. Before the crisis everyone was competing for Turkmen and Azeri gas. Now it turns out that Russia does not need such great volumes. As a result, Russia's political sensitivity towards gas exports from Turkmenistan or Azerbaijan to other countries has also decreased. Russia used to be highly concerned about any attempts to sell more gas from the CIS to other countries. But pragmatic economic considerations seem to prevail today.

AT: *Gas transportation is key for the future of economic development of Azerbaijan. Azeri oil production will soon start to decline and gas production is raising quickly. Gas reserves in Azerbaijan are sufficient to keep steady gas export at the level of 30 bcm a year possibly until 2050. Where is this gas more likely to go?*

P.K.:As I already said, Russia is unlikely to be the main customer in the short term. I would say, that a limited amount is most likely to go to Europe via one of the ongoing pipeline projects. Among the existing competing projects Interconnector Turkey – Greece – Italy (ITGI) seems more likely to come to fruition because it is less ambitious and less costly than Nabucco. But that will probably take care of only part of

the export volumes from Shah Deniz, ACG and South-West Guneshly. In the medium term, increased exports to Iran may be another alternative. Part of the Iranian regional needs are now covered by increased gas sales from Turkmenistan. The new Turkmenistan - Iran (Dauletabad-Sarakhs-Khangiran) gas pipeline was launched last year. Starting in 2011 Iran is expected to import a total of 20 bcma of Turkmen gas. But the future, in my view, is not so much in sales to the Iranian internal market as much as to the Persian gulf through reexport via Iran. This is potentially a growing area as gas demand in some countries like UAE and Saudi Arabia is not entirely covered by local production. Finally, the option of sales East, to China is a longer term possibility subject to the success of the Caspian delimitation talks.

AT: *Those are the expectations for hydrocarbon transportation. But what about upstream? Do you think that the role of capital from emerging markets (Middle East, Asia) will increase in the development of Greenfield gas in Azerbaijan?*

P.K.: That may well happen. Currently, national oil companies (NOCs) have a limited role in Azeri hydrocarbon production as the lion's share is produced by international companies and more specifically, BP. But the future of BP is not clear now, and BP itself may well absorb some Gulf or Asian stakeholders. So the profiles of existing oil companies may be changing to become more Asian or Middle Eastern. Some Asian and Middle Eastern companies are already present in Azerbaijan. It is the Turkish TPAO which is a stakeholder in Shah Deniz, ACG and BTC, Iranian NIOC in Shah Deniz, Japanese Itochu and Inpex in ACG and BTC, Chinese CNPC and Sinopec in several smaller fields, and the Korean KNOC in the Inam project. Although Azerbaijan is a mature hydrocarbon province, it has still significant Greenfield potential. According to our estimates, Azerbaijan still has remaining commercial reserves of 7.7 billion barrels of oil within a total of 49 fields, and 13.5 trillion cubic feet of gas within 48 fields. Given the openness to foreign investors, this might be of great interest to companies from emerging markets. Corporations, sovereign funds and private equity from the Middle East and Asia often have a better financial position than their Western peers these days. But I would think outside of the hydrocarbon world as well. Oil and gas is just one sector, and emerging market capital will play an increasing role in the diversification of the Azeri economy and promoting growth in other sectors.