

**Under reconstruction! We apologize for the absence of certain materials.****UKRAINE'S ODESSA-BRODY OIL PIPELINE: WHOSE OIL AND WHERE SHOULD IT GO?**

01 June 2003

The end of the war on Iraq and the pending arrival of large volumes of Iraqi oil on the world market will have an immense impact on how this market operates, primarily with respect to Prices. As U.S. President George Bush said in pretty straightforward terms, low oil prices will boost the U.S. economy. In this respect, the routes of oil pipelines to be built in regions relatively close to the Persian Gulf could undergo drastic changes. Washington has its own plans to build oil pipelines from Iraq to Turkey and to Israel (this implies restoration of the Mosul-Haifa pipeline, which has not been in operation since 1948). Iraqi and other factors (in ag-Sregate) will have an effect on the implementation of oil transportation projects in the Black Sea-Cas-region, including in Ukraine.

Ukraine's strategic project is the Odessa-Brody pipeline and the Yuzhnyi (Pivdenniy) terminal, meaning that the Euroasian Oil Transportation Corridor (EAOTC) for delivering Caspian oil to Europe is still the country's most important venture, since it is its main hope for becoming integrated into the international oil transportation infrastructure. But despite the fact that a small section of the pipeline is already in use and a large number of possible alternatives for developing this project are being reviewed, realistic deadlines for putting the entire system into operation have not yet been set. Debates have begun again in Ukraine on its prospects, but in a different vein, the talk is now about whether to pump Caspian oil to Europe, or whether to transport Russian oil from Brody to Odessa.

Official Kiev could try and implement any of these routes, but only if its potential partners, Poland, Germany, Russia, and the Caspian countries, are really interested. With the exception of Russian oil companies, Ukraine's partners are doing nothing more than making sweeping declarations. As for investments in the EAOTC, potential oil consumers and production companies are still unable to guarantee its full-capacity operation. This means that the authorities' intention to implement one of the alternative routes for the EAOTC must be approved by investors and transnational oil companies.

**Factors Determining the Configuration of the Planned Pipelines**

In the next few years, the configuration of the oil pipelines in the Black Sea-Caspian region could undergo significant changes. Let us take note of several factors influencing this process.

First, the most important question is, who will control the global oil market? If the U.S. succeeds in having a great influence on Iraqi oil (very soon its production will drastically increase and deliveries will be regulated, including by building new pipelines), the price will drop to 20 dollars a barrel. If, on the other hand, Baghdad stays in OPEC as a conscientious member of this cartel, it will still be in the "corridor" of this international organization, which sets the price at \$22-28 a barrel. Low prices will freeze the construction of expensive pipelines, for example, the Baku-Ceyhan route. Second, no matter what happens, price formation will depend on the efficiency of the policy of OPEC and other countries, such as Russia, Norway, and several more. Third, the revival (in the near future) of the economies of the world's leading nations will give rise to an increase in demand for oil, which will boost its production and accelerate the implementation of new pipeline projects. Fourth, a stable situation in Iraq will make it possible to reach its pre-war production level of 2.5 million barrels a day within the next couple of years, and in another 3-4 years ensure the production level reached before the Iranian-Iraqi war of 3.5 million barrels. In 8-10 years, the country will be able to produce up to 6 million barrels, which will drastically change the balance of forces in OPEC. Fifth, the US's "egoistic" policy in Iraq with respect to France and Germany will force these states to set their sights on the hydrocarbons of the Caspian countries.

These and several other factors will also have a significant influence on the global oil market, and the active policy of the oil-producing countries and transnational oil companies will lead to the formation of new pipeline systems. The oil transit countries will also play an important role in these processes by offering economically profitable projects for oil delivery.

**The First to Bypass the Bosphorus**

According to the forecasts, by 2010 Kazakhstan and Azerbaijan will be exporting approximately 100 million tons of oil annually, and about 50 million tons will be going through Russia's Black Sea ports. The Black Sea straits, which are already loaded to full capacity, can only handle up to 80 million tons of oil, so the question of activating bypass routes is extremely urgent.

Today, five such projects can be identified: Druzhba-Adria, Odessa-Brody, Baku-Tbilisi-Ceyhan, Burgas-Alexandroupolis, and Burgas-Vlore. Work is going on in all these directions, although at different rates. The first route will go into operation in 2004. Construction of the Baku-Tbilisi-Ceyhan route may be delayed due to its high cost, as well as environmental and other problems. As for the Burgas-Alexandroupolis project, the Russian, Greek, and Bulgarian governments intend to sign an intergovernmental memorandum soon on its implementation. Some sources have it that such giants as Exxon/Mobil and Chevron Texaco are interested in the Burgas-Vlore route.

Of course, there is no chance of all five projects being implemented in the next few years. Which one wins the "contest" will largely depend on international support (they are all transnational projects), the consent of transnational companies to pump oil, and the guarantee of funding. And it is precisely the amount of oil to be pumped and the funding that are the bones of contention.

A few years ago, many experts predicted that there would be no demand for the Odessa-Brody oil pipeline. In light of the abundance of alternatives for its implementation, a discussion has arisen today about how to best use this route, to pump Russian oil from Brody to Odessa or Caspian oil to Brody and on to Europe. This discussion is stopping Ukraine from choosing the most economically expedient route and beginning to implement it.

At present, it is important for Kiev that this route is one of the first to go into operation, since there is not enough Caspian oil for all the projects. However, it can be presumed that the Ukrainian "pipe" will not stay "dry" even if it is not the first to be activated. Time will tell whether this is in fact true.

**EAOTC-Ukraine's Strategic Project**

With the intention of closing the producer-transit country-oil consumer circuit, Ukraine has been holding talks for the last three or four years with oil producers in the Caspian and potential consumers in Europe. But it has not yet received any specific guarantees regarding the EAOTC's work-load, or investments in the project. Nevertheless, a small section of the oil pipeline and the Yuzhnyi terminal are already operating using Russian oil under reverse conditions.

Ukraine's advantageous geographical location, the increase in oil production in the Russian Federation and Caspian countries (with a shortage of pipeline capacities), completion of the construction of the first phase of the EAOTC, its linking up with the Druzhba pipeline, and the possibility of pumping oil in the opposite direction have created conditions for using the Odessa-Brody route in a number of different ways (see the table).

**Technical Specifications of the EAOTC Project**

Length of pipeline	674 km.
Diameter	1,020mm
Initial throughput capacity	9-1 4.5 mill, tons
Throughput capacity after second phase goes into operation	45.0 mill, tons
Number of main pumping stations	1
Number of main pumping stations after second phase goes into operation	3
Dead weight of tankers	Up to 100,000 tons
Tank farm of first phase	200,000 cu m
Tank farm after second phase goes into operation	600,000 cu m

Today, Ukraine has three main alternatives at its disposal for using the EAOTC. The first is the long-term prospect of transiting Caspian oil to the West. This implies both to Poland (Odessa-Brody-Plock-Gdansk) and to Germany (Wilhelmshaven). In the latter case, two sub-alternatives are possible: through Slovakia and the Czech Republic, or through Poland. But either one of them will help Ukraine to become integrated into the European Union.

The second alternative is to link the EAOTC up to the Druzhba-Adria pipeline, which will make it possible to only partially (in terms of load volumes) resolve the question of the project's efficiency.

The third is to fill the EAOTC in the near future with Russian oil for reverse deliveries (Brody-Odessa). This will make it possible to quickly reimburse the expenditures on building the complex, which is operating at a loss. Admittedly, the prospect of rapid economic gain means rejecting one of the main principles of the state's energy security-diversifying

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Somewhat older sub-alternatives for developing the EAOTC are also being discussed: building a Ceyhan-Samsun route for delivering Iraqi oil, as well as laying a pipeline to Moldova and building a small oil refinery there. These projects do not have any prospects, since their implementation is fraught with serious political and economic difficulties.

But on the whole, compared with other rival routes, the EAOTC has both negative and positive aspects.

#### **The Project's Main Negative Factors**

At present, the Odessa-Brody system is pumping 100,000 of the 600,000 tons of crude oil needed. The Ukrtransnafta Open Joint-Stock Company is planning to allot the 250 million hryvnas (the monetary unit of Ukraine) in refunded VAT to purchase crude oil for this oil pipeline and is holding talks with Chevron. This company is being asked to fill the pipeline with crude oil and will be compensated when Caspian oil is pumped through this pipeline.

A law has not been adopted on transferring pipelines, including the Odessa-Brody, on concession.

Long-term contracts have still not been signed on delivering the amounts of oil necessary for operating the pipeline.

The main potential suppliers of Caspian oil-Azerbaijan and Kazakhstan-do not have any free oil to offer at present. The oil produced by the State Oil Company of Azerbaijan (almost 9 million tons) is largely refined at local refineries, and only about 2.5 million tons of this amount are exported via the Baku-Novorossiisk pipeline. Oil from the Azerbaijan International Operating Company, on the other hand, goes via the Baku-Supsa pipeline to Western Europe. Of the 42 million tons of oil produced in Kazakhstan in 2002, 32 million tons are exported mainly via the oil pipeline of the Caspian Pipeline Consortium (CPC) and other pipelines to Ukraine through Russia.

The agreements signed on Ukraine's participation in the Druzhba-Adria oil pipeline do not permit (without being amended) the Odessa-Brody route to join up with it.

Most of the unresolved problems involved in implementing the EAOTC do not depend on Ukraine.

#### **Positive Factors**

The first section of the EAOTC has been built and linked up with the Druzhba oil pipeline, and a separate section and terminal are already in operation; the price of tanker shipment has risen; there is increased demand for low-density Caspian oil in Western Europe; the Black Sea straits are overloaded and can no longer cope with oil being shipped on tankers, and Turkey has instituted tougher regulations for tankers passing through the Bosphorus and Dardanelles; there is a stable increase in oil production in Russia, Kazakhstan, and Azerbaijan; the European Union is supporting the EAOTC project and there are numerous alternatives for implementing it.

Of course, there are other sub-alternative routes for implementing this project, but they are mostly repetitions of the basic routes. Below we will analyze all the proposed and, at first glance, rather enticing, from Ukraine's viewpoint, alternatives for its use.

#### **Odessa-Brody-Plock-Gdansk**

The EAOTC project is transnational and without international support it will be essentially impossible to implement. Prominent companies and certain countries now show greater, now lesser interest in it, but neither planning, nor investments in continuing the project have begun. For example, Poland was the first to support the Ukrainian initiative by founding the Golden Gate Company, which was to build the Brody-Plock section (the Plock-Gdansk branch has already been built). This company, created on 11 November, 1998, was founded by the Polish companies Energopol, Geopol, RP Investment, and PROCHEM In 2000, the Ukrainian concern, Nadra, joined its stockholders, and in October 2001, a decision was made to sell two sets of the company's shares to PERN Przyjazn, a Polish state oil transportation enterprise, and JSC Ukrtransnafta.

The company's shareholders are more than 300 legal entities owning sets of 0.2% to 15% of the authorized capital, but the largest founders are Polish enterprises interested in building this pipeline. The cost of constructing the Brody-Plock section is close to \$300 million, with a throughput capacity of 10 million tons a year. Another 150 million dollars are needed to increase it to 25 million tons a year. JSC Ukrtransnafta and Golden Gate are doing the design work for building this section.

Four years have passed since the Golden Gate Company was founded, but laying the Polish section of the route has not even started. Ukrainian President Leonid Kuchma noted that Poland, after declaring its interest in finishing building the oil pipeline, is not taking "any real steps" in this direction.

The European Union also showed an interest in the EAOTC. The EU began looking at the possibility of participating in the Odessa-Brody-Gdansk oil pipeline after a joint appeal from the Ukrainian and Polish prime ministers, who asked this European structure to give more active support to the construction of the Odessa-Gdansk oil transportation corridor. Loyola de Palacio, European Commission vice-president in charge of transport and energy, said at one time that this project "is no longer Ukrainian or Polish, but European." In turn, Polish Vice Premier Marek Pol stressed that this route will significantly boost Ukraine's integration into the EU.

Ukraine is looking at the idea of creating a united consortium for managing the oil pipeline from Odessa to Gdansk, which could include the Odessa-Brody route already in operation and Yuzhnyi terminal, as well as the Plock-Gdansk section and the terminal complex in Gdansk. For this purpose, a draft Law on Making Amendments to Art 3 of the Ukrainian Law on Concessions (on the Pipeline Transportation of Oil) was drawn up and submitted to parliament. But it gave rise to heated disputes over the executive power's "intentions" to give the oil pipelines to Russia. The Verkhovna Rada (the country's parliament) postponed its discussion until later.

For several years now, the Polish section of the EAOTC has been "stuck in the mud," mainly due to the lack of real financing. It could be put on indefinite hold for several reasons: the relatively high cost of finishing construction of the Polish section, the low volume of the oil refining market and petroleum product consumption in Poland, the absence of a deepwater port (to handle 500,000-ton tankers), and so on. It is pretty safe to say that there will be no deliveries of Caspian oil to Gdansk in the next three to four years.

#### **Odessa-Brody-Uzhgorod-Bratislava-Litvinov-Wilhelmshaven**

During the Hannover Messe-2003 Expo Fair in April 2003, Germany expressed an interest in pumping Caspian oil via the Odessa-Brody pipeline to the deepwater sea port of Wilhelmshaven on the North Sea coast, which can handle 500,000-ton tankers.

At the Ukrainian-German and German-Ukrainian forums held on 24 March, 2003, a joint action plan was signed for the same year that envisages organizing consultations to involve Germany in building the EAOTC. And the PriceWaterhouseCoopers Company (PwC), as project developer in charge of drawing up a business plan for the Odessa-Brody route with the participation of international companies, is looking into the expediency of using potential routes for transporting Caspian oil to Wilhelmshaven through Poland (including the section of the future Brody-Gdansk oil pipeline) or through Slovakia and the Czech Republic.

Germany is at the initial stage of joining the EAOTC, we can even say at the assessment stage. In this respect, it is rather difficult to predict the extent to which it will participate in implementing the project. The lack of coordination between the German and American viewpoints on Iraq and the overall cooling in relations between these two states could give a significant boost to Germany's energy policy, primarily in the Caspian.

On the other hand, due to the high capacity of the German oil and petroleum product market, as well as its significant investment potential and other positive factors, this route is one of the most promising.

#### **Novorossiisk-Odessa-Brody**

The abovementioned CPC pipeline (Tengiz-Novorossiisk), which is 1,580 km in length, connects the fields of Western Kazakhstan with the Russian coast of the Black Sea. At the first stage, the pipeline has a capacity of 28.2 million tons of oil a year, which should be increased in two more phases, first to 38 million tons, and then to 67 million tons during the second half of 2006.

The pipeline will be charged with oil from Kazakhstan, mainly from the Tengiz and Karachaganak fields, and later also from the Kumkol deposit. In 2002, production here amounted to 47 million tons, and in 2003, there are plans to obtain up to 50 million tons. According to the official forecasts, oil production in the country will reach 60 million tons by 2005, and 88 million tons by 2010. And beginning in 2005, additional capacities will be required to export it from the west of the republic.

The question is currently being discussed of building a connecting branch between the CPC oil pipeline and the Odessa-Brody line. If this question is decided positively, two branches with a total length of up to 600 km will have to be built (one in Russia and one in Ukraine). At the moment, however, there is not even an approximate estimate of the economic specifications of the project, the PriceWaterhouseCoopers Company has only just begun drawing up its feasibility study, which will be submitted to the governments and oil-producing companies of Russia and Kazakhstan. But major controversies between the potential participants, significant construction expenses, and relatively high transportation costs will make it difficult to implement this route, at least for the next five years.

What is more, delivering oil from the CPC (Novorossiisk) by tankers to the Yuzhnyi terminal and on by pipeline to Europe looks much more economically expedient, which Nurlan Balgimbaev, president of the Kazakhoil Company, talked about at one time. This route could significantly reduce the load on the Black Sea straits and become a role model for cooperation among Ukraine, Russia, and Kazakhstan, as well as western oil-producing companies.

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### **Odessa-Brody-Uzhgorod-Omisalj**

The gist of the Druzhba-Adria project is to reconstruct Croatia's Adria pipeline, which connects the oil refinery in Sisak with the deepwater port in Omisalj (for 500,000-ton tankers) in such a way that oil can be pumped from land to sea, and to connect this pipeline with the Druzhba pipeline. The Druzhba route in this context implies the section of pipeline that runs from the Russian border through Belarus, Ukraine, Hungary, Slovakia and again to Hungary to Szazhalombatta, and the Adria oil pipeline implies the section from Szazhalombatta to the Hungarian-Croatian border and the Jadran oil pipeline from the Hungarian-Croatian border to the port complex in Omisalj. An agreement on their connection was signed at the end of April 2002 by the Transneft-Druzhba Company (Belarus), MOL (Hungary), JC Transneft, Transpetrol (Slovakia), Ukrtransnafta (Ukraine), and JANAF (Croatia). And it was signed in December of the same year at the governmental level for ten years with the possibility of prolongation.

There are plans to build a route for delivering oil, mainly Russian, as well as transiting oil from other countries to the world markets (including the U.S.) via Omisalj. In so doing, current pipeline capacities are to be loaded gradually and increased in three stages-5 or 8, 10, and 15 million tons a year. The total length of the route is more than 3,000 km.

Completion of the work on the first phase of the project, costing 20 million dollars, will make it possible to export 5 million tons of oil a year. The first oil to be pumped via the Druzhba-Adria line was to be delivered in tankers to Omisalj in December 2003. But implementation of the project will not begin until 2004, due to environmental problems, as well as a few controversial aspects in the Ukrainian and Croatian viewpoints.

Due to the significant length of the pipeline, all the sides in the project have been asked to reduce the transit fee to 64 cents for pumping 1 ton of oil 100 km. The talks begun in 1997 were not successfully completed until 2001, since Ukraine insisted on the previous fee of 73 cents (in 2003, other oil pipelines charged 68.5 cents). Such an uncompromising stance was explained by Kiev's desire to stop Russia building a bypass pipeline, the Sukhodol'naia-Rodionovsk. But Ukraine suffered a fiasco at every turn: the fee was reduced, the bypass pipeline was built, and Ukraine was deprived of significant amounts of transit oil.

In January 2003, JSC Ukrtransnafta proposed transporting Caspian oil via the Odessa-Brody-Uzh-gorod-Omisalj route for three years along with implementing the Druzhba-Adria project. After the talks held on 22 April, 2003, Croatian Economics Minister Ljubo Yurcic stated that the delivery of oil within the framework of the Druzhba-Adria project could be combined with pumping Caspian oil via the Odes-sa-Brody route, and further via the Uzhgorod-Omisalj route, since these pipelines are not in competition with each other (more on this below). But it does not seem possible to realistically hook the Odessa-Brody oil pipeline up to this project for several reasons.

- First, the technical specifications do not allow for pumping different grades of oil separately. They can only be mixed and a quality bank created for reimbursing the owner of the low-density oil for the economic losses he incurs. Since Russian Urals oil is heavier than Caspian, Russia is unlikely to agree to this step. In so doing, agreements between the sides do not stipulate the intention to create a quality bank, as a result of which the owner of the low-density oil will not agree to lose 2-4 dollars on each barrel.
- Second, an analysis of the contracts and agreements on the Druzhba-Adria project has shown that all the most important questions regarding access to these pipelines and their operation have been farmed out to the Russian Transneft Company. For example, the June agreement of 2002 envis ages identifying the capacities for delivering Russian oil to the port of Omisalj, whereby the sides are entrusting Transneft with dispatcher functions and operational control over additional oil flows. What is more, this structure also has the right to additional deliveries, which could raise the amount of oil currently being transited to almost 15 million tons a year. The transportation fee is deter mined on the basis of tonnage, therefore it is more profitable to pump heavy than low-density oil, nor is indexing stipulated to account for inflation of the dollar (December agreement of 2002 and January agreement of 2003).
- Third, Transneft is taking a rather hard line in its dealings with oil companies and will not permit alien oil into its "own" project, particularly if there are no legal guarantees for Ukraine.

Today, the reserves of the Druzhba oil pipeline (in terms of its throughput capacity) in Ukraine amount to 9.2 million tons, and if amendments are made to the agreements signed, Kiev could integrate the EAOTC into the Druzhba-Adria system. But there are not the necessary legal guarantees for this, which makes this integration less than likely.

In this way, Ukraine's chances of joining the Druzhba-Adria project up with the Odessa-Brody route at the first and second (10 million tons) phases of the pipeline system development look extremely problematic.

### **Brody-Odessa**

In 2002, Transneft received 374.4 million tons of oil from producers, which was 9.1% more than in 2001, including 29.3 million tons from Kazakhstan (a drop of 0.2%) and 2.6 million tons from Azerbaijan (an increase in 5.2%). Russian refineries received 186.5 million tons, 10.1% more than in 2001. Export deliveries amounted to 186.4 million tons (8.2% more), including to the "far abroad"-151.1 million tons. In the first quarter of 2003, 39,820,000 have been sent to the "Far Abroad" (10% more than for the same period in 2002). Here it is appropriate to note that Russia's pumping capacities for exporting oil are not only essentially fully engaged, but there is even a shortage of pumping capacities; according to preliminary data, in 2003, they amounted to 15 million tons.

The rapid increase in oil production in Russia has taught its oil companies a lesson-export routes could not handle the necessary volumes. For example, in March 2003, Transneft introduced restrictions on export twice, up to 50,000 and 100,000 tons a day.

It is anticipated that the main increase in export pipelines in Russia will be ensured by gradually introducing the third phase of the Baltic Pipeline System (BPS) into operation, which will make it possible to increase the throughput capacity of the terminal in Primorsk to 30 million tons by late 2004. What is more, an increase in deliveries via the Druzhba pipeline by 5 million tons is envisaged, as well as the reconstruction of existing and the building of new tank farms (1 million tons) in the Novorossi-isk port.

For the past two years, TNK, LUKoil and Yukos have been repeatedly expressing their desire to pump oil via the Odessa-Brody pipeline, but in the reverse direction. Its use (even with slightly higher transportation costs) will make it possible for these Russian companies to increase the export of oil, and for Ukraine to use the pipeline to its full capacity.

As a result of the Ukrainian-Russian talks (end of January 2003), Ukrtransnafta put the Yuzhnyi terminal into operation using the Odessa-Brody section of the oil pipeline (52 km) in reverse. Oil belonging to JSC TNK is loaded into tankers at this terminal.

Pursuant to the entered agreements, in 2003 there were plans to pump more than 4 million tons of oil via the Michurinsk-Kremenchug-Yuzhnyi route to this terminal. During the first five months, Ukrtransnafta loaded and shipped 767,000 tons of it (nine tankers). In so doing, 7.5 million dollars entered the republic's budget.

According to Iu. Boiko, head of the Naftogaz Ukrainy Company, on 19 March, 2003, Moscow made a proposal to Kiev to pump Russian oil through the entire Brody-Odessa pipeline, but in the reverse direction, and this proposal is being analyzed. According to some data, it came from the Tiumen Oil Company. But suddenly obstacles arose in the way of this initiative-an article entitled "The Ambiguous Reverse," published in the newspaper Den. Its authors, American, German and Polish ambassadors accredited in Ukraine, called on the leadership of our country not to transfer the oil pipeline to Russia's exclusive use, and also criticized the agreement on the Druzhba-Adria project signed by Ukraine. And whereas the need to amend the international agreements on this project arouses no doubts in the experts, the commotion stirred up by the ambassadors with respect to the Odessa-Brody pipeline is not underpinned by effective measures from these three countries to advance the Ukrainian project. For example, American companies are the largest oil producers in the Caspian anyway; apart from declaring its interest in extending the project to Wilhelmshaven, Germany has not yet proposed anything; and Poland has only just started designing its part of the pipeline.

In this way, the absence of efficient assistance from the West is pushing Ukraine into Russia's embrace, although Kiev is also interested in reducing its energy dependence on Moscow. The latter is offering specific alternatives for transporting oil, which make it possible to minimize losses from the idle pipeline. On the other hand, the Russian proposals for its use are still rather general in nature.

Ukraine must take maximum advantage of Russia's proposals by signing a transportation agreement for only one year, but in so doing actively speeding up development of the western alternatives for transporting Caspian oil as the main ones.

### **Iraqi Oil for the Odessa-Brody Pipeline**

Today, Ukraine is placing less hope on Iraqi oil, although there are still appeals to revive the Cey-han-Samsun project. The last outburst of interest in this oil is related to the fact that by participating in the stabilizing forces in Iraq, Poland could be placed in charge of a zone of responsibility-80,000 sq. km in area between Basra and Baghdad-which will most likely allow it to have control over part of Iraqi oil production.

An intergovernmental agreement on the construction of this oil pipeline (700-800 km in length, throughput capacity of 100 million tons a year), which was to connect the Mediterranean and Black Sea coasts of Turkey, was signed by Kiev and Ankara as early as June 1997. Then it was ratified by the parliaments of both countries. Implementation of this project was halted due to a U.N. Security Council embargo on the export of Iraqi oil. Unfortunately, neither the embargo, nor the interest of the world's leading countries (the U.S., Russia, China, France, and so on) in retaining the procedure for exporting oil from Iraq that existed at that time (essentially the re-export of oil by Russia and several other countries to the U.S.) did not stop Ukraine and Turkey. And there is no point in placing any hopes on this standstill alternative of the EAOTC project, since the U.S. is very

interested in Iraqi oil itself (incidentally, it has every right since it won the war). And in view of the surplus oil from the CIS countries of the Black Sea-Caspian region, the current several million tons of Arabian oil will gradually be ousted from this market.

Today, only swapping Iraqi for Caspian oil can be viewed as a theoretical alternative for filling the Odessa-Brody oil pipeline. But this alternative is rather complicated and unfeasible due to the legal and political problems involved with its implementation.

On the whole, it is too early to talk about mechanisms for redistributing Iraqi oil and about privatization of the Iraqi oil sector. The final cost of this oil if it is delivered via the Odessa-Brody pipeline will be higher than that of oil from the CIS countries (due to the large transportation costs), which will always be the main obstacle to implementing this project.

### **Odessa-Brody-Moldova**

On 14-15 April, 2003, a delegation from JSC Ukrtransnafta and the Ukrainian Foreign Ministry held talks with Moldovan President Vladimir Voronin. According to the Ukrtransnafta press service, on 12 May, 2003 an agreement was reached on creating a bilateral working group for "determining the possible alternatives for laying a branch of the Odessa-Brody oil pipeline through Moldova," as well as on building an oil refinery. In this way, the Ukrainian Institute of Oil Transport is trying to revive a project to build a branch of the pipeline that will join the Odessa-Brody line with an oil refinery that could be built in Moldova for refining Caspian oil. Several years ago, within the framework of the GUUAM association, Moldova was asked to consider this project. Its government is again looking into the question of building an oil refinery with a capacity of up to 3 million tons of oil a year (it could be built in two to three years).

The main obstacles are the same as before, Kishinev's lack of financial resources to build the oil refinery and oil pipeline, as well as the low consumption volume of petroleum products in Moldova.

### **Price WaterhouseCoopers' Business Plan**

On 16 May, 2003, a meeting was held in Kiev of an international round table called "The Odessa-Brody Oil Pipeline: Commercialization, Security, Integration," the highlight of which was the presentation of a business plan for developing the EAOTC project drawn up by the well-known auditing-consulting company, Price WaterhouseCoopers. According to its conclusions, the most efficient alternative for commercializing the project is to deliver Caspian oil via the Odessa-Brody oil pipeline and on through the system of other current and planned pipelines to oil refineries in the Czech Republic, Austria, and Germany. The business plan is to be carried out in three phases.

The first phase is to the oil refinery in Kralupy (the Czech Republic, which has reserves for refining up to 3 million tons of oil) and to two plants in Southern Germany, in Ingolstadt (3 million tons) and Wogburg (1 million tons). The implementation time is 3-4 years (by 2006-2007). The second phase is to the Austrian oil refinery in Schwechat and the refinery in Karlsruhe, Southern Germany. Up to 2 million tons of Caspian oil a year can be delivered to each of these plants, or the total amount for this phase of up to 11 million tons of oil. The implementation time is 4-5 years (by 2007-2008). The third phase is to the German port of Wilhelmshaven (19 million tons) with an implementation time of 5-6 years (2008-2009).

The company recommends that Ukrtransnafta place top priority on holding talks to transit oil to the Czech Republic, Austria, and Southern Germany.

Another transportation alternative to the Polish city of Gdansk can also be carried out no sooner than 2007, since it requires a large amount of funding. On the whole, according to PwC, the transit of Caspian oil via the Odessa-Brody system will be in demand by western oil companies. The main reason for this is the limited throughput capacity of the Black Sea straits.

In accordance with the conclusions of PriceWaterhouseCooper, the EAOTC will not only not be in competition with Russian pipelines, but will also bring Russian companies certain advantages. In particular, at the first and second phases of the project, they will have the opportunity to increase the export of Urals oil by 6 million tons, and access to Wilhelmshaven will allow them to have use of this deepwater port.

But this proposal, which seems so alluring at first glance, has its pitfalls. Even though it was just the business plan, and not the feasibility study for the project, it failed to highlight the key issues, which is inadmissible for a company of such prestigious international standing as Price WaterhouseCoopers. It did not present even the minimum amount of information on the reserve base (sources of oil deliveries) and comparative estimates (albeit preliminary) of the transportation cost via different routes (their length), or the possible ranges of transit rates for planned and current pipelines. On the whole, its business plan is declarative and does not take into account the current political realities, primarily the nature of relations between Russia and Ukraine. Any attempt by Kiev to compete with Russian oil using oil pipelines operating on Ukrainian territory will arouse a harsh reaction from Moscow, and the Ukrainian leadership will immediately reject such projects. Most Western European countries have medium-term agreements with the Russian Federation on the delivery of specific amounts of oil, which will not allow Russian oil to be replaced in the currently operating pipelines, and it will take at least 2-3 years and a significant amount of investments to build new ones.

### **Conclusions**

The Odessa-Brody pipeline is still a strategically important venture for Ukraine from the viewpoint of diversifying oil delivery sources, the country's integration into the international oil transportation infrastructure, providing the country's oil refineries with raw material, and increasing revenue into the state budget. Despite completion of the first phase of the pipeline, operation of a terminal and a separate section of the pipeline, and proposals from specific countries and companies to implement the project, the pipeline is sitting idle at present and the question of deadlines for putting this EAOTC venture into operation is still open.

In Ukraine, as in any other country, experts are looking at the different alternatives for implementing the EAOTC keeping in mind the trends on the world oil market, as well as the outcome of the Iraqi war, and weighing up the pros and cons. But the choice of strategy for developing this project is being hindered (as always) by the Ukrainian leadership's political orientation toward Russia. Having one section of the EAOTC in operation, even if it is only partially loaded, is much more appealing than having an eternally "empty pipe," as is threatened if the country turns its sights to Caspian oil. What is more, neither western, nor Caspian partners have given Ukraine any guarantee of investing in the project or of filling the pipeline with Caspian oil. These factors, as well as Russia's proximity, with its vast oil supplies and influence on the Ukrainian leadership, could turn the pipeline in the reverse direction-from Brody to Odessa. It should also be noted that Ukraine must not simply finish building this pipeline (both the second phase, and its extension to Europe) and the Yuzhnyi terminal, but also carry out a set of measures to fill them with oil and ensure full-fledged development of the project.

As of today, the most important tasks are as follows: completing construction, signing contracts with suppliers and consumers on the pumping of oil, organizing an international experts' examination of the project and technological testing, including loading of the system, creating an international consortium for continuing construction of the pipeline to Poland, and drawing up other alternatives (primarily to Germany).

The current format of bilateral talks is not in keeping with the times and the state of the Odessa-Brody pipeline. Neither Poland, nor even Germany can at this point decide the fate of this transnational project independently. The European Union could do this, for many members (or potential members) of which the Ukrainian project is extremely interesting. The European Commission must include it on the list of priorities for developing the energy policy of the growing EU, neighboring countries, and partners and reconsider its own mechanisms of financial support. The latter presumes (after amendments to the EU legislation) partial financing of the feasibility study on different alternatives for extending the pipeline to Europe and of implementing the project, as well as the possibility of granting loans for finishing construction of the route. Russia, Kazakhstan, and Azerbaijan should also be included in the talks with the European Commission on the project.

As we can see from the above, there are no doubts today about the essential possibility of implementing the EAOTC project. But a question arises regarding how efficient the chosen route will be and how quickly it can be put into operation.

The lack of practical support from the partners is giving rise to concern that implementation of the EAOTC could be postponed, although the project itself is the simplest and cheapest way of resolving the oil export problem by bypassing the overloaded Black Sea straits.

In the next few years, there will unlikely be a new oil pipeline in the region, and the first phase of the Ukrainian route is already in operation. Many states and oil companies are interested in it. Ukraine has no other option but to see that the EAOTC takes off.

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