Kashagan and the Shifting Landscapes of Capitalization in the North Caspian Oil Industry:

Practical Lessons beyond the Clichés

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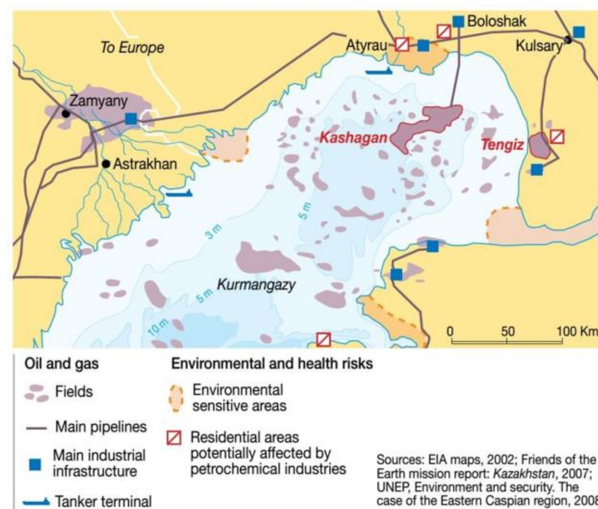
Executive summary

This brief states that the demise of the Northern Caspian oil project in Kashagan as a matter of *cash-all-gone*, as The Economist argued in 2014[i], is erroneous. Rather, the companies and the Kazakhstani state have being propping up each other in order to find channels of capitalization whilst keeping control of one of the largest oil-fields on earth. Moreover, although oil has started flowing from Kashagan only in late 2016, and implementation costs have skyrocketed through the years, the project has nevertheless been a catalyst for profit opportunities – cash must have gone somewhere after all.

Throughout the paper I highlight how the extraction of hydrocarbons is assembled through a complex network of actions involving: the formation of large partnerships between Transnational Oil Companies (TOCs) in order to share costs and responsibilities; the signing of binding contracts between the state and TOCs; the co-optation of environmental concerns; financialization; the sponsoring of corporate social responsibility projects; and the institution of special regimes of labour and taxation in Special Economic Zones. All these actions are aimed at controlling, rather than eliminating, the ecological, economic, and social risks immanent to extraction, whilst keeping the latter profitable for both the state and the companies. By offering some insights into this assemblage the paper counters simplistic policy-oriented interventions that downplay the wider international and local power relations involved in oil extraction, soliciting instead an approach that takes into account the latter multi-scale articulation and inter-related complexity.

Introduction

In the wake of the First Gulf War and the demise of the USSR, Kazakhstan's mainly untapped hydrocarbon reserves attracted the interest of an industry in desperate need of new resources. In the usual hyperbolic language of the industry the country gained the reputation of the latest "energy frontier"[ii], whose depths hid a glorious "Oil Dorado"[iii].



When Kashagan was discovered in 1993 it was advertised as the largest discovery since Prudhoe Bay, Alaska, thirty years before, electrifying both the transnational oil companies (TOCs) in charge of exploration and the government. Today, more than twenty years later, Kashagan has been sarcastically renamed “Cash-all-gone” and the hopes have been largely frustrated. Production costs have been rising fast[iv], a tendency seen in the industry at large, whilst the sharp decline of world oil prices has raised doubts on whether extraction is so difficult that Kashagan's EROCI (Energy Returned On Capital Invested) makes its oil a “capital sink” rather than an exploitable resource[v].

Through a careful reading of the relevant literature, as well as conversations with insiders of the industry and academics, in this paper I show how, contrarily to what is often assumed, Kashagan offers lucrative opportunities for both the companies and the Kazakhstani state, whilst at the same time locking the oil industry ever more into the socio-economic fabric of the region.

What's in for the Companies?

When international and national institutions for environmental protection, as well as environmental NGOs, engage with the behaviour of oil companies, often they do so in a “hole-centric” manner: they focus on the point of extraction and its environmental consequences whilst overlooking the broader network of relations that the extractive hotspot materializes. In this section, I suggest that taking on oil companies should involve also engaging with the denunciation of labour regulations, the role of financial markets and of oil contracts as co-constituting the viability of extractive activities.

Located four-and-a-half kilometres under the shallow waters of the Northern Caspian, Kashagan presents some of the most challenging conditions for oil extraction: the field is heavily overpressured (eight-hundred bar), presenting a challenge for drilling; in winter, with temperatures falling as low as minus twenty degrees Celsius, a coating of ice several metres thick covers the waters; the oil has a very high content (nineteen per cent) of hydrogen sulphide (H2S), a highly toxic and corrosive gas. The complexity of the processes of extraction and transportation has led, from the very beginning, to the involvement of some of the largest TOCs in the project: currently Shell, Exxon Mobil, ENI, CNPC, Inpex, Total, and the national oil company KazMunayGaz (KMG), all have shares in Kashagan's operating consortium, the North Caspian Operating Company (NCOC).

Indeed, as the scale and complexity of the project unfolded, the partners of the project turned away from the traditional single operator command-and-control model. The change of the operatorship in 2009 led to the creation of NCOC which, although spread responsibility for the development of the project, it created further delays. As an insider pointed out: “There used to be a normal operatorship set-up. Now it's just one committee after another. Each company has its own internal auditing, permitting

procedures, personnel management, communication, etc. Every single step has to be seen by everyone else. It's as if there was no CEO but the board met every day"[vi].

If the oil industry has incurred in increasing production costs, these have often been compensated with liberalization and financialization. For instance governments have encouraged foreign investment through production sharing agreements (PSAs) that establish joint ventures between companies and producing states, giving the former large shares of "equity oil". Such moves by states have propped up companies to develop fields in increasingly risky environments. For instance a PSA that gave Shell 100% equity participation was crucial for the company's move to develop offshore deepwater resources in Nigeria[vii]. Similar arrangements have also been the norm in Kazakhstan, as in the case of the country's two giant oil-fields: Tengiz and Kashagan.

In this respect it has been shown how the Tengiz "oil contract" between Chevron (TCO) and the Kazakhstani state entailed the binding of the state's share of production to the enterprise profitability. In practice this meant the state did not receive its share until 2008, when the company reached the agreed profitability threshold, fifteen years after the start of the contract[viii]. In Kashagan too, the PSA implies the same contractual obligations. In the light of the exorbitant costs of the project, this is likely to entail that the operating consortium will keep the state's share of production for a period of decades. Another implication of PSAs is that once signed, the state is legally prohibited from terminating the contract or altering its terms. This means that the changes in legislation implemented by the state to increase its bargaining power vis-à-vis MOCs (Tax Code in 2001, PSA legislation in 2005, Law on Subsoil Use in 2010) will only affect new projects, but neither Kashagan nor Tengiz. The rigidity of contractual terms works as a huge incentive for the operating consortium to profit from the project in the long run, playing on oil future markets to compensate for increasing production costs in the short term.

Indeed, the development of Kashagan has also been affected by the rampant financialization of the oil industry. When the discovery was made public in 2000, the state grossly over-estimated reserves in order to attract investment[ix], without distinguishing between reserves-in-place and recoverable reserves[x]. Whilst the figures for oil in place range from thirty to fifty million barrels, given the complexity of the reservoir the recovery factor is relatively low, about fifteen-twenty per cent. As the companies kept silent on these data, their shares on capital markets skyrocketed, as their silence equated to an invisibly "creative book-keeping". Initially, given the very high implementation costs, companies were keener to keep control of the field, whilst capitalizing on stock and future markets, rather than speeding up the project. For instance British Petroleum (BP), one of the initial partners, pointed first to recover its initial investment on stock markets, before committing to a further investment. As the project was declared commercially viable, BP had already recovered its costs with extra profits and sold its shares in 2001[xi]. Nevertheless, the stress on financialization and the relative under-investment in material production had slowed down the implementation,

causing the operator, AgipKCO (ENI), to announce the first delay in production to 2008.

Finally, although at current market prices the companies involved in the project could incur in financial losses in the short-term, they are also benefiting from the fact that the national currency has lost more than half of its value since the project false-start in 2013. Indeed, the contribution of the devaluation has been to considerably decrease the costs for personnel, goods, and services. Moreover, in 2002 the seaport of Aktau was transformed into a Special Economic Zone (SEZ). Here joint ventures between local and international companies produce pipe racks and steel, exempted from the payment of corporate, land, and property taxes as well as VAT[xii]. The Luxembourg-based steel giant ArcelorMittal and the Singaporean concern Keppel, specialised in off-shore rigs, have both opened plants in the zone[xiii]. The clause on the mandatory "Kazakh content" in the volume of goods and services supplied to the companies, reaching sixty per-cent, permitted the circulation of cheap labour for these companies, but also the expansion of a market for local subcontractors. The creation of the SEZ translated in lower costs for the oil companies operating in the area as they have been able to purchase cheaper machinery and equipment for their operations.

What's in for the Kazakh State and Local-Regional Economy?

Policy initiatives in – and about – oil-producing countries have been highly influenced by the so-called "resource curse" literature[xiv]. This literature argues that huge amounts of cash flows entering oil-producing countries create corruption, war, civil unrest and authoritarianism. However, it has been noted how the resource curse thesis tends to see the state as a discrete entity, as a fetish whose practices are insulated from its relationships with oil companies[xv]. The concern is that policy informed by this literature tends to produce normative knowledge about oil-producing countries without taking into consideration the wider international, and transnational, power relations that shape them. Rather, I suggest that states' practices, regulations, and institutions cannot be analysed without considering how they are produced through constant engagement with other actors such as TOCs.

Contrarily to the "curse" assumption, in the case of Kashagan a decade-long delay in production and taxable spin-off activities has meant billions of revenues lost for the Kazakh state coffers. However, delays in implementation have been partially compensated through fines and fees. Operating in an area rich in biodiversity, the consortium has been under constant pressure from local and international environmental organizations[xvi], as well as being repeatedly fined by the state for flaring toxic "sour gas" and for leaks from the pipelines that connect the rigs to onshore facilities. However, rather than stopping the project for the high risk that it poses to the surrounding environment, ecological concerns have been "captured" by the state and used as negotiating tools for raising KMG's stake in the project. In 2007, for instance, the state requested over $10 billion in compensation for non-compliance with environmental standards, blocking work on the field until the parties reached an

agreement. After months of negotiations, the shareholders finally agreed to allow KMG to raise its stake from 8.33% to 16.81%, paying $1.78 billion or roughly half their book value [xvii] . Nature thus became an accumulation strategy for the state, as the enforceability of fees monetized ecological risk, and created new markets for ecological restoration by local and international companies.

Kashagan has not produced any consistent volumes of output yet. Nevertheless it has offered opportunities for many companies, from logistics to construction to consultancy. It has been a channel not only for multinational, but also local capital, as a large amount of FDI from the Virgin Islands and the Netherlands was invested back in Kazakhstan, and utilised to establish large companies in the construction and logistics sectors, acquire media outlets and invest in financial assets. Vectors that connected regime members to foreign locales of capital accumulation strengthened the patrimonial system created around Nazarbayev and established a capitalist class expression of state institutions—an evolution of what anthropologist Katherine Verdery called *entrepratchiki*, half entrepreneurs and half apparatchiks[xviii]. As the Ministry of Energy has declared on his Facebook page in occasion of Kashagan's launch in December 2016, more than seventy joint ventures between TOCs and newly formed Kazakh companies have been established so far.

To see Kashagan as a “failure” would then be misleading, since, although it had not produced any oil, the project has nevertheless been productive for many years. The real estate sector in nearby Atyrau has been booming, companies have been implementing social responsibility projects all around the region, and the infrastructural “carbon lock-in” has been expanding: ports for export and for assistance to off-shore operations, shipyards for repairing and maintenance, the expansion of the Atyrau refinery, and a plant for the treatment of sulphuric acid.

Moreover, the corporate social responsibility projects implemented by NCOC – such as the building of schools, hospitals, cultural and sport centres; the renovation of roads and the upgrading of power-grids – have been an effective way for the state to partially outsource its own functions as a provider of social services, while permitting the company to brand itself as a caring and trustworthy actor in the region, downplaying the high ecological risks connected with the project – the possible explosions caused by high pressure and high temperature of the associated gas; the toxicity of hydrogen sulphide and the volatility of the enormous quantities of processed sulphur; the probability of leaks in the Caspian waters.

Towards a New Approach

Instead of implying a confrontational and zero-sum game between the state and oil companies, with this paper I wanted to underline the networked activities and relations – financial, environmental, and social – that characterise large extraction projects such as Kashagan. The latter, I have suggested, are enmeshed in a whole range of collateral activities which offer opportunities for capitalization, the reduction of costs and

responsibilities and, ultimately, control over resources as well as human and non-human life. Hence, when assessing the effects of extractive activities it would be fruitful to correct the erroneous perception of states-TOCs' relations as confrontational. Rather, it should be stressed how, in a world in which countries and companies stubbornly keep extracting hydrocarbons in ever more costly conditions (ecologically, socially, and economically), we can expect these actors to continue cooperate to control costs and risks, whilst finding profitable activities besides the traditional upstream-to-downstream oil commodity chain. By offering a more complex narrative, this brief tried to challenge policy interventions that focus on discrete entities – a corrupt state, a vampire company, a polluting project – without taking into account the multi-scale relations through which they are assembled. While we are not in front of an issue that could be simply resolved by "policy" interventions, attending to these complex intersections might better equip international and national institutions for environmental protection, as well as environmental NGOs, to address the broader network of relations that the extractive hotspot materializes.

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i "Cash All Gone: One of the World's Biggest Oil Projects Has Become a Fiasco", *The Economist*, 11 October 2014 [Online] Available at: http://www.economist.com/news/business/21623693-one-worlds-biggest-oil-projects-has-become-fiasco-cash-all-gone

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iii L. Kleveman (2003), *The New Great Game: Blood and Oil in Central Asia*, London: Atlantic Books

iv The cost estimate for phase 1 was increased to $46bn in January 2012, from the original estimate of $24bn. It has now reached over $50bn. The partners of the joint operating company (North Caspian Operating Company) are KazMunayGaz (16.81%), AgipKCO (Eni) (16.81%), Shell (16.81%), Exxon Mobil (16.81%), Total (16.81%), China National Petroleum Corporation (8.33%) and INPEX (7.56%).

v In *Capitalism in the Web of Life: Ecology and the Accumulation of Capital*, Jason Moore (2015:106) defines EROCI as "calories or joules per dollar". He goes on to show how "peak oil" does not picture an absolute peak in output, but rather "the peak 'gap' between the capital set in motion to produce a given commodity and the work/energy embodied in that commodity"(ibid.)

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xi Conversation with Assistant Professor of Oil and Natural Resource Management, Kazakh-British Technical University, Almaty, 2nd June 2016

xii Law of the Republic of Kazakhstan (2014), *On Special Economic Zones in the Republic of Kazakhstan (With Amendments and Additions as of June 10, 2014)*, [Online] Available at: http://www.kaznexinvest.kz/en/SEZ/legislation.php

xiii Organization for Economic Cooperation and Development (2011), *Competitiveness and Private Sector Development: Kazakhstan 2010 – Sector Competitiveness Strategy*, OECD Publishing, [Online] Available at: http://dx.doi.org/10.1787/9789264089792-en

xiv M. Ross (2013), *The Oil Curse: How Petroleum Wealth Shapes the Development of Nations*, Princeton and Oxford: Princeton University Press; M. Ross (2001), "Does Oil Hinder Democracy?",

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xv M. Huber (2011), "Oil, Life, and the Fetishism of Geopolitics", *Capitalism Nature Socialism*, 22 (3): 32-48

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