CCEE POLICY BRIEF

December 2016 | No.31

WHY DID AZERBAIJAN AND KAZAKHSTAN SIGN THE VIENNA AGREEMENT ON CUTTING OIL PRODUCTION? *

Background

A long awaited deal – which could potentially stabilize global oil prices - was reached on 10 December in Vienna, between OPEC and non-OPEC oil producer countries. The non-OPEC parties, which include Russia, Azerbaijan and Kazakhstan, agreed to cut oil production by 558,000 bpd (barrels per day).

Among the Caspian littoral state signatories, Russia's reduction commitment is the largest, at 300,000 bpd, while Azerbaijan is cutting 35,000 bpd. Kazakhstan - despite OPEC's expectation of a 50,000 bpd reduction - has agreed to a cut just 20,000 barrels from the November 2016 level. Kazakhstan's weaker commitment to OPEC stems from the fact that in recent months, its oil production and exports have risen. This is partly because the Tengiz field has returned to full production, while outputs from Kashagan - a vast oil field in the Caspian – have been ramped up.

While both Azerbaijan and Kazakhstan may share expectations of the resumption of stable world oil prices, they have taken different approaches to the OPEC-non-OPEC deal, and the decline of oil prices has impacted each country differently. Furthermore, since the increase in production at Kashagan, the two have a common goal of exporting oil to European markets. Previously Kazakh oil was transported via the Baku-Tbilisi-Ceyhan pipeline, but Kashagan field's commercial production will require a new means of bilateral engagement.

*Editorial piece. This piece was prepared by CCEE experts.

Analysis

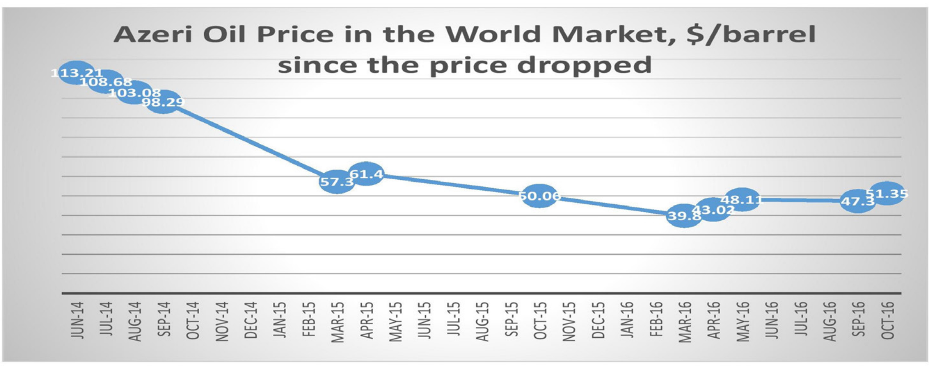
Azerbaijan's expectations and motivations

Since the global decline of oil prices, Azerbaijan has witnessed negative effects, mainly because the economy is heavily dependent on this commodity export. Moreover, the decline of oil prices has not been stable; there have been major fluctuations from $115 per barrel in June 2014 to less than $30 in January 2016 - another source of disappointment.

ISSN 2313-1233

This turbulence causes revenue losses for the Azerbaijani government; according to the SOCAR Vice President Elshad Nasirov, the average cost of production and export for SOCAR is $20 per barrel of oil. However, it is estimated that for BP, which accounts for the majority of Azerbaijan's oil exports, per barrel of oil production and export costs around $14-16, i.e. less than SOCAR's. In the context of low oil prices, especially around $40 or lower, it no longer makes sense to export oil.

Table 1. Azeri Oil Price in World Market, USD/barrel between June 2014-October 2016



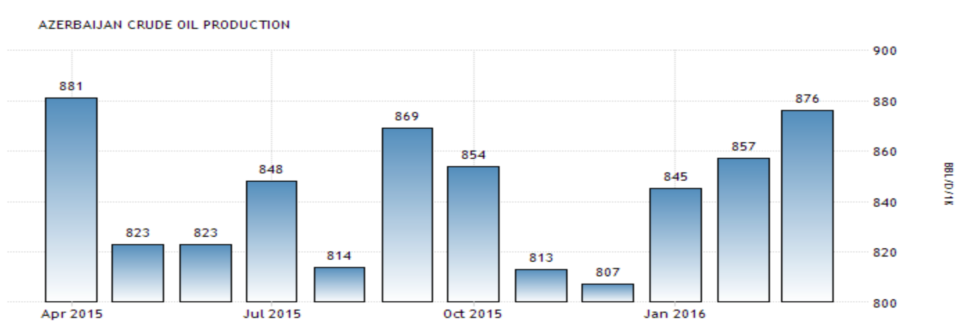
Source: State Oil Company of Azerbaijan Republic and CESD calculations, October 2016

In terms of the $20 production and delivery cost per barrel, Azerbaijan faces threats from two directions:

The first is the lack of financial resources to develop old, onshore oilfields. Under these conditions, it has become hard for oil companies in the production and export consortium to promise financial backing for development of oil fields. In the long term, the lack of regular financial investments in old oil fields will make it harder to stabilize oil production, and consequently exports. This also limits the profitability of Azerbaijan's exports.

Azerbaijan's oil production reached its peak in 2010, at more than 1 million barrel per day. After that it began to decline, and is currently around 830,000-860,000 bpd, as seen in Table 2.

Table 2. Oil Production in Azerbaijan during April 2015- March 2016



Therefore the oil market regulation and production effectiveness - export ratio, low oil prices - pose threats. In order to find good equilibrium, the price needs to be around $55-65 per barrel.

The second reason is the negative impact on the state budget calculations, which in the last two years have been damaged by minimal revenues. The Central Bank has twice devalued the local currency (the manat). For instance, the breakeven oil price for Azerbaijan's budget was set at $50 per barrel for 2016, although Parliament amended the budget on 22 January 2016 and adjusted the price to $25 a barrel. Since the signing of the OPEC-Non-OPEC deal, hopes for the stabilization of oil prices have been raised. The direct impact is reflected in the 2017 state budget, which puts prices at $40.

Over the last year, the Azerbaijani government expected a positive change in oil prices, but has not been in a position to participate in the relevant decision-making processes, which are controlled by the OPEC cartel. However, Baku engaged with OPEC member countries via official consultations at the bilateral level, hoping its interest would be raised in OPEC's meetings. In parallel, since the end of 2015, senior Azerbaijani officials have raised the question of cutting oil exports. The logic behind this was to limit exports slightly if oil prices were lower than $40 per barrel, and increasing if the price rose to more than $40. With the moderate stabilization in the global oil market during the second quarter of 2016, the Azerbaijani side did not act unilaterally to cut production. This is also because Azerbaijan has not been optimistic about positive change, despite attempts to engage more with decision-making countries during 2016. The Azerbaijani leadership saw little reason to be optimistic in early 2016, because OPEC's meeting would not bring a decision, and the absence of a decision at each meeting brought greater destabilization. Therefore the Azerbaijani President Ilham Aliyev, speaking at a World Economic Forum (WEF) session in Davos, Switzerland, requested a coordination of actions and increasing the level of multilateral mutual trust – specifically between— members of the cartel and the major oil-producing states that are not members of OPEC.

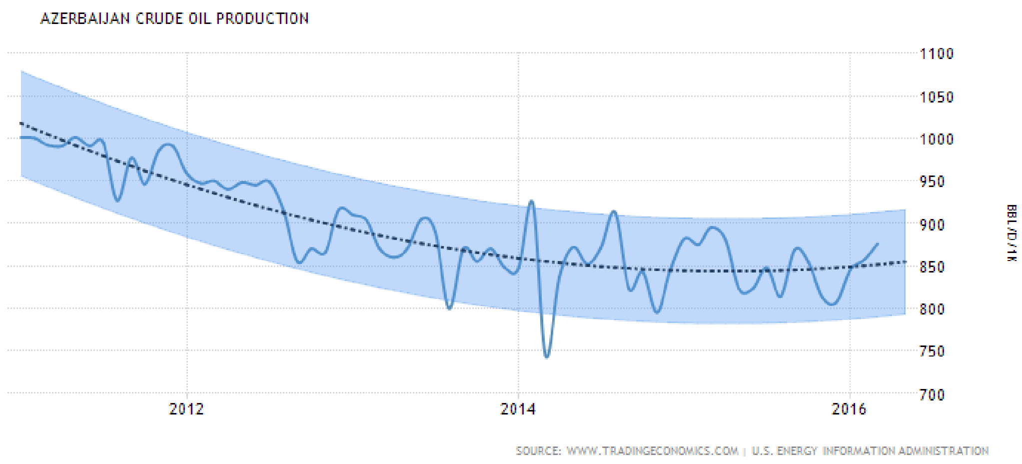
This line, voiced by President Aliyev, saw continued discussion with OPEC members, focused on cutting oil exports with the involvement of non-OPEC countries. For instance, the Azerbaijan President invited the Venezuelan President to Baku on October 22, where he once more stressed the importance of cooperation between OPEC-non-OPEC members, and the development of a strong control mechanism. After the meeting the President Aliyev officially announced that "Azerbaijan unilaterally declares that it will not increase its oil output and export, so that the world oil market is stabilized and oil prices increase."

A few days later, on 24 October, Azerbaijan received an official invitation to the OPEC High Level Committee Meeting on the implementation of Algerian agreements, to be held in Vienna in late October. Before the invitation, OPEC members agreed to limit oil production in the range of 32.5-33 million barrels of oil per day at an informal meeting in Algeria on 28 September. However, the final decision was expected at the Vienna meeting in early December.

At the October meeting, Azerbaijan's Minister of Energy, emphasized that "OPEC and non-OPEC countries share the same challenges and should seek common solutions," adding that "Azerbaijan depends financially on the oil and gas industry." However, with the 10 December deal in Vienna, Azerbaijan committed to cut 35,000 barrels per day from its production.

This reduction of 35,000 barrels per day, which Azerbaijan will follow by January 2017, means that it will reduce the production from 2016's average of 842,000 per day to 807,000 per day by 1 January.

Table 3. Azerbaijan's oil production between 2012-2016



The 35,000 reduction will be agreeable for shareholders, like BP, but further decreases will be damaging. According to Gordon Birrell, BP's Regional President for Azerbaijan, Georgia and Turkey, "Decrease of production rates with the lapse of time is natural for large oil fields. Therefore, we will spare no effort to minimize lowering of production. We are not yet ready to reveal the exact figure of oil production for 2017 as the issue is currently under consideration of SOCAR and Azerbaijani government."

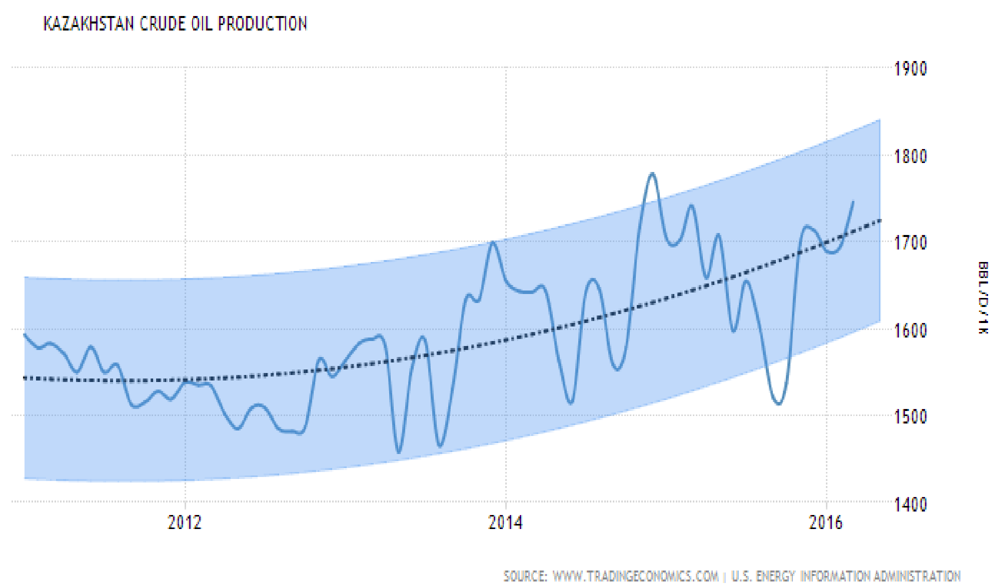
The effect of the cuts on the 2017 forecast will see a 3.7% drop in production to 39.797 million, compared with 2016. However, the $60-65 per barrel price for oil will make up for the loss. However, if prices drop below $50, Azerbaijan will not benefit from the Vienna agreement – though nor will any other signatories.

Kazakhstan's expectations from the Vienna agreement

Similar to Azerbaijan, the Kazakh government expected and hoped for the resumption of stable oil prices. But unlike Azerbaijan, the timing of the Vienna deal is not satisfactory for Kazakhstan for two reasons.

First, Kazakhstan was disappointed that global oil prices fell, given the delay of the development of its major oil field, Kashagan. If Kashagan had come online a few years ago, Kazakhstan would have made back much more of the 55 billion invested in the project. During the discussions of the OPEC-non-OPEC deal, on 14 October, the first batches of oil were exported from Kashagan. Since then the production of oil has slightly increased. This is the reason that Kazakhstan announced it will cut production by 20,000 bpd, using the November 2016 statistics as a benchmark. Notably, Kazakhstan's oil production was revised up by 10 tb/d to now show a lesser decline of 30 tb/d for the year 2016, yet with growth of 0.26 mb/d forecast for 4Q16. Crude oil output in September increased by 0.23 mb/d, compared with August, to average 1.23 mb/d, and total liquids supply reached 1.50 mb/d. Growth of 0.21 mb/d is forecast next year for an average of 1.77 mb/d.

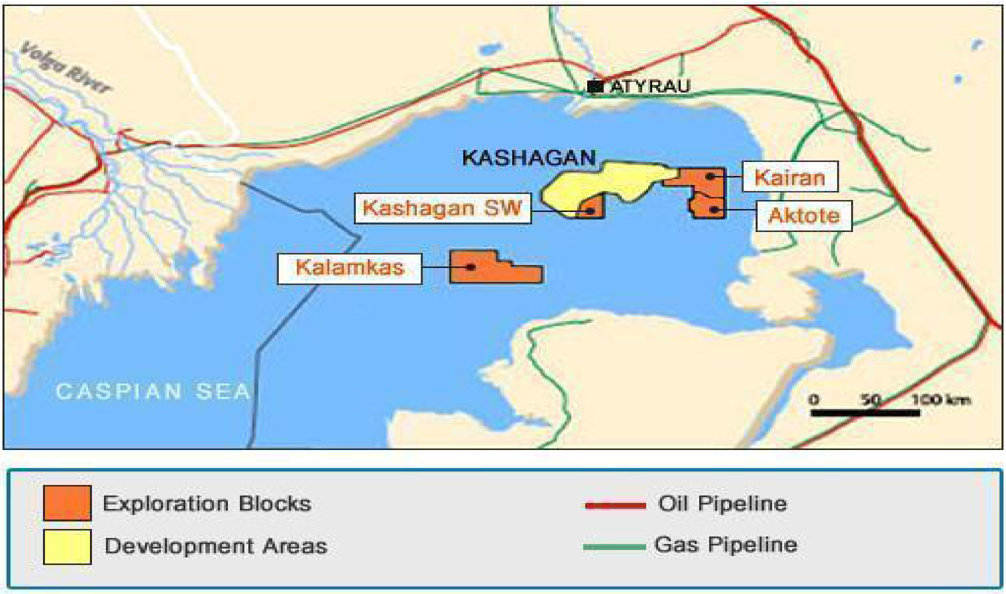
Table 4. Oil Production in Kazakhstan during 2012-2016



A year before, the Kazakhstan government announced that they saw no problem with exporting 80 million tons of oil annually, if the price is around $50. The red line for Kazakhstan was declared as $40; in the event of prices hitting $30, production would be cut to 73 million tonnes. Therefore, under current conditions, $50 is acceptable for Kazakhstan's exports, with Kashagan coming into play.

The second reason is Kazakhstan's commitment to the development of oil fields – production and export were delayed in the last years, and its international legal commitments must be realized. This project is run by an international consortium including Kazakh national company KazMunayGas, American ExxonMobil, Shell, French Total, Italy's Eni, China National Petroleum Corp., and Japanese Inpex.

Kashagan itself can stabilize Kazakhstan's financial losses in the long term. According to Ashley Sherman, senior Russia and Caspian analyst at Wood Mackenzie, "Kashagan would be reaching stabilized output at 75,000 bpd and then ramping it up to 100,000 bpd or more by the end of the year". Wood Mackenzie expects a fast increase in output at Kashagan phase one - the first stage of the project which is due to be completed by the end of 2017 - with annual production averaging more than 150,000 bpd in 2017 and 230,000 bpd in 2018." Kazakhstan is taking a realistic and moderate approach, based on a view that while global oil prices might stabilize around \$50, or hover between \$40 and \$50, there will not be a significant rise – such as up to \$60-65. The promise to cut exports by 20,000 per day is a sufficient commitment for the Vienna deal.



Conclusion

Azerbaijan and Kazakhstan both hope that the OPEC-non-OPEC deal will bring the slight stabilization of oil prices. For both countries, \$50 is acceptable for the continuation of production and export, while below \$40 is the red line for Azerbaijan government.

Unlike Azerbaijan, Kazakhstan does not want to reduce production more than 20,000 per day, for two main reasons. First, Kazakhstan has been resuming oil production in the last two months since Kashagan came into force, and this oil field will see a major boost in production of oil. An average price of \$50, or even \$45 is acceptable.

The second reason is Kazakhstan's commitment and also that of the Kashagan oil field consortium; the delay in past few years brought big financial loss to Astana and the consortium.

Also, both governments have acknowledged that the Vienna agreement will not bring a dramatic rise in oil prices; this was echoed by the US Energy Information Agency, which forecast that average oil prices could climb to $51 in 2017.

Last but not least, Kazakhstan's modest commitment to the Vienna deal and resumption and increase of oil production offers a good opportunity for Azerbaijan, because it will bring greater volumes of oil which can be exported via Azerbaijan to European markets. For instance, in the first eight months of this year, the volume of transportation of oil and oil products from Kazakhstan in the direction of the Batumi oil terminal LLC via Azerbaijan totaled 1.6 million tons according to the government of Azerbaijan. In this sense, the Kashagan field will open new opportunities. According to Robert M. Cutler, senior researcher at the Carleton University in Canada, "As Kashagan has now just begun commercial production, after years of delay, the two countries have signed an agreement confirming the earlier understanding and reaffirming the intention to build the undersea Trans-Caspian Oil Transport System (TCOP) together." The barriers to these plans are known, though more detail is needed. However, according to Cutler, the construction "would open the possibility for the Trans-Caspian Gas Pipeline (TCGP) from Turkmenistan to finesse political costs by sharing the same route." This opportunity, and Kazakhstan's approach of maximizing its production in 2017, means that Astana may even consider annulling its modest Vienna commitment after a few months later.

Caspian Center for Energy and Environment

ADA University
Ahmadbay Aghaoghlu Street,11,
Baku, Azerbaijan, AZ1008

Tel : (+994 12) 437 3235 ext 307
Fax : (+994 12) 437 3236
E-mail : ccee@ada.edu.az
Web : www.ccee.ada.edu.az
www.ada.edu.az