

Europe's Energy Security

Gazprom's Dominance and Caspian Supply Alternatives



Svante E. Cornell
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Editors



Central Asia- Caucasus Institute
Silk Road Studies Program

Europe's Energy Security: Gazprom's Dominance and Caspian Supply Alternatives

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Preface

The politics of energy have been key to the political and economic development of the Caspian region from the very first days of independence. Indeed, the energy security of the nations of the region has been at the heart of their efforts to build sovereign and prosperous states. This has been true whether countries have been endowed with large resources of fossil fuel, or completely devoid thereof. For producers, the arrangements governing the exploration and transportation to world markets of their energy resources has been a central element of their foreign policies, and in fact has largely decided their level of meaningful sovereignty. For consumers of energy, levels of dependence on energy-endowed powers have been equally important in determining their ability to formulate their domestic and foreign policies independently. Small wonder, then, that any analysis of the politics of the region has to factor in the political, economic as well as societal role of energy.

Yet for Europe, the discovery, on a higher political level, of the importance of energy security has been more recent, and mainly linked to the increasingly assertive policies that the Russian government and especially its monopolistic subsidiary, Gazprom, have adopted over the past years. This has led many Europeans to increasingly think in terms of the diversity of supply of oil and gas, and to realize Europe's highly problematic position vis-à-vis Russia.

As Europe has begun to explore ways to diversify its supply of energy, the potential role of the Caspian region has inevitably emerged on the agenda. Indeed, the Caspian Sea region is the most obvious candidate to serve as a new and relatively untapped source of natural gas and oil for Europe. Geographically, the region is located in Europe's vicinity, and both the states of the region and those that link it to Europe are largely friendly to, and seeking greater integration with, Europe.

Indeed, Caspian resources are already becoming a part of Europe's energy mix. In 2005, long before successive energy crises catapulted the issue of diversification of supply to the headlines of European media, the Central Asia-Caucasus Institute & Silk Road Studies Program released a book entitled *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West*. This book coincided with the completion of the first pipeline linking Caspian resources to the West, assessing this milestone to be of vast importance both to the region and to Europe. But the project, followed by a parallel natural gas pipeline, was only the first step in the long process of linking the Caspian region to Europe. Today, Azerbaijani oil is exported to the EU – mainly to Italian refineries – through the Turkish Mediterranean port of Ceyhan; while the first Azerbaijani natural gas recently reached the EU through the Greek market.

This has anchored the Western coast of the Caspian to Europe, with substantial implications for the broader interaction between the EU and the countries of the Caucasus. While this achievement is of historic proportions, it constituted only a first step in the process of diversifying Europe's energy supplies through direct links with the Caspian region. Indeed, the next chapter in this longer process is yet to be completed: linking the large quantities of energy available in the East Caspian producers of Central Asia to Europe. As major exploration projects will gradually come online in the coming years, competition over the export routes and destinations for these resources has already begun.

The fate of the western Caspian resources was decided in a manner highly beneficial to Europe; but not mainly thanks to Europe's efforts to accomplish that. Instead, it was the determination of the states of the region – Turkey, Georgia, and Azerbaijan – in combination with strong American support that made this happen. But balances have changed both in the region and globally: China's rise and Russia's newfound assertiveness pose important challenges to Europe's interests in the energy resources of the Caspian region.

These interests are by no means only selfish: by achieving direct links to the energy resources of both the East and West Caspian, Europe will contribute substantially to enhancing the sovereignty and security of the countries of the region, providing these landlocked countries with an additional vector in their foreign policies that would complement, not replace, their existing

relationships with Moscow and Beijing. Moreover, this would provide the ground for a broader long-term relationship between Europe and the region, one that would include – aside from energy – also issues of governance and democratic development, as well as security.

This book aspires to study several aspects of Europe's energy dependence on Gazprom, and the role of the Caspian as a source of alternative supplies. The book begins with two overviews of Europe's economic and energy security, by Robert Larsson and Mamuka Tsereteli, which show Europe's vulnerability, but also the potential lying in the complementarities between Europe and the states of Central Eurasia.

The book then proceeds to discuss the role of Gazprom in both Russian domestic and foreign policy, in chapters by Vladimir Socor and Pavel Baev, respectively, which provide a disturbing picture of the emerging Russian energy diplomacy. Following this, the focus shifts south and east. A chapter by Temuri Yakobashvili puts forward the role of the emerging Black Sea region as a hub in European energy security, followed by chapters devoted to the specific roles of Turkey and Azerbaijan in chapters by Volkan Özdemir and Elin Suleymanov. Subsequently, two specifically important infrastructural projects are studied – the Nabucco pipeline, in a chapter by Nicklas Norling, and the Trans-Caspian pipeline possibilities, by Svante Cornell. The book concludes with a chapter by Zeyno Baran on the need of a more cohesive EU approach to energy security.

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Svante E. Cornell

Niklas Nilsson

Executive Summary

European energy security is facing a set of serious challenges connected to Europe's dependence on Russian energy and the need for diversifying energy supply sources.

Already high and rising European energy demand will, especially with the eventual decline of North Sea resources, further increase the importance of the already significant energy imports from Russia and the Middle East. Europe currently imports over half of its natural gas from Russia, while several East European states are almost completely dependent on Russia for their gas supply.

The problematic aspects of European dependence on Russian energy became especially obvious during the Ukrainian gas crisis in January 2006, and have been subsequently reconfirmed by Russian energy diplomacy against Belarus, Georgia, and Lithuania. These developments have highlighted both a Russian willingness to use its energy leverage as an active component of its foreign policy and the vulnerabilities the EU is subjected to through reliance on Russia as a dominant gas supplier.

In this regard, the considerable oil and gas resources in the Caspian region, primarily in Azerbaijan, Kazakhstan, and Turkmenistan, constitute the most accessible alternative energy supplies for Europe. Especially for gas, Russian resources are unlikely to fill future European demand due to a lack of domestic investment in new energy projects and infrastructure. Such investments are made unlikely in the foreseeable future by the Kremlin's political utilization of Gazprom, manifested in Russia's artificially low domestic gas prices, and the company's increasing engagement in business conflicts aimed at eliminating foreign presence in the domestic energy sector.

It is thus nearly certain that significant amounts of oil and gas from the region will reach the European market in the near future. The question is through which supply routes this will take place; either through Russia directly through the East-West corridor. As supply diversification should be

understood as a key component of European energy security, it is imperative that access routes to Caspian resources are secured, which are not under Russian influence.

So far, the Baku-Tbilisi-Ceyhan (BTC) oil pipeline and the South Caucasus (or Baku-Tbilisi-Erzurum) gas pipeline (SCP), constitute the only infrastructure for bringing Caspian energy to the European market, which is not under Russian control. A major problem in consolidating independent transit routes to Europe, envisioned as an East-West Energy Corridor through Turkey and the South Caucasus, lies in securing sufficient energy supplies from Kazakhstan and Turkmenistan on the eastern shore of the Caspian Sea. In this regard, oil constitutes less of a problem than gas, since oil can be shipped across the sea from Kazakhstan to Azerbaijan, adding to the already considerable Azerbaijani oil supplies fueling the BTC pipeline and reaching Europe.

For Caspian natural gas to reach Europe in significant amounts, however, considerable infrastructure development is required. Since Azerbaijani gas deposits have proven insufficient for considerable export to European markets through the SCP, access is needed above all for bringing the considerable natural gas reserves of Turkmenistan across the Caspian Sea and on to Europe. A successful implementation of EU and U.S. sponsored projects such as the Nabucco and Trans-Caspian pipelines would provide the infrastructure needed for bringing significant amounts of Turkmen gas across the Caspian Sea and on to Europe through pipelines independent from Russia.

There is, however, a clear risk that these projects will fail to materialize, especially as an effect of the so far rather successful Russian strategies for counteracting them. Russian energy strategy is based on the principle of as far as possible absorbing control over Central Asian resources, implying control over energy production and transit, as well as gaining stakes in infrastructure and energy companies downstream in Europe.

Russia has sought to counteract independent European access to Caspian energy in several ways. First, through its energy monopoly Gazprom, Russia has secured long term contracts with Kazakhstan and Turkmenistan for purchases and re-exports of these states' energy resources through the

Russian pipeline network. This relationship was consolidated by the agreements made during President Putin's trilateral meeting with Kazakh and Turkmen presidents Nazarbayev and Berdimukhamedov in May 2007, granting Russia increased control over Kazakh and Turkmen energy exports to Europe. As the practically sole outlet for Central Asian gas, Russia is able to purchase cheap gas from these states which is utilized for domestic consumption, thus freeing up Russian gas for export to Europe, often at twice the price.

In addition to Russian efforts to control exports of Central Asian energy exports, Russia has taken the lead in forming an intergovernmental gas cartel through the Gas-Exporting Countries Forum, the first steps toward which were taken at a meeting in Doha in April 2007. The formation of a GECF cartel would consolidate Russia's dominance as a gas exporter, allow Russia an even larger degree of control over European energy supply, and would likely help Russia to manage future Iranian competition on the European market.

Second, Russia is seeking to provide new infrastructure for energy transit to Europe from the Caspian, which is aimed at reducing the rationale for projects such as Nabucco, which would connect the region's resources to the European market through Turkey, and the Trans-Caspian pipeline. For oil, the Burgas-Alexandroupolis pipeline constitutes a competitor to the BTC and is fueled through tanker traffic across the Black Sea, from Russia's port of Novorossiysk. The Blue Stream gas pipeline, running north-south under the Black Sea between Russia and Turkey, is intended to compete with the SCP; however it has so far not been running at full capacity. Two other Russian projects have been proposed with the intention of competing with the Nabucco project. These are the Blue Stream II, effectively an extension of the Blue Stream for supplying gas to the Balkans, and the South Stream, planned to run under the Black Sea from Russia to Bulgaria. South Stream thus also conforms to Russia's strategy of as far as possible reducing its dependence on transit states such as Turkey, following a similar logic as the proposed Nord Stream pipeline to be built under the Baltic Sea.

The realization of these proposed projects would seriously impede the prospects for independent European access to Caspian energy resources. While access would certainly be secured, European prospects for supply

diversification would be diminished, and dependence on Russia would increase even further.

Third, the EU's inability to unite around a common energy strategy is allowing Russia and Gazprom to secure European energy demand through buying majority shares in European energy companies, and striking bilateral deals with individual EU states. The realization of the existing Burgas-Alexandroupolis pipeline, as well as the proposed Blue Stream II and South Stream pipelines, requires the consent only of the states directly involved in these projects. To these, transit taxes and prospects for developing energy storage sites and becoming hubs for energy imports to the EU are naturally highly beneficial. A similar argument can be made for the Turkish agreement to the Blue Stream pipeline, although this was concluded under highly questionable circumstances, allegedly involving severe cases of high-level corruption.

These three points underline imminent challenges to the development of independent European access to Caspian energy. Indeed, if Russia proves successful in its strategy for controlling all parts of the production- and supply chain, Nabucco and the Trans-Caspian pipeline would likely lose their commercial viability. Furthermore, doubts regarding the viability of these projects naturally make individual EU states, whose participation is crucial for the realization of Nabucco (such as Bulgaria, Hungary, and Austria) more inclined to accept projects initiated by Russia, as these may be implemented much more efficiently and involve significant benefits for these states. A major problem on the EU's part is thus its lack of cohesion and differing national priorities among its members, resulting in an inability for providing Nabucco with the political and financial support required for the project to be perceived as realistic.

A successful EU energy diversification strategy also requires the participation of key non-EU states in the production- and transit chain. Energy transit from the Caspian would turn Turkey into a major energy hub to Europe, and Turkey's participation is crucial in any effort to bring Caspian resources to Europe outside Russia's influence. However, the political and economic relations which have emerged between Russia and Turkey and especially the energy relationship between these states, which was consolidated with the realization of Blue Stream, may provide Turkey with

profitable incentives to become a link in Russia's supply network to Europe, rather than the key host state for Nabucco. Future Turkish alignment in Caspian/Black Sea energy politics will likely be closely related to the prospects offered for EU integration.

Also crucial is the willingness of Kazakhstan and Turkmenistan to commit their energy for export to Europe. In this regard, Kazakhstan is pursuing an export strategy based on multiple routes. Especially, as output from the Kashagan field rises, Kazakhstan needs to find new routes for its oil exports. This can be done through three options: expanding the existing Caspian Pipeline Consortium pipeline (CPC) running through Russia to the Black Sea coast; feeding additional oil into the BTC pipeline; and exporting eastward to China through a new pipeline that is currently under construction. Kazakhstan will thus be in a position where it can adjust its export between these three channels, thus granting Kazakhstan greater sovereignty and room for maneuver.

Turkmenistan has made long-term agreements to export its gas through Russia, but is also seeking to diversify its export routes. The development of a trans-Caspian pipeline has long been hampered due to discoveries of natural gas in Azerbaijan's Shah-Deniz field and Turkmen-Azerbaijani disputes over demarcations in the Caspian Sea; however, recent developments suggest that these states may be moving closer to resolving their differences, thus potentially removing a major obstacle to the Trans-Caspian pipeline. Turkmenistan has recently also explored possibilities of exporting gas to China, as well as to Pakistan through Afghanistan.

The energy strategies of Kazakhstan and Turkmenistan present both opportunities and challenges for EU diversification strategies. On the one hand, if serious commitment can be provided for the Nabucco and Trans-Caspian pipelines, the EU would stand a good chance of securing a significant share of the energy exports of these states. On the other hand, Russian and especially Chinese competition for these resources is likely to pose significant challenges to EU strategies.

A crucial issue in this regard is the need for EU-U.S. alignment, as their interests in energy diversification through direct imports from the Caspian region are for all practical purposes identical. Serious political and financial

support is needed to provide feasibility for both the EU-sponsored Nabucco project and the U.S.-sponsored Trans-Caspian pipeline. Moreover, these projects are mutually dependent, as one will not make sense without the other.

Policy Implications

European Strategy toward the Black Sea/Caspian Regions

- Concerning its overall relations with the Black Sea and Caspian regions, the EU needs to realize their strategic importance and develop more proactive approaches toward these regions within its long-term political and economical security strategies. This should include promoting closer ties with the regional states and, where possible, their gradual integration with European institutions. The EU could undertake several measures to support the region's development and improve EU access to its resources. These include supporting the development of infrastructure for energy and trade, and the promotion of active investment policies.
- The EU needs to develop an active strategy for securing access to the energy resources of the Caspian region, and handling Russian and Chinese competition for these. Any such strategy must acknowledge the region's geopolitical realities, and would benefit from drawing on US experience.

European Energy Policies toward Gazprom and Russia

- In order to tackle European energy dependence on Russia, a more formal framework should be established to streamline EU energy policies. European states must realize that working together on issues of energy security, especially when dealing with Russia, will be mutually beneficial in the long term. This should include more proactive steps toward demanding reciprocity in interactions with Russia, including greater transparency, allowing third-party investment in the energy sector, and respecting the rule of law. The EU should also consider prosecuting companies like Gazprom or Transneft for their monopoly positions.
- European companies doing business with Gazprom, politicians dealing with energy security issues, and consumers depending upon deliveries of Russian gas, need to recognize the complications and uncertainties created by the relationship between Gazprom and the Russian state. Companies

should acknowledge that current politics play a crucial role in the decision-making of Gazprom, limiting its reliability and understandability as a partner. Politicians need to consider the mercantilism in the behavior of the Russian leadership driven by far closer ties with the energy business than those that exist between European companies and their respective governments. Consumers need to realize the fact that Russian gas may be subject to political intrigues and conflicts that could escalate to a level where the Kremlin would indeed consider the ‘weaponization’ of its energy instruments.

- The most efficient measure for the EU and U.S. to forestall the emergence of a Russia-led gas-cartel would be to preemptively open direct access to Central Asian gas on competitive terms, which would undermine both Russia’s ability to dominate a cartel and the cartel’s price-setting power. European consumer countries also need to prepare for developing Iranian gas fields, when this becomes politically possible. Upon the formation of a gas cartel, the entry of Iranian gas to export markets may well otherwise end up being managed by Gazprom. Boosting liquefied natural gas development outside Gazprom’s influence is another important means for diversifying supply. LNG from Qatar would play a crucial role in this regard, especially as its close links with the West would probably keep it out of a gas cartel.

Developing the East-West Energy Corridor

- It is absolutely vital that the EU diversifies its energy supply by establishing an East-West energy corridor through Turkey and the South Caucasus. The completion of the Turkey-Greece pipeline is an important first step, but must be supplemented by the Greece-Italy connection, Nabucco, a trans-Caspian gas pipeline, and perhaps in the future White Stream.
- The U.S. has demonstrated its commitment to financially and politically supporting the trans-Caspian pipeline, which is an essential link in the East-West corridor, and Europe should align with this strategy. The Nabucco pipeline could serve as a major incentive for Turkmenistan and Azerbaijan to resolve their differences, and its construction would also reignite the urgency of a trans-Caspian pipeline. These two projects stand or fall together, and a precondition for securing funding for Nabucco is to provide the project with clarity and strong political support. As

Azerbaijan and Turkmenistan have the capability to fill the bulk of the pipeline, a joint push from Europe and the U.S. in realizing this would likely be far more positively received among investors than relying on Iranian gas.

- Europe should also actively support the Turkmen-Azerbaijani dialogue, as this is a requirement for a Trans-Caspian linkage. A component of this could be supporting joint development of the Kyapaz/Serdar field and ensuring the westward export of its resources. Furthermore, a higher degree of direct European engagement is needed with the new Turkmen leadership, as this would likely encourage the country's much needed transformation process from totalitarian dictatorship into a "normal" semi-authoritarian state.
- Even Russia and Iran would benefit from the realization of Nabucco and the Trans-Caspian pipeline. Greater competition will compel Russia to invest further in its energy industry. Iran, for its part, could focus its efforts on providing a future supply of gas for Nabucco, and on developing its LNG industry, which holds great significance for both Europe and Iran in the longer term.
- Political determination to realize Nabucco and the Trans-Caspian pipeline is also needed for securing the engagement of the producer and transit states that constitute key components of the East-West energy Corridor. In light of its current dependence on Russian energy, Turkey itself faces a need to diversify its energy supplies. However, given the uncertainty of EU-sponsored projects, consolidating its current political and economical relationship with Russia also holds several advantages, especially if Russia would allow for increased amounts of its gas to be exported through Turkey. This would further diminish Turkey's room for maneuver in energy politics and in all likelihood thwart EU strategies for diversified energy imports from the Caspian region, as Russian-sponsored alternatives would remove the rationale of Nabucco and other diversification projects.
- When dealing with the region, Europe must realize that it is in no position to put conditions on energy- or other relationships. Central Asian states are not devoid of options; as both Russia and China are in more advantageous positions both politically and geographically in the region. Instead, European engagement with the region should evolve through a broad dialogue on security, energy and governance.

Part I: European Energy Security and Central Eurasia

Europe and Caspian Energy: Dodging Russia, Tackling China, and Engaging the U.S.

Robert L. Larsson*

Key Argument: Europe's high and rising energy demand is highlighting the security problems associated with its dependence on especially Russian gas supplies, and the need for diversifying European energy supply. The Caspian region provides the most accessible alternative in this regard, provided that the region's resources are transported through the Caucasian corridor, which also requires significant infrastructure investments. The EU, however, faces several challenges to securing Caspian energy resources, above all in the form of Russian attempts to consolidate its gas monopoly position and competition from China. Also, the EU has so far been unable both to pursue a common energy policy and to acknowledge the geopolitical realities of the Caspian region.

Policy Implications

- Unless Europe proves able to reduce its gas consumption, Europe faces an increasing need for new gas supplies. While these may in part be met by increased North Sea Imports and LNG, the lion's share will likely be imported through pipelines.
- This may cause an increased reliance on Russian gas, which is troubling especially in light of Russia's unreliability as an energy supplier. Europe thus needs to diversify its gas imports, and the best option in this regard is the Caspian region.
- Securing access to the resources of the Caspian region, and managing Russian and Chinese competition for these, requires the EU to develop an active strategy toward the region, acknowledging its geopolitical realities, and aligning with and drawing on the experience of the U.S.
- In order to diversify its gas supply, the EU should also promote the development of infrastructure independent of Russia through the Caucasian corridor and on to Europe. In this case, the proposed Nabucco pipeline is the best option proposed so far.

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Introduction and Background

This chapter is written with the basic assumption that Europe is in need of new energy supplies. It aims to address the topic of Caspian energy resources from a European point of view, focusing primarily on natural gas, and assessing in particular how these assets should be secured and brought to Europe.

Europe has not been self-sufficient in natural gas since 1980 and in 1996-1997, import levels of natural gas outflanked domestic production, due in large part to the gradual depletion of North Sea resources. In terms of volume, the great importers and consumers, such as Germany, Italy, Spain, and the Slovak Republic, have increased their already significant imports of gas. Minor importers, such as the Netherlands, the Czech Republic, Greece, and Portugal, have also substantially increased their share of imports.

Europe has three main sources for gas, namely the North Sea, North Africa, and Russia.¹ Globally speaking, Russia, Iran, and Qatar are the major producers, but geographical proximity to North Africa and the North Sea are reasons for Europe's trade pattern. Today, Russian gas constitutes the bulk of European imports.

In 2003, 38 per cent of the EU's gas imports were of Russian origin accounted for. Today, however, the Eastern part of Europe, with a much higher dependence on Russian gas, is included in the EU. In parallel, Spain and Portugal are more dependent on Algeria and Libya. Table one illustrates that the EU now imports 50 per cent of its gas from Russia. In addition, 70 per cent of the EU's gas imports are used for power generation,² indicating the strong linkage between energy supplies and security.

Country	% of total imports
Russia	50
Algeria	23
Norway	22
Others	5

Source: EU figures in Energimyndigheten (2006), Europas naturgasberoende: åtgärder för tryggad naturgasförsörjning (Eskilstuna: Energimyndigheten), p. 21.

¹ See Energimyndigheten, Europas naturgasberoende: åtgärder för tryggad naturgasförsörjning, Eskilstuna: Energimyndigheten, 2006.

² Jonathan Stern, "European Gas Supply and Security Issues", presented at the seminar "European Dependence on Russian Energy", Nätverket för Olja och Gas, Stockholm, 13 September 2005.

According to estimates made by the International Energy Agency (IEA), the EU's import needs will be five or six times higher than its domestic gas production in the year 2030. While Russia is indeed important, Russia's exports of gas to Europe will not necessarily meet this demand. Russia already has substantial difficulties in meeting existing contracts. Furthermore, any rise in Russian exports may well either be used domestically or go to the Pacific instead.³ In the short-term perspective, there are physical reasons – existing pipelines – for assuming that Europe will be the key market for the lion's share of Russian gas. In addition, most analyses on future gas needs in Europe rely on, for example, the IEA's so-called reference scenario. This is basically a business-as-usual scenario where no actions to reduce usage or increase efficiency of energy are envisaged. If the IEA's 'alternative scenario' is scrutinized, however, it is clear that not all suggested new gas pipelines to Europe are needed. Europe's energy need could decrease by 90 billion cubic meters per year if it made an effort to reduce usage and increase efficiency.⁴

Turning to crude oil, the domestic reserves of oil in Europe are limited. Production levels have been relatively constant during the last decades. Imports decreased after the oil crises of the 1970s, but have risen again since the early 1980s. For example, the Czech Republic and Portugal have substantially increased their imports of oil in relative terms, while in absolute volumes; Italy, Spain, and the UK have increased their imports even more. Russia together with other suppliers of the former Soviet Union (FSU) had a 30 per cent share of Europe's imports of oil in 2004. The FSU was followed by Norway and Saudi Arabia, which had roughly 20 and 10 per cent respectively.

³ Isabel Murray, "Russian Energy and European Dependence", presented at the conference "New Security Threats in Eurasia: Implications for the Euro-Atlantic Space", *Central Asia - Caucasus Institute & Silk Road Studies Program*, Stockholm, 19-20 May 2005.

⁴ IEA, *World Energy Outlook 2006*, Paris: *International Energy Agency (IEA)*, 2006.

Origin	2000	2002	2003	2004	Share in % in 2004
Former USSR	89,5	123,2	140,7	158,5	30,8
Norway	114,8	101,6	104,6	104,0	20,2
Saudi Arabia	65,1	53,1	61,5	66,1	12,9
Libya	45,5	38,8	45,7	49,6	9,7
Iran	35,5	25,9	34,7	35,9	7,0
Middle East (other)	13,1	19,6	11,7	9,0	1,7
Others	121,5	110,7	94,5	91,0	17,7
Total imports	485,0	472,9	493,5	513,9	100,0

Source: Organization for Economic Co-operation and Development.

The backdrop of Europe's problems is that the future depletion of oil and gas resources in the North Sea will further increase the importance of Russian and Middle Eastern resources. Turmoil and political instability in the Middle East is likely to remain for the foreseeable future. Russia is less volatile than the Middle East, and its reserve base contains around 30 per cent of the world's total proven resources of gas and 6 per cent of its oil. Russia hence holds a great potential for remaining Europe's key supplier.

Nonetheless, Russia under Vladimir Putin has a new boost of confidence, much due to its power position on the international energy market, and it is advancing its interests in and around Europe to an extent that has not been seen since the time of the Soviet Union. This is not to Europe's advantage.⁵ By acquiring assets in the form of companies and infrastructure on European downstream markets, Russia is entrenching its position as a key actor in Europe. The Russian endeavors contain an ambition to strengthen control over states that traditionally have not been connected to Russian influence, for example Algeria. As a consequence, Russia enjoys great influence over most pipelines that supply Europe with oil and gas – not only those that run through Russian territory.

⁵ See further Larsson, Robert L, "Tackling Dependency: The EU and its Energy Security Challenges", Stockholm: *The Swedish Defence Research Agency (FOI)*, 2007, FOI-R-2311-SE.

Europe's problems on the domestic market are numerous. Challenges stem from illegal state subsidies, cross-ownership, climate targets, custom tariffs, and protectionism, but the geopolitical challenges often overshadow other aspects. The EU has traditionally failed to acknowledge the magnitude of the strategic nature of energy trade.

However, after a series of incidents when Russia used its energy leverage to bully Georgia, Ukraine, Belarus, Moldova, Lithuania, and Estonia, Brussels got a rude awakening and, in 2006, the EU Commission and the General Secretary of the Council at the time, Javier Solana, created a document called "An external policy to serve Europe's energy interests"⁶. The document concludes that the threats toward supplies come from unstable countries and those that use energy as a mean for pressure. In addition, the document stresses that an external actor who enters the inner European market without facing competition at home constitutes a threat. These formulations point toward two suppliers – the Middle East and Russia.

The topic of security of supplies has thus gradually found its way to the top of the European energy agenda. The European Council also stressed the importance of the matter when it called for a common EU policy during 2006.⁷ The efforts are aimed at forming a common external energy policy by forming a dialogue between producers and transit states, and also by seeking the diversification of sources in combination with mechanisms for crisis management. These can be seen as the first tentative steps toward a new energy agenda for Europe. Nonetheless, the so-called third legislative package on energy that came in September 2007 bears witness to the fact that a stronger policy is in the making.

If one assumes that the EU will fail to reduce its craving for more gas and oil, it then has to increase supplies by increasing imports. Practically, it means that besides managing the existing trade patterns, the EU must first increase its efforts to acquire assets of oil and gas and second find new import channels for these energy carriers.

⁶ EU Commission, "An External Policy to Serve Europe's Energy Interests", *European Union*, 2006, S160/06.

⁷ Council of the European Union, "Brussels European Council 23/24 March 2006: Presidency Conclusions", Brussels: *European Union*, 18 May 2006, 7775/1/06.

Due to the overwhelming political and geographical problems connected to sub-Saharan and South American resources, the assets of the Caspian basin have emerged as a promising alternative.⁸ The reason is not primarily the region's *proven* reserves, but rather its *potential* reserves combined with an actual accessibility for foreign actors – something that is missing in other parts of the world, for example the Middle East.⁹ The following sections elaborate on the regional assets and possible ways for the EU to access these.

How to get Hold of the Caspian Energy Assets

There are substantial differences between the oil and gas sectors. Gas is usually traded by long-term contracts and it is overwhelmingly pipeline borne. Oil, in contrast, is mainly traded on a spot market and is much easier to transport by trains or tankers. The energy extracted in the wider Caspian region, however, lacks natural outlets to ports and is reliant on pipelines.

Since it is impossible to buy Caspian energy on a spot market in the same way as in Europe's trade with the Middle East and North Africa, Europe must pay greater attention to its strategy toward the Caspian region for this to be successful.¹⁰ Three issues must be included: a common energy policy; a policy to de-Russify Caspian energy; and a policy to tackle China. To this could be added a policy for joining forces with the U.S.

Europe has balanced between a market-based strategy and a geopolitical strategy for some time. On the one hand, the EU has the ambition to promote transparent, mutual and non-discriminatory trade relations. On the other hand, however, the EU has shifted its posture from a pure market-based approach in favor of a geopolitical strategy. Even if this can be seen as

⁸ For the purpose of this paper, the energy producers of the Caspian region are the former Soviet republics of Azerbaijan, Kazakhstan, Uzbekistan, and Turkmenistan, together with Iran. Russia is naturally a key producer, but since the chapter seeks to explore ways to avoid further dependence on Russia, it is not included unless stated otherwise.

⁹ For a background and overview of the regions resources, see IEA, "Caspian Oil and Gas: The Supply Potential of Central Asia and Transcaucasia", Paris: *The International Energy Agency (IEA)/The Energy Charter Secretariat*, 2001.

¹⁰ Some of the peculiarities of the region and the problems of exploration and development are discussed in Svetlana Tsalik, "Caspian Oil Windfalls: Who Will Benefit", New York: *Caspian Revenue Watch*, 2003.

a necessary strategic choice, it may also rock the EU's foundation and legitimacy.¹¹

A common energy policy for the EU has long been in the making, but has never gained momentum. Although there have been attempts to incorporate energy issues into some chapters of the treaties signed at numerous intergovernmental conferences, some EU members have been reluctant to support the idea. Due to high energy prices and emissions of greenhouse gases, there are indications that new efforts will be made. In this context, Russia's arbitrary policy has acted as a catalyst. However, disunity still plagues cooperation and the different agendas of EU member states make it difficult to join forces.¹²

The EU's 'post-modern' and market-based approach works quite well vis-à-vis its traditional suppliers, such as Norway, but any engagement in the Caspian region requires the EU to adhere to a realistic posture. Hence, the EU's acknowledgement of geopolitical realities is an advantage – it is impossible to be post-modern in the Caspian region. As long as the U.S., China, and Russia act this way, so must the EU. The EU cannot take for granted that the energy companies act in the interest of their respective nation, or in the EU's.¹³ It is a well-known fact that several of Europe's largest energy corporations, such as EON, Enel, and BASF, have vested interests with the Russian *de facto* gas-monopoly Gazprom. Hence, unless the EU develops a strong, coherent, and unified energy strategy, it will be very difficult to act as a strong consumer lobby when dealing with coercive producers and strong competitors in the Caspian basin, as well as on its home turf.

Currently, producers exploit or exacerbate the existing lines of division within the EU.¹⁴ Italy and Germany have both been willing to concede to Russian energy policies, while new EU members such as Poland and Estonia have obstructed Russia's strive for increased influence – often in a counter-

¹¹ See discussion in Larsson, *Tackling Dependency...*

¹² "Disunity Hampers Common Energy Policy", *Oxford Analytica*, 1 December 2005. [<http://www.oxan.com>], accessed on 2 December 2005.

¹³ Correljé, and van der Linde, "Energy Supply Security and Geopolitics: A European Perspective", *Energy Policy*, No. 34, pp. 532-543, 2006.

¹⁴ Karin Anderman et al., "Russia-EU External Relations: Russian Policy and Perceptions", Stockholm: *Swedish Defence Research Agency (FOI)*, February 2007, FOI-R-2245--SE.

productive way. Existing trends on the global energy markets suggest that bilateralism is increasing in importance. In Europe's case, this is embodied by the Nord Stream project¹⁵ and, for example, by Hungary's connection to Russia.¹⁶ The bottom line is that the EU must, if it wants a share of the Caspian reserves, get together and act as one united union from a geopolitical point of view.

As indicated, Russia's strong position is a pivotal dimension in Caspian energy exports. Kazakhstan, Uzbekistan, and Turkmenistan are to some extent dependent on Russian pipelines in order to ship energy resources to consumer markets. As the middle-man monopoly player in the region, Russia enjoys leverage.¹⁷ This leverage embodies itself in such a way that Russia is able to buy Central Asian energy cheaply and re-sell it at a much higher price in Europe. This has been a source of concern for both consumers and producers. Consequently, the states of Central Asia have become more interested in shifting toward new markets in China and India.

The acts of liberalization that have been seen in Russia are limited in scope and, in fact, Gazprom's gas export monopoly has been consolidated into law. This limits the potential of Central Asian exporters to become serious competitors to Russia. For Europe, a consequence is that when Central Asia turns away from Russia, it also turns away from Europe – unless a trans-Caspian gas pipeline is constructed. Besides the rather relentless efforts aimed at convincing Russia to act in accordance with the Energy Charter,¹⁸ Europe should promote initiatives for bringing Caspian energy to European markets without relying on Russia.

Another important issue is the competition between consumers. An obvious example is the struggle between Japan and China over Russia's Siberian resources, but also U.S.-China competition in South America and Central Asia. This competition is not only an issue of money, but also one of

¹⁵ Robert L. Larsson, "Nord Stream, Sweden and Baltic Sea Security", Stockholm: *Swedish Defence Research Agency (FOI)*, March 2007, FOI-R--2251-SE.

¹⁶ Robert L. Larsson, "From Blue Stream to Nord Stream: Strategic Gains and Economic Flaws", in: Jakob Hedenskog, and Viktor Lavrenyuk (Eds.) *Comparing the Baltic and Black Sea Regions: Regional Security, Energy Security and Euro-Atlantic Integration*, Stockholm: *Swedish Defence Research Agency (FOI)/Centre for International Studies (CIRS)*, 2007, pp. 31-55.

¹⁷ Janusz Bugajski, "Energy Policies and Strategies: Russia's Threat to Europe's Energy Security", *Insight Turkey*, Vol. 8, No. 1, 2006, p. 146.

¹⁸ Energy Charter Secretariat, "The Energy Charter Treaty and Related Documents", 2004.

strategic commitment. Russia and China have a historical legacy of mistrust and competition along with a number of minor disputes. Seemingly, these problems are over-bridged by the energy trade, but they are far from resolved. Russia does not want to become strategically dependent on China as a customer.

However, at the tactical level, the situation is changing quickly and Russia is using its resources in order to enforce economic concessions and economic support for its various projects. In the Caspian region, Russia and China are not trading partners, but competitors. China has increased its presence in the region and this has, by and large, been at Russia's expense (even though Russia retains a key role). In this context, it is worth bearing in mind that the Chinese perspective on development is long-term in nature,¹⁹ while Russia opts for short-term profit. Step-by-step, China is building a mighty state and biding its time. As Europe's policy is also of a short-term nature, it tends to miss the big picture when it is occupied with technical cooperation and other foreign-policy issues.

Competition is usually understood as something to strive for, but competition among consumers is only of benefit for the producers. As a response to international criticism of Russia's energy policy, President Putin has threatened Europe with turning eastward, toward Japan and China, where 'more grateful' importers are found. Implicitly, he is saying that critics of Russia may well end up without oil or gas, a statement that might invoke a culture of appeasement. Europe thus has to engage in an arena where stakes are rather high. While there are physical limitations to Russia's ability of realizing its threat in the short term, the energy-thirsty Asian powers are more than willing to pay for additional pipeline capacity from the Russian heartland. Their interest in criticizing Russia for its energy policy, or taking a tough stand on Human Rights and its failure to build democracy, is lukewarm to say the least. Consequently, during the coming years and decades, there will likely be shifts in the Russian export pattern. Russia's ambition to conclude long-term contracts, for example, suits the Chinese tradition, while Europe is more interested in developing spot markets for oil

¹⁹ For more information on China, see Ingolf Kiesow, "China's Quest for Energy: Impact upon Foreign and Security Policy", Stockholm: *The Swedish Defence Research Agency (FOI)*, 2004, FOI--1371--SE, and Kristina Sandklef, "Energy in China: Coping with Increased Demand", Stockholm: *The Swedish Defence Research Agency (FOI)*, 2004, FOI-R--1435--SE.

and gas. There is a clear risk that the U.S., China, India, and Japan will sidestep Europe and lay their hands on what Russia has to offer. As indicated, China is also a competitor to Russia as it tries to secure the Caspian assets by tying the Central Asian states closer to itself. It has so far been quite successful in this endeavor, and challenging both Russia and China might be an overwhelming task given Europe's inexperience of acting in this market.

There is only one actor that, at least partially, shares Europe's values and that has strategic reach, namely the U.S. The U.S. both has experience of the region²⁰ and the resources for strategic commitment. Together, the U.S. and EU thus have great potential for advocating initiatives that are mutually advantageous. It is not in the U.S. interest for Caspian energy to go to China or for Europe's dependence on Russia to increase even further. However, one of the easiest ways of channeling Caspian energy to world markets is via Iran, an option that Washington disapproves of. These and a few other options are elaborated on below.

How to Bring it Home

This section focuses on four options for bringing Caspian energy to Europe. The main advantages and drawbacks for Europe are outlined and discussed here, while some specific aspects are elaborated on in subsequent sections of this volume.²¹

Option One: Secure the Caucasian-Turkish Lifeline

There are options and ongoing projects for bringing Caspian energy to Europe without Russian transit. The most prominent project undertaken during the last few years is the Baku-Tbilisi-Ceyhan oil pipeline (BTC), aimed at channeling Caspian oil via Georgia to Turkey's south coast.²² Driven by Western interest and actors, most notably British BP, but with strong support from Washington, it has come to be the most important oil

²⁰ See for example John C.K. Daly et al., "Anatomy of a Crisis: U.S.-Uzbekistan Relations, 2001-2005", Uppsala: *Central Asia-Caucasus Institute & Silk Road Studies Program*, February 2006.

²¹ For example the chapter on Nabucco by Nicklas Norling and the chapter on Trans-Caspian Energy Security by Svante Cornell.

²² The best publication on the topic so far is S. Frederick Starr, and Svante E. Cornell (Eds.), "The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West", Uppsala & Washington: *Central Asia-Caucasus Institute & Silk Road Studies Program*, 2005.

pipeline in the region, not only for Georgia whose reliance on Russian oil has diminished, but also for Europe. The BTC has the advantage that it can be used for Central Asian oil, shipped over the Caspian Sea, and thereby dodging the Russian pipelines and providing the Central Asian oil producers with an export alternative to Russia and China.

Figure 1: The BTE and BTE (SCP) Pipelines



The Russian competitor to the BTC is the planned Burgas-Alexandroupolis oil pipeline via Bulgaria to Greece. This project is controlled by the Russian state and aims to bring Kazakh oil from the Caspian Consortium Pipeline that ends at the Russian port of Novorossiysk at the Black Sea. Bulgaria is, naturally, embracing this idea. Through this pipeline, Russia would also be able to undermine any Ukrainian ambition to promote its role as a transit state for oil.²³

²³ See for example, Vladimir Socor, "Bulgaria's Ambitions for Caspian Oil Transit", *Eurasia Daily Monitor*, Vol. 4, No. 169, 2007.

Figure 2: The Planned Burgas-Alexandroupolis Oil Pipeline



A similar project to the BTC, but for gas, is the Baku- Tbilisi- Erzurum (BTE)²⁴ pipeline, aimed at bringing gas from the Caspian Sea via Georgia to Turkey.

An important challenge to the project is that the Azerbaijani gas reserves that are earmarked for the BTE are limited and,

so far, no feasible option of bringing Central Asian gas across the Caspian has emerged. Even though recent discoveries indicate that Azerbaijan has larger gas resources than previously thought, this is why a Trans-Caspian gas pipeline is of key importance.

From Europe's viewpoint, the BTE is also a highly important project, even though Europe has not yet realized this fact. Constituting one of the few new pipelines to Europe without any Russian influence, it has the potential to strengthen Turkey's role as a hub for energy supplies to Europe. Given Turkey's interest in EU membership, Brussels might be willing to promote such a development, although this would not be a part of the formal EU plan.²⁵

One of the advantages of the BTE is that it would provide a supply line for the new Nabucco initiative. Nabucco is basically a supply route of gas from Turkey (driven by the Turkish Botas company) to Austria (OMV Gas) via Bulgaria (Bulgargaz), Romania (Transgaz), and Hungary (MOL). The gas is supposed to originate in the Caspian region (for example via the BTE) and/or the Middle East (including Iran and Iraq). The project was initiated

²⁴ Also known as the South Caucasus Pipeline.

²⁵ Dov Lynch, "Russian Peacekeeping Strategies in the CIS: the Cases of Moldova, Georgia and Tajikistan", Basingstoke, New York, N.Y.: Macmillan in association with the Royal Institute of International Affairs Russia and Eurasia Programme: St. Martin's Press, 2000, pp. 20-22.

by the European Parliament and Council of Europe in 2003.²⁶ If on schedule, it will be in operation between 2011 and 2014, but this is unlikely. If the project is realized, gas may be supplied from several different sources, which is a clear advantage for Europe.

Figure 3: The Planned Nabucco Pipeline



Russia's existing gas pipeline from Russia to Turkey, called Blue Stream, is meant to have a second pipe added, known as Blue Stream II, which would eventually end up feeding the Balkans with gas. This project was supposed to be a competitor to BTE, but given BTE's gas supply difficulties, it may serve rather to complement it – if it is ever realized. Blue Stream I, however, has been a failure so far and has not run at full capacity. One reason is that it was underpinned by political and strategic factors rather than sober economic assessments. Turkey has, furthermore, used its import monopoly leverage on Russia in order to get a price concession of gas, something that Moscow did not appreciate.

Moscow's remedy to the drawbacks of Blue Stream and Blue Stream II is to shift its focus to a new initiative called South Stream, a project for bringing

²⁶ Roman Kupchinsky, "The Saudi Arabia of Gas", *The National Interest Online*, 2007, [<http://www.nationalinterest.org/PrinterFriendly.aspx?id=13880>], Last accessed: 4 April 2007.

gas from Russia across the Black Sea to Bulgaria, thus avoiding dependence on Turkey.

Figure 4: The Blue Stream Pipeline



In contrast to Blue Stream, South Stream might become a serious competitor to Nabucco. The idea of South Stream is consistent with Russia's energy strategy, which clearly states that Russia should avoid dependence on transit states. This posture is also a key driver behind the construction of Nord Stream – the planned gas pipeline across the Baltic Sea²⁷ (see below). If Europe wants to focus on increased supplies of gas, rather than reducing demand – a philosophy that is all but sustainable, it should welcome every new inlet of gas. However, the absence of an economic rationale for constructing pipelines in all directions, generates an urgent need to prioritize. From Europe's point of view, Nabucco would be the best option since it may be supplied from several sources, while no sole supplier controls the system.

²⁷ See further: Larsson, "Nord Stream, Sweden and Baltic Sea Security".

For a long time, Hungary was meant to be the most important hub for Nabucco, but Hungary's attitude toward Nabucco was never more than lukewarm, and it has argued that the economic burden for the project should be carried by the EU.²⁸ Nabucco and developments around Hungary deserve specific mention. In fact, some signs indicate that Hungary is becoming a political rogue state in terms of energy. Already in early March 2007, Hungary's socialist Prime Minister Ferenc Gyurcsany flirted with Gazprom's idea to build an extension of Blue Stream with the purpose of giving Russia a back door to Europe. The reason for this is not primarily a strong affiliation to Gazprom, but rather a severe economic and political predicament in Hungary. Budapest is yearning for cash and it needs to show its public that the government is capable of ruling. When Russia hinted at subsidized prices, Budapest gave in to the Kremlin's desires.²⁹

During the past several years, as a step to strengthen its position on the Central European markets, Russia has tried to take over Hungary's energy company MOL. Already in March 2006, Putin promoted the deal but not until recently has Budapest been willing to sell.³⁰ During 2007, Hungary has nevertheless flip-flopped over Nabucco, and the process has been revitalized.

Romania, the most eager participant, has been joined by states such as Azerbaijan together with the EU for advancing the project with greater enthusiasm than before. Relations between Hungary and Austria became more complicated after Austrian OMV tried to take over Hungarian MOL. With Russian support, it seems that Austria aspires to become the major hub at Hungary's expense.³¹ Whatever the prospects of Nabucco, the bottom-line is that Russia has strengthened its strategic position on Europe's southern flank.

²⁸ Deutsche Presse-Agentur, 'Hungarian Energy Giant Calls for EU funding for Nabucco Pipeline', *Deutsche Presse-Agentur (Reposted at M&C News)*, 2007. [http://news.monstersandcritics.com/business/news/article_1282023.php/Hungarian_energy_giant_calls_for_EU_funding_for_Nabucco_pipeline], last accessed: 4 April 2007.

²⁹ Kupchinsky "The Saudi Arabia of Gas".

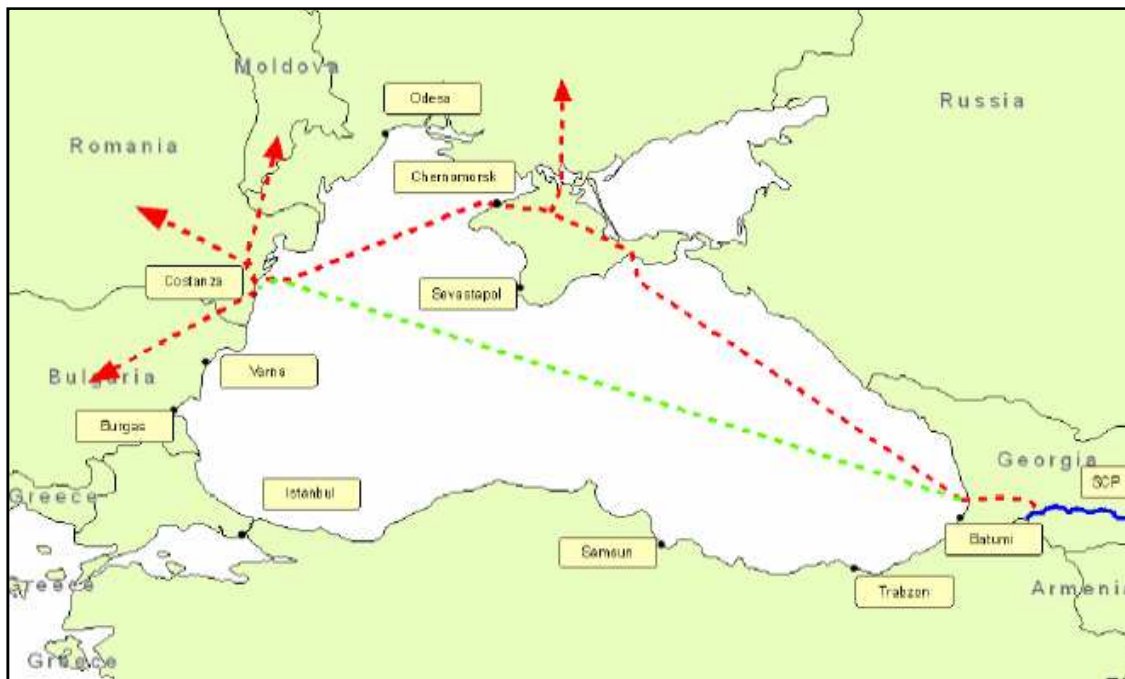
³⁰ Ibid.

³¹ See reporting in Vladimir Socor, "Strategic Issues Facing the Nabucco Project", *Eurasia Daily Monitor*, Vol. 4, No. 174, 2007; Vladimir Socor "Nabucco Gas Pipeline Project is Back on Track", *Eurasia Daily Monitor*, Vol. 4, No. 173, 2007; and Vladimir Socor, "Bulgaria Seduced by South Stream Gas Project?" *Eurasia Daily Monitor*, Vol. 4, No. 170, 2007.

Option Two: Explore the Potential of a New Ukrainian Route

Georgia and Ukraine have boosted their friendship since the Orange and Rose revolutions, due in large part to a united stand on Russia. Georgia has acknowledged the problem of Russian-dominated exports to northern Europe and at the same time has striven to further its own importance as a transit state for Caspian energy to Europe. Consequently, actors in Georgia are interested in building a gas pipeline from the Supsa port on its Black Sea coast, under the Black Sea, to Romania and possibly also Ukraine in order to, in the longer term, target the Polish market.³² The name of the project has been GUEU, but is now known as White Stream.³³

Figure 5: The Two Suggested Routes of the Proposed White Stream Gas Pipeline



Source: (Giorgi Vashakmadze, 2007).

However, if realized, it is highly doubtful whether such a project will be a serious competitor to any of the other initiatives. Georgia's power to advance a project of this magnitude can be questioned, and Ukraine is still plagued by political turmoil and indecisiveness. Should the Ukrainian situation stabilize, there are reasons to explore this option further as it is one of the few

³² Alkhazashvili, M., "Interest Growing in GUEU Pipeline", *Georgian Messenger*, 2007. [http://www.messenger.com.ge/issues/1331_april_5_2007/eco_1331_3.htm], last accessed: 11 April 2006.

³³ Giorgi Vashakmadze, "Reduction of Transport Risks - a Key Factor for Supply Diversification and the Role of GUEU-White Stream", *Vilnius Energy Security Conference 2007*.

alternatives for promoting non-Russian gas in northern Europe. The pipeline capacity is, however, set at 8 bcm per annum, so several pipelines are needed to have an impact.

Option Three: Accept Russian Dominance

Russia and Europe have been trading in energy for a long time, but in essence, the Russian-EU energy partnership was launched in 2000 by the sixth EU-Russia summit that proposed a new energy dialogue. However, only a few issues are dealt with on the aggregated EU-Russia level, partly because not all European states are members of the EU, and partly because most states pursue their own agendas and therefore opt for bilateral policies toward Russia, something Russia naturally promotes. It prefers a situation where it can deal directly with Brussels when it suits Russia, and then opt for bilateral approaches when Brussels is difficult to tackle or lacks the authority to be decisive. The EU has not yet taken any action to prevent single members from entering into long-term contracts that other members consider problematic. Thus far, the most important EU projects for international cooperation have been a plethora of bilateral frameworks; these have little substance, however.³⁴ The bottom line is that all these projects are vague and have largely failed to construct solid ground for deep cooperation between Russia and the EU. Bilateral projects are overshadowing all common efforts.

In the wake of what has been said, Russia is gaining access to European downstream markets, but limits foreign access to Russia's upstream market. In Russia's opinion, the only way of reaching a decent level of energy security (primarily security of demand), is to have Russian vertically-integrated companies controlling production, transit, and sales to end consumers. However, this is a misconception. If Russia would allow foreign companies to access upstream markets, foreign demand would be secured.

Russia has not yet ratified the Energy Charter Treaty and the Transit Protocol,³⁵ though this has been done by other CIS states. This is a key

³⁴ Philip Andrews-Speed, "Energy Security in East Asia: A European View", *Symposium on Pacific Energy Cooperation*, Tokyo, 12-13 February 2003, p. 8f.

³⁵ The main reason has been Gazprom's position and ability to create opposition in the Duma, especially up until 2001. Jonathan P Stern, "The Future of Russian Gas and Gazprom", Oxford: *The Oxford University Press/The Oxford Institute for Energy Studies*, 2005, p. 137.

project that Russia needs to adhere to if it wants to convince Europe that it is honest in its intentions of becoming a reliable supplier. At the same time, adherence to the ECT by the states of the Caucasus and Central Asia is an advantage for bringing Caspian energy to Europe.

If Europe is prepared to accept Russian supremacy and embrace either the Nord Stream or the South Stream project, the proposed Amber (Russian gas via the Baltic states) or Yamal II (Russian gas via Belarus) pipelines, it should also be prepared to handle the politically underpinned risks that have emerged in Russian gas trade since 1991. Presently, there is a risk in experiencing coercive policy, 'annoying behavior,' 'technical problems,' 'contractual disputes,' 'discriminatory price policy,' or similar problems aimed at reaching geopolitical, political, or economic goals for almost all receivers of Russian energy. The risk is higher for the FSU states as Russia's priorities and leverage are strongest there.

Option Four: Understand the East and South Asian Dimension and Focus on LNG

The East and South Asian dimension of European and Caspian energy relations is seemingly a peripheral concern for the EU, but it also has an impact on the larger picture. For example, when the U.S. is strengthening its ties with India in order to balance Chinese influence at the strategic level, it also has an impact on Chinese relations with Pakistan when it, in turn, tries to counter-balance the U.S. power position. In terms of energy, it has an impact insofar as when the U.S. supports India's nuclear program, it might also undermine the Non-Proliferation Treaty and provide Iran with yet another argument for continuing its nuclear efforts, partially with Russia's support. Energy and strategy thus become intertwined in an arena that may well have military implications. At the same time, the U.S. is eager to ensure that Russia's support to Iran is kept to a minimum, and that Russia does not interfere in America's endeavors to tackle Iran's nuclear ambitions. As a result, Washington has taken a low policy line on Russia's coercive energy policy against Ukraine, Estonia, and Georgia. This has consequences for Europe, in that American support for Europe's endeavors to lecture Russia is reduced.

As indicated, there are rational economic arguments for pumping Caspian oil and gas to world markets, including via Iran. This could be done in one of

three ways. The first way would be to construct a Trans-Caspian pipeline (or shipping routes) for Kazakh, Turkmen, or Iranian energy to Azerbaijan, which would then be connected to the BTE or the BTC.³⁶ One of the numerous problems is that the legal disputes over the Caspian Sea are still unsolved and Russia will ensure that it is kept this way if a solution means that Russian power would be constrained. A second option is a land-based pipeline via Turkmenistan and/or Iran to Azerbaijan. This would result in reliance for decades on Iran, a country subject to sanctions and a possible target for military actions. A third option is to send energy from Iran, either as a part of a domestic swap deal, or by constructing pipelines to the Iranian coast. This would provide possibilities of sending Caspian energy from Iranian ports, but the political problems would not be solved. A solution for natural gas would be more expensive than oil since conversion to LNG is necessary. LNG, *liquefied natural gas*, makes it possible to send gas by tankers to Europe. Iran together with Qatar is one of the world's most prominent suppliers of gas and it would be in its interest to develop its infrastructure for LNG.

From Europe's perspective, LNG is increasingly popular. The LNG share of European gas imports is roughly 11 per cent, but this share might double in the coming decades. As indicated, the drawback of the Iranian option is that Caspian energy is supposed to be an alternative to energy from the volatile Middle East – and Iran indeed engenders the same potential for volatility.

There is also another looming problem, a problem wherein Russia once again is involved: namely, in its attempts to form a cartel for gas. In Doha on April 9, 2007, it was announced that the Gas-Exporting Countries' Forum (GECF), which includes the world's most prominent gas producers such as Russia, Libya, Qatar, and Iran, would join forces and deepen cooperation in the gas market.³⁷ Russia will take a leading position, comparable to Saudi Arabia's role in OPEC.³⁸ There are yet fundamental differences between this structure and OPEC and its similarities should not be exaggerated. Gas is traded by long-term contracts and there is no real world market price except for what is

³⁶ Stern, "The Future of Russian Gas and Gazprom", p. 137.

³⁷ Anatoly Medetsky, "Khristenko Backs Gas-Pricing Group", *Moscow Times*, 10 April 2007. [<http://www.moscowtimes.ru/stories/2007/04/10/001.html>], last accessed: 10 April 2007.

³⁸ Roman Kupchinsky, "The Saudi Arabia of Gas", *The National Interest Online*, 22 March 2007. [<http://www.nationalinterest.org/PrinterFriendly.aspx?id=13880>], last accessed: 4 April 2007.

traded on the spot market. Russian gas is in contrast primarily traded via pipelines. It is therefore impossible to turn to an open market if the ordinary supplier is unreliable.

As argued by Vladimir Socor, what a gas-OPEC initially could do, however, is to decide on export routes and divide the market between its members, thus maximizing prices in the long term.³⁹ The most advanced forms of cooperation will naturally take some time to develop, but Russia has been on the offensive so far and its current policy has already, to a great extent, undermined the role of importers.⁴⁰ It is interesting to note that the Central Asian states are not included in the GECF. A key explanation is that Russia prefers to deal with them bilaterally as it has the upper hand.⁴¹ This will thus be a producer cartel with substantial political and economic clout over the EU and its members.

Conclusions

The conclusions of this paper can be summarized in five points.

- 1) Europe's need for gas is only bound to increase if it continues to muddle through without making any efforts to improve its situation. If the EU paid more attention to energy savings, reduced consumption, and increased efficiency, the urgent need for new supplies would be reduced dramatically and all suggested pipelines would not need to be built. A consequence would be that the European consumers would save money and that some of the politicized problems of energy trade could be reduced.
- 2) If Europe fails to limit its augmenting demand, new supplies of gas are needed. Increased imports from the North Sea and by Liquefied Natural Gas (LNG) will likely be important contributions, but it will hardly be enough and the EU should be prepared for strong competition.
- 3) Concerning pipeline-borne natural gas, there are concerns of relying on Russian gas for three main reasons. Firstly, Russia has used its energy policy coercively against EU members and other states. Secondly, Russia has

³⁹ Vladimir Socor, "Gas Supplier's Cartel: not an "OPEC", but Cartel all the Same", *Eurasia Daily Monitor*, Vol. 4, No. 62, 2007.

⁴⁰ Vladimir Socor, "Toward a Russia-Led Cartel for Gas?" *Eurasia Daily Monitor*, Vol. 4, No. 63, 2007.

⁴¹ Socor, "Toward a Russia-Led Cartel for Gas?"

strategic ambitions in and around Europe, which makes its energy policy vis-à-vis Europe and vis-à-vis some of Europe's traditional suppliers, for example Algeria, a point of friction. Finally, Russia has, due in large part to its nationalistic posture, developed a domestic energy sector wherein investments are hampered. The result is that despite its large resources, Russia has problems in supplying enough amounts of gas, even under existing contracts.

4) The best option for Europe, if it is to import more natural gas, is the Caspian region, which holds huge potential. Doing so would require Europe both to act with greater enthusiasm and to acknowledge the geopolitical environment, since competition from Russia and China is difficult to handle. By joining forces with the U.S. and drawing on its experience in dealing with the Central Asian and Caucasian states, Europe would be able to tackle China, dodge Russia, and channel Caspian oil and gas to European and world markets.

5) If Europe is to evade transport routes dominated by Russian influence and ensure that energy flows toward Europe instead of China and India, there is only one feasible option – namely the Caucasian corridor. Infrastructure for oil already exists, and gas infrastructure is under construction. Turkey is a potential transit hub, which also could be used for channeling Russian, Iranian, and Iraqi energy toward Europe, but the development of intra-Turkish infrastructure might be needed. The best inlet of gas to Europe from the Black Sea would be by the suggested Nabucco pipeline, while the worst would be its competitor, South Stream.

The Black Sea/Caspian Region in Europe's Economic and Energy Security

Mamuka Tsereteli*

Key Argument: Europe faces a set of serious challenges to its economic and energy security in terms of access to resources, markets, and other crucial commodities, such as skilled labor. This is especially evident in light of unfavorable demographic trends and increased Russian dominance in the energy field. The Black Sea/Caspian region holds a strong potential for contributing to Europe's economic- and energy security. Especially the Caspian basin is extremely rich in energy resources which could, if secured, help alleviate Europe's strategic dependence on Russia. The region also constitutes a considerable market, and provided transport infrastructure is developed, is positioned as a transit route for European trade access to Eastern Asia.

Policy Implications

- European governments need to realize the region's significance and include it in their development of long-term political and economic security strategies. These should include promoting closer ties with the regional states and allowing for their long term integration with European structures.
- The EU could undertake several measures to support the region's development and improve EU access to its resources. These include supporting the development of infrastructure for energy and trade, granting easier entry to the EU for the region's products, and active investment policies in the region.
- In order to secure access to the region's energy resources, the EU should promote and support infrastructure along two main routes: Eastern Caspian-Azerbaijan-Georgia-Turkey to Europe for oil and gas, and Eastern Caspian-Azerbaijan-Georgia-Ukraine to Europe for mainly oil.

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Introduction

The objective of this paper is to demonstrate the potential for cooperation between Europe and the Black Sea/Caspian Region in the areas affecting economic and energy security. This region fits the new strategic view of European development, providing alternative energy and other natural resources, as well as other factors of economic security: including human capital and new market opportunities. Ukraine, Georgia, Azerbaijan, and others are in need of access to European markets not only to export or transit hydrocarbons, but also to promote additional economic opportunities with other resources and agribusiness products. In addition, they seek active security cooperation from Euro-Atlantic structures. Europe needs the natural resources of Central Eurasia, new markets for its goods, and a relatively cheap labor force in order to maintain its competitiveness in the world economy. At least two key factors have great importance for Europe: the first is that Ukraine, the South Caucasus, and the Central Asian States together have a joint population of nearly 130 million people, thus offering a substantial market for European products and services, as well as potential labor force in light of the aging population in Europe. The second is that Caspian energy resources have the potential to substantially diversify Europe's energy supplies away from a current over-dependence on Russia. If supported by the appropriate policies, Europe has the potential to, in several years, emerge as better-situated and stronger vis-à-vis Russian energy dominance.

To achieve this goal Europe will need to do the following: To elaborate and implement the common energy strategy, where the need of individual states will be harmonized with common European needs; To develop an infrastructure that would support the common strategy by providing additional access options to resources in Central Eurasia; To move forward toward the integration of the Black Sea/Caspian Region into the European economic space, and for those who express will and show the readiness, to move forward toward European political space.

Recent developments in Europe and Central Eurasia, as well as growing tensions between the EU and Russia over energy issues, have brought new opportunities for alternative suppliers of energy and transit corridors. The

energy disputes of early January 2006, when the disruption in Russian gas supplies to European countries, including Germany and Italy, reaffirmed Europe's vulnerability in its dependence on imported Russian gas. Russia's political decision to cut off gas supplies to Ukraine, the main transit country for Russian gas headed to Europe, amid a dispute over prices, awakened the EU. The Russian government seemingly replicated this incident in early 2007 when a price and transit fee dispute with Belarus caused another crisis. These incidents have shown the weakness of Europe and diminishing power of the consumer amid high energy and resource prices in the world.

At the same time, these cases demonstrated both Russia's power as a main supplier, and also that it has less dependence on European energy buyers than before. Due to very high oil prices Russia is now in a stronger position to dictate many conditions to its European consumers, not only in terms of pricing issues for natural gas, but also its interest in acquiring distribution networks and downstream assets in Western Europe. Russia's position relative to Europe on this issue is likely to remain very strong through the next decade before alternative supplies are developed and the energy balance is transformed. As it was mentioned, this can only happen if there is a unified, strategic policy towards the alternative options of economic and energy security, based on a comprehensive understanding of the historical, cultural, and economic context of the surrounding countries, particularly ones who aspire to be integrated into the European space.

Economic Security for Europe

An interest in economic security¹ has forever been a driving force for the political and societal development of states, and more than ever, guarantees to the access of resources and markets stand to determine the geopolitics of the twenty-first century. Historical experience proves that relatively easy access to resources, open trade, and the readiness to accept new ideas helped

¹ The concept of economic security refers to the long-term security of access to economic opportunities, to markets, and to resources such as people (human capital), capital, energy, water, technology, and education. This concept is critical for individuals and nations. The search for economic security is a natural part of the quest for liberty. Only free people can build free societies and states, and freedom is based on the economic security of individuals. The long-term internal stability of every state is the key factor for national security. There is no stability without economic growth and opportunities for individuals to be free in their choice of economic activities.

spark European development in the sixteenth century ahead of the Islamic world and China, eventually becoming the world leader by the end of the eighteenth century.

In the modern world, economic welfare and prosperity are the most important building blocks of national security. By the end of the twentieth century, nations – more than ever – realized that instead of expanding their frontiers by force and instead of the costly operation of controlling territories, they could peacefully, without the use of military force, improve their access to factors of production and markets located within other states. This of course does not eliminate power as a factor of international relationships. Obviously, large and powerful states are able to pursue more assertive policies, but it is no longer an effective policy for larger powers to bear the political and strategic costs of having to rule over others directly, when the possibility exists to exploit resources through trade and capital movements.

However, there may be some specific exceptions from this general trend. Temporary scarcity or the perception of scarcity of physical resources, such as oil, food, or water could determine the military actions of nation-states. But the effectiveness of such actions in the long run is questionable. Most of the former imperial powers, including Russia, with its internal struggle to conceptualize this new reality, came to the understanding that economic presence is now more important than its military alternative, although unlike other big powers, like the US, or UK, Russia still prefers control over shared access to resources.

The world is facing serious economic security challenges, predominantly determined by the growing population and growing need of resources in developing countries. The world's population will increase to 8 billion by 2030 from the current population of 6.5 billion, and 95 percent of that growth will be in developing countries. If this population growth is supported by growing economic potential and standard of living, more and more resources, and in particular energy resources, will be required. The International Energy Agency predicts a 50% increase in energy demand by 2030, even if efficiency is increased. About 70 percent of this increase is going to be in developing countries, and those countries are relying primarily on fossil fuels because of the very significant cost advantage. Just the aforementioned general numbers

indicate the inevitability of increased pressure on the European economy. In addition to energy needs, there will be other driving factors for the economic security of Europe for years to come:

- An aging population in Europe, along with a diminishing workforce and a changing demographic composition will affect market structures as well the structure of required jobs and services.
- Depletion of the domestic energy reserves and the growing import dependency on energy resources on the backdrop of growing demand for energy in the world; the growing role of Russia as energy supplier and the need for diversification.
- Growing physical limits of access to resources and in particular to oil and gas fields.
- Substantial transfer of wealth from Europe, and the West in general, to resource rich states, including Russia; State-sponsored sovereign funds beginning to operate on European markets, acquiring substantial infrastructure and other assets, with the consequences still to be assessed.
- Different approach to energy security between Western and Eastern Europe. The Soviet time infrastructure legacy determines the higher degree of dependency on Russian energy of the East.
- Russia's increasing need for the resources of Central Asian/Caspian states to supply Europe with natural gas, thus increasing the importance of transit through Russia; But instability in transit issues that are related to both political factors, as well as reliability of supply and infrastructure, is creating economic threats to Europe.
- Status of Iran; if conditions are right and political developments in Iran would allow Europe to build closer ties with that nation, it could dramatically improve the energy security of Europe over the next decade.
- HIV/AIDS and other diseases that will significantly affect the demographics of many countries and regions of the world, including Russia and Eastern Europe.

All those factors are greatly affecting Europe and will have long-term security implications for the entire Transatlantic and Eurasian space.

Demographics will be the most important issue for the economic security of Europe. Europe's share of the world's population has shrunk dramatically in

the last 30 years, from about 15 percent of the earth's inhabitants to around 6 percent. Europe already has the oldest population on earth, and as this continues, it will further see a dramatic reduction in the natural size of its work force population – unless imported from other countries.² In order to move somewhat closer to the objectives stated in the Lisbon Agenda,³ Europe needs to open opportunities for its own citizens and for others as well. One important issue for the economic security of Europe will be the connection between the business environment and demographics. As a result of the existing government-controlled economic model, with limited working hours, extremely generous benefits to the unemployed, limited competition, and difficult rules for hiring and firing, Europe is losing both its own talented individuals and also many potential investments. This worsens its demographic problems, and Europe's objective to become the most competitive and dynamic knowledge-driven economy by 2010 seems set to become just an unfulfilled dream. By protecting some jobs through government policies and subsidies, most of the EU countries are losing more attractive jobs and business, sinking into greater unemployment, all requiring more benefits spending. 'Brain drain' is becoming a reality in Europe, as its talented people increasingly prefer to relocate to a more business friendly environment in North America.

Another important factor added to the spectrum of European economic security challenges is the increased pressure from Russia to allow state-controlled energy companies, predominantly Gazprom, to acquire energy and other economic assets in Europe, while Russia prevents involvement of foreign companies in the ownership of its own energy assets. In addition, Europe, like North America, is facing an increased pressure from government-sponsored investment funds focused on purchasing assets in developed countries. Several investment funds set by the Russian government are already beginning to operate on European and U.S. financial

² Lynn A. Karoly and Constantijn Panis, "The 21st Century at Work: Forces Shaping the Future Workforce and Workplace in the United States" *Rand Corporation*, 2004. [<http://www.rand.org/publications/MG/MG164/>].

³ In March 2000, the leaders of the European Union's twenty-five member states met with the aim of bringing a new impetus to economic reforms. Known as the 'Lisbon Agenda,' these reforms aimed transforming the Union into the most vibrant and competitive based knowledge economy by 2010. At the height of the so called 'dot-com' boom in the U.S., Europe's leaders were confident that they could replicate a similar success.

markets, and these are perfectly capable of obtaining ownership of many important assets through attractive financial transactions. Russia successfully uses its power as a supplier in relationships with Europe, obtaining substantial advantages, while Europe is missing a similar opportunity: the EU fails to leverage the fact that it accounts for 60 percent of Russia's trade, 50 percent of its investments, and that Europe has become a major destination of travel, and sometime a second home to many wealthy Russians.

Access Factors: The Black Sea/Caspian Dimension

The most significant factors of national economic security are access to markets for key products, and access to a large spectrum of resources that includes human capital, money, water, food products, energy and other mineral resources. It is important to emphasize the critical significance of both physical security and the economic and commercial viability of access routes. The factors of individual and national economic security are obviously interconnected and interrelated, although our focus lies mainly on factors of economic security at the national and supra-national level, and on the issue of access to markets and resources. In that regard, and in light of greater European dependency on Russian energy, the identification of viable alternatives for energy security is critical. The Black Sea/Caspian region is one such alternative.

Europe is one of the major trade destinations in the world. Millions of tons of cargo and containers, as well as tens of millions of passengers cross in and out of Europe's borders every year. They face different types of barriers in terms of access to markets. There are two major factors of economic security with the potential for affecting Europe's access to resources. The first factor is the geographic/physical factor. The second one is political. Both are very important, and in many senses interrelated. Linked to the two is energy, and for this reason, it is the key commodity to focus on. Energy access projects face difficulties as concentrations of oil reserves are often in geographically remote areas, far from major markets. The natural and political barriers make coherent access strategies for Europe an absolute necessity. The major trade and supply routes destined for Europe currently pass through narrow straits,

canals, and busy pipeline systems. Frequently, these routes traverse politically unstable areas, rife with a variety of security threats.

Of particular importance, of course, are the energy supply routes and relating transportation issues. For example, the Bosphorus and Suez are two of the most important transportation links connecting Europe with its important suppliers of resources. There are several other existing and potential chokepoints in the world that require constant attention and management from the European perspective. Several of them, like the straits of Hormuz and Bab-el-Mandeb directly affect European energy and economic security. There are also political barriers created by some states or international institutions. For example, Russia does not allow investments in its energy transportation infrastructure in order to keep control over the flow of energy resources, including the transit of resources from Central Asia.

The economic and trade potential of the Caucasus and Central Asia is largely untapped by Europe. Caucasus and Central Asian exports and imports constituted 313 million tons in 2005, and only 68 million tons of that constituted exports and imports to and from Europe. The European share of exports was 22%, out of 255 million tons, and 15% of imports, out of 66 million tons. Despite the fact that trade almost tripled since 2000, the ratio of European trade to the rest of the world is still minor. Oil and oil products dominate exports – about 70% of the total exports from the region. The rest is metals, ores, grain etc.⁴

Energy and European Security

A variety of different products and commodities are vital for the functioning of the European economy, but it is energy resources, notably oil and gas, that are of critical importance for the region in the immediate future. Europe is a net importer of energy, and according to a European Commission report, two-thirds of the EU's total energy requirements will be imported by 2020, with natural gas imports estimated to rise to 75%. The fact that there is a growing demand for energy resources in the world further adds strain to the issue of access. Unlike the United States, China, or Japan, Europe's

⁴ "Poti Sea Port", presentation from *Invest in Georgia*.
[http://www.investingorgia.info/projects/Port_Poti_presentation.pdf], accessed on 8 January, 2008.

geography endows it with a geographic proximity to major sources of energy. Europe currently has three major sources of energy: the Northern Sea region and the potential Norwegian arctic sector from the north, Russia from the east, and the Middle East and North Africa from the south. Potential new players to join this list are the Caspian states, which have the potential to help Europe diversify away from its growing dependence on Russian oil and gas. In fact, some of the oil already flows from the Caspian region to European refineries via the Baku-Tbilisi-Ceyhan pipeline and other transportation links.

Europe faces competition for resources from consumers that are larger and increasingly ambitious. Like in Europe, the United States' internal production share in the consumption of oil is declining rapidly, which means that U.S. dependence on imported oil will rise and, according to different estimates, may reach 68%, with an increased share of imports coming from the Gulf States. As the United States began to take pro-active steps toward diversifying its energy supplies in the early 1990s, Central Eurasian resources attracted increasing attention. There is a growing demand for energy in Asia, and in particular in China, and Chinese state-sponsored companies are aggressively pursuing opportunities in Kazakhstan and Turkmenistan at whatever cost. This tactic has worked for them elsewhere in the world, particularly in Africa and Latin America.

On the backdrop of this strategic energy picture, the security of energy supplies has become a dominant issue for European consumers. The Caspian Sea and Central Asian resources have a substantial role to play in the future oil supplies of the world. It is estimated that the Caspian will provide at least 10 percent of the expected increased production capacity in the next decade. Based on the assumption that current oil prices will remain stable, oil production from the Caspian may reach 6 million bpd by 2020. The problem of the region is that it is land-locked and requires the development of new infrastructure, which would allow the potential of the region to be fully opened for the region itself, as well as for the broader European, and world energy security. Since maritime connections to the region are limited, the pipeline options for access to these markets are of critical importance for the region. Most often used for transcontinental oil movements, pipelines are

critical for landlocked areas. They also complement maritime transportation by providing bypasses or shortcuts.

In general, pipelines are the primary option for transcontinental transportation since these are cheaper than railroad, barge, or road alternatives. Pipelines constitute a safe mode of transportation if operating within a nation's borders, or between neighbors such as the United States and Canada, Norway and the EU, or between allied countries such as Azerbaijan, Georgia, and Turkey. On the other hand, pipelines may carry vulnerabilities if crossing politically unstable areas. Moreover, political factors often play significant roles even in relatively stable areas, such as Russia. The political turmoil and price war with Ukraine was an issue of concern for European energy security, as a significant share of Europe's oil and natural gas supplies from Russia arrive via Ukraine.

Previous to the recent crisis over Russian gas, Europe was generally a passive observer of developments in the Central Eurasian region. The Baku-Tbilisi-Ceyhan pipeline (BTC), which connects Azerbaijan's offshore oil fields to the Turkish Mediterranean port of Ceyhan via Georgia, was developed only through strong U.S. support to the project. With the BTC pipeline now in operation, and the development of Caspian natural gas pipeline shipments through Turkey a reality, Europe is acquiring additional supply routes, without major political efforts on its own part. In addition to existing supply routes, Europe now has a Caspian-Caucasus-Turkey-Mediterranean oil pipeline, which can ship light Caspian crude oil directly to the Mediterranean, and then to the refineries in Southern Europe, avoiding the congested chokepoints. The BTC pipeline stands as an example of how strategic planning, coupled with well-designed policies, and effective implementation can help commercially viable projects materialize.

In terms of access to natural gas, Europe's major suppliers include Norway, Russia, Algeria, West Africa (LNG), and the Middle East (LNG). Europe's natural gas demand is projected to increase substantially in the future and exceed 700 billion cubic meters (bcm). Even according to conservative scenarios, the demand for importing natural gas to the EU will reach 400 bcm

per annum by 2030.⁵ Russia will try to fill this gap with its own gas, as well as with gas from Turkmenistan, Uzbekistan, and potentially from Kazakhstan, if these countries do not have alternative delivery options by that time.

Among the top policy priorities for the EU, energy development aims for the “avoidance of strategic dependence”. Despite this professed aim, Europe has a strategic dependence on Russia's Gazprom that has constantly preempted its potential competitors in European markets by outpacing the EU's development toward a secure supply-diversification strategy. Aside from dealing with the EU as a whole, Gazprom has pursued more bilateral channels by engaging various vertically-integrated European energy companies into the development of several new infrastructure projects that will result in an increase of export volumes for Russia and higher prices for European consumers. This will inevitably strengthen Gazprom's already dominant position in the European natural gas market.

On a parallel track, Gazprom is further entrenching its hold over Europe's natural resources market by acquiring internal transportation and distribution networks of the older EU countries (like Germany, France, Italy), according to the expansion pattern seen in new EU countries. Gazprom has a very clear strategy: to obtain a strong dominance over natural gas supply and distribution networks in Europe. By obtaining control over the transit infrastructure in transit countries, Russia limits access to markets for other potential suppliers. By obtaining businesses in the distribution sector, Gazprom limits the ability of importing countries to conclude long-term gas purchase agreements with other producers. Frequently European companies have special insider roles in these arrangements, which make European energy security vulnerable to Gazprom's pressures.

European dependence on Gazprom varies from 22 percent of consumption in France, 44 percent in Germany, 60 in Turkey, 65 in Austria, 79 in the Czech Republic, 97 in Bulgaria, and 100 percent in Finland and Slovakia, to name a few. These are prominent examples of “strategic dependence.” At the same time, Gazprom does not have funds for investment in exploration, and its

⁵Presentation by Fatih Birol, “Outlook for European Gas Demand, Supply and Investment to 2030”, based on *World Energy Investment Outlook: 2003 Insights*, IEA, 2003. [<http://www.iea.org/dbtw-wpd/textbase/work/2004/investment/outlook%20for%20European%20gas%20demand.pdf>], Accessed on 8 January 2007.

future suggests a heavy dependence on gas from Turkmenistan and other Central Asian states. In the region, Gazprom has aggressively sought to channel all gas through its transit systems. Gazprom is not only after Turkmenistan's gas, but it has also pursued opportunities in Uzbekistan, Kazakhstan, and Azerbaijan. By becoming the sole transit system for Central Asian gas, Gazprom hopes to increase its share in the European gas market, which represents a challenge to Europe. All these developments, and potentially the construction of a new pipeline on the Baltic Sea bed en route to Germany, undercuts the EU's goals of supply diversification and ensures the almost monopolistic position of Gazprom in European markets. This will enable the Russian energy giant to set price levels, control distribution, and even consumption levels. As seen many times, Russia may use its role as a natural gas supplier as a political tool. The final stimulus, somewhat energizing European energy policy, was the new dispute between Russia and its usually obedient neighbor, Belarus, in early 2007. Subsequent cuts in supplies to European consumers convinced numerous European policy-makers that a proactive diversification policy was the only effective response to Russia's actions.

On January 11 2007, the European Commission published a document entitled 'An Energy Policy for Europe', including calls for a common energy policy to become a central element in the EU's external relations. It also recognizes energy security as a key factor of the EU's geopolitical security. This is a first important step toward a consolidation of Europe's energy policy, but much remains to be done and substantial resistance is expected from some European energy companies who hold monopolies in their markets and are closely associated with Gazprom.

Other Infrastructure Projects

In addition to pipelines and other energy related infrastructure, several important projects with implications for Europe's access abilities are currently under consideration. One is a network of highways connecting Baku to Black Sea ports in Georgia and then to the Turkish highway system. This network can potentially be linked to Istanbul in the west, and the Mediterranean ports of Mersin and Ceyhan in the south. This would further serve to increase trade in the region and substantially shorten the time for

shipping containers and other cargos destined for the Mediterranean and Southeastern Europe.

A railway connection between Azerbaijan, Georgia, and Turkey with the further European connection could dramatically increase the flow of goods between Europe and Central Asia and the Caucasus, and has the potential to link Europe to China. This would involve new projects connecting the railway system of Kazakhstan to China, thereby creating the opportunity to ship rail cars from Europe all the way to China via the Caucasus and a Caspian Sea ferry connection.

Considering the rapid development of China's Western region, with a population of 300 million and 102 billion dollars of ongoing investment programs, the potential of connecting to this region is arguably a very attractive opportunity for the European producers and service providers. A planned substantial expansion of the Poti port should allow transshipments from Central Asia to substantially reduce the time and costs for transportation to Europe. This is the shortest way to connect Europe and Central Asia, and potentially China via international waterways. With the potential turnover of 25 million tons and annual average growth rate of 15-18%, the port of Poti is by far the most convenient maritime outlet connecting the vast region of Central Eurasia to the EU through the western shores of the Black Sea, and through the Mediterranean via the Bosphorus.⁶

All these infrastructure projects will give the producers of Caspian energy and other outputs increased confidence in the availability of market access and would thus help to boost production in the region. It is clear that different shipment options will be considered and used to deliver cargo to the western shores of the Black Sea, and potentially to the Mediterranean. A greater Black Sea-Caspian Sea transit system is one obvious option to consider. Some of Europe's most pressing challenges and requirements – anti-terrorism efforts, energy supply, labor supply, institutional consolidation and enlargement, and available markets of substantial size – are to be met in this region.

⁶ "Poti Sea Port: Gateway to Caucasus and Central Asia", presentation from *Invest in Georgia*. [http://www.investingeorgia.info/Projects/Port_Poti_presentation.pdf], accessed on 8 January 2008.

Looking to the Future

The Black Sea/Caspian region holds great potential for a positive contribution to Europe's economic and energy security. The enlargement of both NATO and the EU has positioned Europe strategically to benefit from deeper relations with the countries of this region. In addition to greater physical proximity and a developing transportation infrastructure, there is now greater political will in the countries of the region to develop closer links with Europe. Relationships with NATO and the enlarged EU are becoming the top foreign policy priorities for most of the states in this region. Presently lacking is a greater political will on Europe's part, based on a better understanding of the long-term political and economic security objectives by some European governments. The recent EU decisions and actions to boost closer ties with the countries included in the European Neighborhood Policy is a small step in the right direction, but what the countries of the region need is a long-term strategy of greater integration of the region with European structures.

As mentioned above, Europe needs access to resources, markets, and most importantly—people. The countries of the Central Eurasia region can provide these important elements to the European economy. In order to be positive examples of transformation, the Western-friendly countries in the region need support and help. They represent today one of the major areas of opportunity, with a unique potential of human resources, transit lines, energy resources, and communications between Europe, Central Asia, and the Far East.

The lack of an effective Eastern strategy may introduce different types of economic, energy, societal, and political threats to Europe. These may include, but are not limited to: disruptions in energy and other supplies; disruptions in access to the markets for European goods; terrorism; and transnational crime. At the same time, an improved understanding of the region's economic security will help resolve some existing conflicts and prevent many future ones. Europe needs to employ generally pro-active policies toward the Central Eurasia region, which should include:

- Easy entry to the EU for products from the Black Sea/Caspian Region will boost trade, prevent large-scale migration to Europe from those

countries, and create economic opportunities and interdependencies between the regions.

- Active European trade and investment policies in Ukraine, the Caucasus and Central Asia, utilizing European export-support agencies and funding institutions, to boost sales of European products and services in the region, and to increase engagement of the regional cheap labor force. Focusing predominantly on outsourcing some of the industrial and other non-competitive European jobs, vs. importing labor to the EU countries (which may, nevertheless, be inevitable to some extent) may cause much greater positive political and societal consequences for both Europe and the countries of Central Eurasia.
- Promotion and political and financial support for Trans-Caspian and Trans-Black Sea energy infrastructure to ensure alternative energy supplies to Europe from the Caspian region via two major routes: a) Eastern Caspian-Azerbaijan-Georgia-Turkey, to Europe, for natural gas and oil, and b) Eastern Caspian-Azerbaijan-Georgia-Ukraine, to Europe, for mostly oil. The EU needs to sponsor the comparative analysis of the different options of the natural gas supply, including commercial dimensions and impact on prices for consumers. The new Nord Stream pipeline in the Baltic Sea, if constructed, will substantially increase the retail price of Russian natural gas, due to a need to recover the planned \$18 billion investments. The suggested analysis will show how much European customers have to pay for the gas delivered from different sources and will help decision-makers to identify the appropriate strategy. An active European strategy of support for diversified supply and transit will boost European energy security. It will also help transform Russia into a cooperative player.
- Coordination of infrastructure planning in all directions, including border infrastructure, rail inter-operability, mutual open access for inland waterways, improvements in road safety, and extension of the Single European Sky initiative.
- Active support for the cultural integration of the Central Eurasian region into Europe. Whether Europe wants it or not, the large number of people from Ukraine and other countries of the region will be moving to Europe, and they need to be integrated in the mainstream societal life of European

countries. Shared values and active educational efforts should support this process.

- In addition, countries of the region will need to work closely with the United States and Europe, as well as with Russia in a direct way to convince the latter that the stability and prosperity of Ukraine, the South Caucasus and the Caspian region do not pose a threat. Indeed, the very opposite is true: stability in the South Caucasus would help Russia stabilize the North Caucasus and focus on longer-term security threats for Russia, such as a weakened strategic position in the Far East, depopulation, HIV/AIDS, and transnational crime.

Part II: Gazprom in Russia's Domestic and Foreign Policy

Russian Super-Giant in its Lair: Gazprom's Role in Domestic Affairs

Pavel K. Baev*

Key Argument: The close relationship between the Kremlin and Gazprom is less beneficial for the company than is commonly assumed. While granting Gazprom a monopoly on the domestic and export markets for natural gas, it has also denied the company several advantages of being a monopoly and encouraged state use of its resources for political purposes. In this regard, Gazprom has over the last year become increasingly engaged in business conflicts aimed at eliminating foreign presence in the domestic energy sector. The expected election of Dmitri Medvedev as Russia's president is unlikely to significantly affect this pattern or help develop and modernize Russia's gas industry.

Policy Implications

- European companies doing business with Gazprom, politicians dealing with 'energy security' issues, and consumers depending upon deliveries of Russian gas, need to recognize the complications and uncertainties created by the relationship between Gazprom and the Russian state.
- Companies should acknowledge that current politics play a crucial role in decision-making in Gazprom, limiting its reliability and understandability as a partner.
- Politicians need to consider the mercantilism in the behavior of the Russian leadership, driven by far closer ties with the energy business than those that exist between European companies and their respective governments.
- Consumers need to come to terms with the fact that Russian gas may be subject to political intrigues and conflicts that could escalate to a level whereby the Kremlin would indeed consider the 'weaponization' of its energy instruments.

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Gazprom HQ building in St. Petersburg to be erected by 2016

Introduction

Russia's largest state-owned company Gazprom, which delivers more than 75% of natural gas produced in the country and holds a monopoly over its transportation, distribution, and export, is widely perceived as so tightly controlled by the Kremlin that the question about its separate domestic agenda, whether political or economic, might appear nonsensical. In reality, however, the picture is far more complicated than the popular maxim 'What is good for Gazprom, is good for the country' would suggest.

The only case of Gazprom's more or less direct involvement in politics dates back to the December 1995 parliamentary elections, when Prime Minister Viktor Chernomyrdin (Gazprom's founding father) tried to set up a mainstream political party called 'Our Home Is Russia' (inevitably nicknamed 'Our Home - Gazprom'), which captured only about 10% of the vote, far behind the Communists. At the crucial watershed of the June 1996 presidential elections, when seven bankers, later dubbed as 'oligarchs,' decided to bankroll Boris Yeltsin's re-election and put Anatoly Chubais in charge of his campaign, Gazprom opted to stay out of the political fray. It also remained 'neutral' during the turbulent period of summer-autumn 1999, when Boris Beresovsky launched the 'project Putin,' which eventually clinched a rather improbable victory in the high-stakes political battles for Yeltsin's succession. Quickly consolidating his grasp on power, Vladimir

Putin decided that leaving Gazprom to its own devices would involve an unacceptable risk and swiftly executed a management coup, forcing the retirement of 'irreplaceable' Rem Vyakhirev and installing Alexei Miller, a political nobody from St. Petersburg, as the new CEO, while Dmitri Medvedev, deputy head of the presidential administration, became the Chairman of the Board. The pair had a hard time asserting their leadership over the hugely complicated company's affairs, but by the end of Putin's first presidential term, Gazprom had been tightly anchored to the Kremlin.¹

The Scramble for the Yukos Spoils

The vicious attack on the oil giant Yukos, which started in summer 2003 and ended with the auctioning of its last property in summer 2007, and the prosecution of its owner Mikhail Khodorkovsky marked a key watershed in Putin's 'era' and set a new standard for Gazprom's involvement in politics. There is no place here to examine this 'affair' but it is sufficiently clear that it bears the markings of both a carefully planned 'special operation' and a rather awkward financial improvisation. Khodorkovsky's stubborn refusal to plead for mercy forced the Kremlin to resort to harsh punitive measures, and the negative resonance in the West necessitated the expenditure of far greater political capital than Putin had budgeted for. To all appearances, the original plan envisaged the transfer to Gazprom of some 'expropriated' Yukos assets and the parallel 'friendly' takeover of the state-owned Rosneft, which should have resulted in consolidating a leading position in the profitable oil sector. In actuality, it was Rosneft that came out as a winner, not only preserving its independence but also swallowing most of Yukos, while Gazprom had to limit its ambitions to acquiring the rather unpromising Sibneft, perhaps for more than it was worth, so that the resulting controversies led to the departure of Deputy CEO Aleksandr Ryazanov in November 2006.²

The main problem is *not* that instead of one super-company dominating the gas-&-oil business the state has ended up owning two companies with often

¹ The best source on *Gazprom's* early history is Valery Kryukov & Arild Moe, "Gazprom: internal structure, management principles and financial flows", London: RIIA, 1996. Further evolution is thoroughly analyzed in Jonathan P. Stern, "The Future of Russian Gas and Gazprom", Oxford: OUP for the Oxford Institute for Energy Studies, 2005.

² See Claire Bigg, "Gazprom fires deputy CEO", *RFE/RL Newswire*, 16 November 2006.

clashing interests, but that a bitter conflict has split Putin's hermetically sealed court. This conflict is far more significant than the typically exaggerated and in many ways imagined confrontation between the 'liberals' (represented by Finance Minister Alexei Kudrin and German Gref, former minister for economic development) and the so-called 'siloviki' (literally, 'power-players'), who are more often than not at one another's throats.³ What is particularly striking about it is that a group of courtiers led by the deputy head of the presidential administration, Igor Sechin, was consistently able to overcome Putin's strong connections with, and affinity to, Gazprom, so that Sergei Bogdanchikov, the CEO of Rosneft, has clinched the most lucrative deals, quite possibly including the long-expected 'nationalization' of Surgutneftegaz.⁴

Energy Strategy and Political Expediency

The Energy Strategy approved in late 2003 has all the characteristics of a 'lowest-common-denominator' compromise between various state agencies, but already in the first year of its implementation, the real course deviated from its guidelines quite sharply in the direction of asserting greater state control over the oil sector.⁵ Gazprom's interests were supposed to be secured through an emphasis on increasing the share of coal and nuclear power in electricity production, which should have made greater volumes of natural gas available for export. This emphasis has been renewed in many presidential directives issued in 2007, but in reality domestic consumption of gas has increased far more than the Ministry for Economic Development expected, even allowing for German Gref's far weaker clout (inherited by Elvira Nabiulina) compared with GOSPLAN, which back in the mid-1970s orchestrated the energy shift toward natural gas.⁶ Problems in the coal

³ An updated reflection on this conflict is in Daniel Treisman, "Putin's Silovarchs", *Orbis*, vol. 51, no. 1, Winter 2007, pp. 141-153.

⁴ On the uncertainty around Surgutneftegaz that has caused a decline in its production in 2007, see Mikhail Zaharov, "This is my prey", *Polit.ru*, 19 December 2007. [<http://polit.ru/economy/2007/12/19/neft.html>].

⁵ Despite the obvious need in revising, the Strategy still formally remains in force and is available on the Ministry of Industry and Energy website [<http://www.minprom.gov.ru/docs/strateg/1>].

⁶ A sound analysis of the bottle-necks in the energy balance is in Vladimir Milov, "Russian energy policy: myths and reality", lecture at the Moscow School of Political Science, 1 June 2007. [<http://www.energypolicy.ru/news.php?id=1002549>].

industry (resulting in many tragic accidents) and shortcomings in the nuclear sector (related to the decline in heavy machine-building) remain outside the scope of this paper, but what is central to this analysis is the question of prices.

Domestic prices of gas (as well as of electricity) for both the communal sector and industrial consumers have been set so low that it directly affects the development of alternative energy sources and discourages efficient use, since waste remains cheaper than technology for saving. Gazprom has been lobbying long and hard for relaxing the strict state control over these prices that effectively denies it the crucial advantage of any monopoly: the ability to extract extra profit. It was in autumn 2006 that the issue was brought to the Kremlin in the most dramatic manner by both Miller and Chubais, who jointly argued that keeping prices at an unreasonably low level would have devastating consequences for the gas and electricity sectors, respectively. Putin's 'Solomonic' decision, nevertheless, was for a gradual increase, aiming at reaching the 'market' level (which means reasonably close to the export prices) during 2011.⁷ The very gentle increase of 11-15% implemented in 2007 means that the gap between domestic and export prices (at least as far as the benchmark of gas exports to Germany is concerned) has actually increased, while the consecutive 25% increases envisaged for 2008-2010 constitute a hugely problematic part of Putin's heritage. Medvedev, who is due to assume the presidential authority next May, is certainly familiar with this issue but still would find it very hard to execute the plan, whether Putin would indeed accept the position of prime minister or not.⁸ This postponement of a long-overdue question signifies a serious, perhaps even devastating, setback for Gazprom in the domestic political arena.

The much-used 'energy super-power' rhetoric has strengthened the perception in society that it is entitled to an unlimited supply of gas and electricity at easily affordable prices. Thus, at the traditional 'speaking-with-

⁷ See Aleksandr Bekker and Elena Medvedeva, "Putin does not dare", *Vedomosti*, 23 November 2006.

⁸ It is entirely possible that Putin has agreed to step down to the No. 2 position in the state hierarchy with the aim not to keep power but simply to get Medvedev elected; see Andrei Gromov, "President and his successor", *Expert*, 17 December 2007; Oleg Kashin, "To find a successor and neutralize", *Nezavisimaya gazeta*, 18 December 2007. My recent take on this problem is in Pavel Baev, "What role for *siloviki* in the Putin-Medvedev marriage?" *Eurasia Daily Monitor*, 21 December 2007. [http://jamestown.org/edm/article.php?article_id=2372688].

the-people' shows in both September 2005 and October 2006, Putin had to answer questions about the 'fairness' of exporting gas to the West, while in the country many people did not have access to this resource; visiting Kamchatka in September 2007, he had to deal first-hand with the issue of badly needed gas supply and took pains to explain that Gazprom was not to be blamed for the delay with constructing a pipeline.⁹ With all the propaganda efforts, the political decision to keep the energy prices artificially low has created an objective divergence between Gazprom's interests and the needs of the country; so instead of a 'patriotic pride' in the company's market capitalization reaching US\$300 billion, many Russians increasingly see it as a self-serving corporation for which state ownership means little.

Whether Putin relies on sophisticated risk analysis or on sheer instinct, this 'triumph' of political expediency over economic logic demonstrates that the Kremlin has its doubts regarding the stability of the seemingly rock-solid political system and seeks to minimize the ground for social unrest even of such a limited scope as the 'pensioners revolt' in January 2006. This denial of an opportunity to gain any profit on the domestic market has dire consequences for Gazprom, necessitating extensive borrowing and limiting the investment resources for long-term development of its core assets.

Putin and Gazprom

President Putin's particular attention to the gas business, perhaps more in the European market than domestically, and his eagerness in advocating *Gazprom's* interests are so well-known that there have been multiple speculations that he fancies the position of CEO after the expected transfer of power to a new leader in May 2008.¹⁰ At the annual meeting with the media in January 2006, Putin denied that he had this prospect in mind: 'Thank you for the job offer. I hardly see myself heading any business organisation - I don't see myself as a businessman either in temperament or in terms of my life experience.'¹¹ That denial was hardly convincing since

⁹ See Andrei Kolesnikov, "Commander-in-Chief for gas", *Kommersant*, 6 September 2007.

¹⁰ See for instance Aude Lagorce, "Will Gazprom be Vladimir Putin's retirement haven?" *Market Watch*, 16 May 2007. On Putin's particular attention to Gazprom, see Vladimir Milov, "The gas president", *Novaya gazeta*, 26 December 2005.

¹¹ As presented at the presidential website: [http://president.kremlin.ru/eng/speeches/2006/01/31/0953_type82915type82917_100901.shtml].

leading Gazprom would presumably require experience in managing clan conflicts and skills in directing diverse and unconnected business activities, while preserving corporate cohesion rather than any business 'temperament.'¹²

The mechanism that supports Putin's personal involvement in the gas business has always remained opaque as both the Kremlin and the Gazprom HQ are hermetically closed entities that tolerate no leaks.¹³ It is clear that Putin has never had any 'gasmen' in his 'narrow circle' of trusted lieutenants; for that matter, Dmitri Medvedev, despite being Gazprom's Chairman of the Board for seven years, has neither engaged deeply in the company's politics nor developed a solid understanding of the basics of the gas industry, leaving most of the decision-making to Miller.¹⁴ Medvedev's departure from the presidential administration in November 2005, while in hindsight appearing a 'smart' move in the succession master-plan (which quite possibly never existed), in fact inevitably reduced his access to the 'tsar's ear' and changed his priorities toward the 'national projects.' Sergei Sobyenin, former governor of the Tyumen oblast, who succeeded Medvedev as the head of the presidential administration, had developed strong ties with the oil business building a career in local administration, first of all with Surgutneftegaz and its CEO Vladimir Bogdanov; but his real influence in the Kremlin is far less than his prominent post would suggest.¹⁵ Alexei Miller is supposed to be the key channel from Gazprom to Putin, but it is unclear how this channel really operates; for that matter, Miller's protracted absence due to illness in summer 2007 did not have any visible impact on Gazprom's performance or Putin's micro-management of the company's affairs.¹⁶

¹² On the possibility of 'rotation' in 2008, with Medvedev moving to the Kremlin and Putin taking his place as the Chairman of Gazprom's Board, see Elena Mazneva & Ekaterina Derbilova, "Without a boss", *Vedomosti*, 21 December 2007.

¹³ One informed speculation is the report "Putin and Gazprom: Decision making on gas projects in Russia", *Alexander's Gas and Oil Connections*, October 2005/May 2006. [<http://www.gasandoil.com/goc/marketintelligence/russia/putin-and-gazprom.htm>].

¹⁴ On the rather atypical day that Medvedev spent in the Gazprom HQ a few days after his surprise 'promotion', see Aleksei Grivach, "The national treasure", *Vremya novostei*, 19 December 2007.

¹⁵ A good portrait is Natalya Melikova, "Sobyenin's phenomenon", *Nezavisimaya gazeta*, 13 November 2006.

¹⁶ The Kovytko conflict was resolved in his absence; see Ekaterina Derbilova, Elena Mazneva, and Maksim Glikin, "Miller's place", *Vedomosti*, 4 September 2007.

There are hardly any top-level officials with a background in Gazprom in the government; neither the former Prime Minister Mikhail Fradkov, nor Viktor Zubkov, nor Viktor Khristenko, the long-serving Minister for Industry and Energy, have any ties to the company.¹⁷ German Gref, former Minister for Trade and Economic Development, who represented the government on the Gazprom Board, is by no means a fan of expanding state control over the economy and the energy sector in particular, and once famously described Gazprom's plan for purchasing Sibneft as an example of 'Neanderthal thinking.'¹⁸

This surprising under-representation of the all-mighty Gazprom in the top echelons of state bureaucracy objectively limits its ability to influence the agenda of domestic politics, while at the same time encouraging the use of its vast resources for political purposes. The main avenue for such political instrumentalization of Gazprom, most probably supervised personally by Putin, has been establishing control over key electronic and print media outlets that have been consolidated in the branch company 'Gazprom-Media.'¹⁹ This trend manifested itself back in early 2001, when a team of independent-minded journalists was forced to leave the most popular TV channel NTV, which has adopted a cautious mainstream editorial policy after a hostile takeover by 'Gazprom-Media.' At about the same time, the weekly magazine *Itogi* was forcefully acquired (leading to the cancellation of its partnership with *Newsweek*), and in late 2004, popular daily newspaper *Izvestia* was purchased and swiftly transformed into a typical tabloid. It should be pointed out that the well-known radio station *Echo of Moscow* has been allowed by the 'Gazprom-Media' to maintain its 'subversive' liberal profile, and that the purchase of business-oriented *Kommersant* by Alisher Usmanov, the head of Gazprominvestholding, in August 2006, has so far not brought any visible shifts in its non-conformist editorial policy.

As a 'reward' for performing these functions and as compensation for the sustained losses on the domestic market, Gazprom receives various tax

¹⁷ In this ministry, the Federal Energy Agency is now lead by Dmitri Akhanov, who was one of the key managers in RAO EEC, and its former head Sergei Oganessian, had been a vice-president of Rosneft.

¹⁸ See Nikolai Vardul, "New Neanderthals", *Kommersant*, 11 October 2005.

¹⁹ The company reported the gross income in 2006 at only US\$800 million, but the real value, particularly in the election time is certainly far greater; the website is quite informative: [<http://www.gazprom-media.com/>].

breaks and subsidies for infrastructure modernization, so that in 2006 it paid some 360 billion roubles in taxes, while Lukoil, which produces nearly five times less hydrocarbons in energy equivalent, paid nearly twice as much.²⁰ That may be helpful for the corporate accounts, which in the first half of 2007 actually registered a drop in profits by some 25%,²¹ but it does not contribute in any useful way to the company's political profile.

Gazprom's '2008 Problem'

During the last year, Gazprom's political profile in the domestic arena has gradually but significantly changed, as the problem of Putin's 'exit' has grown inside his system of power, designed to prevent rather than to withstand such cataclysms. The general trend in the transformation of political climate has been toward strengthening 'sovereignty,' which in essence means minimizing external influences over the delicate but fierce power struggle in Russia, including even the unprecedented restrictions on the work of OSCE observers at the parliamentary elections. This 'sovereignization' has had a distinct economic dimension, as the Kremlin is steering the course toward greater state control over the economy and creating consolidated 'state-holding' companies in such key industries as shipbuilding, aircraft production, and, rather improbably, nano-technologies.²² Gazprom has been an important vehicle for this course of action, engaging in protracted business conflicts aimed at eliminating foreign control over key projects in the energy sector, first of all the nearly completed Sakhalin-2 (off-shore in the Okhotsk Sea) and the barely started *Kovykta* (Irkutsk oblast).²³ While both conflicts ended in 'victory' in the first half of 2007, it is not clear at all that Gazprom's interests are well-served as its relations with BP and Shell (not to mention Mitsui and Mitsubishi) have soured, while the sharp increase of the corporate debt and the expansion of

²⁰ See Vladimir Milov, "The hidden side of Gazprom's prosperity", *The New Times*, 13 August 2007.

²¹ See Sergei Kulikov, "Gazprom does not count the expenses", *Nezavisimaya gazeta*, 6 December 2007.

²² One thoughtful and sceptical reflection on this trend is Aleksandr Privalov, "On stability and zastoi", *Expert*, 5 November 2007.

²³ See Ivan Rubanov, "Catch-up boys", *Expert*, 29 June 2007; Ali Aliev, "Post-Sakhalin Syndrome", *Expert*, 22 December 2006.

complicated management tasks have added to the already overloaded control mechanisms, which operate with diminishing efficiency.

The political uncertainty regarding the distribution of power after Putin's departure had simply been paralyzing for Gazprom up until December 2007, as its management had to prepare for the prospect of a new leader opting for the installing of loyal sycophants as the CEO and the Chairman of the Board with the inevitable reshuffling in the ranks. Since the Kremlin has assumed the role of decision-maker in the key corporate policies, often going even into micro-management, Gazprom cannot have any control over its own acquisition or investment priorities. It is, therefore, unable to exploit a key advantage of being a monopoly—the capacity for strategic planning unperturbed by unpredictable battles of competition. For that matter, its investment plan for 2007, duly approved in autumn 2006, was drastically revised twice during the year, while the plan for 2008 hardly has any solid guidelines.²⁴

Putin's decision to promote the most humble and unassuming of his lieutenants, Dimitri Medvedev, for the 'throne' came as a complete surprise. At the start of the year, Moscow chattering classes entertained the possibility that Medvedev might be the chosen one; since spring, however, his star appeared to have been eclipsed, as he was overtaken in the entirely hypothetical race first by Sergei Ivanov and then by Viktor Zubkov.²⁵ However, the final result might signify less of a triumph for Gazprom's interests than one might at first expect. In fact, political pressure on Gazprom might even increase as Medvedev would feel the pressure to demonstrate that he puts national priorities ahead of corporate interests. The promises of generous increases in social programs made on the campaign trail, as well as big plans for state investments in infrastructure and 'strategic' industries, could only be fulfilled if the tax base significantly expands, which means less tax breaks for Gazprom; at the same time domestic constituencies are set to desperately resist the planned 25% spike in

²⁴ See Sergei Kulikov, "Gazprom has approved paper growth", *Nezavisimaya gazeta*, 13 August 2007.

²⁵ Persistent rumours put Medvedev in the chair of Gazprom CEO as Miller was widely expected to retire; see for instance Maksim Glikin, Aleksei Nikolsky, Elena Ivanova, "New job for Dmitri Medvedev", *Vedomosti*, 17 September 2007. On possible 'purges' in Gazprom top management, see Natalya Grib, Olga Mordyushenko, "Management under pressure", *Kommersant*, 1 October 2007.

gas prices. Gazprom could be instructed to contribute to all sorts of 'worthy causes,' from counter-terrorist operations (perhaps deploying its own armed units, about which little is known beside the fact that they were legalized in 2007) to preparations for the Sochi Winter Olympic Games, but denied any compensation for such efforts.

Conclusions

The uniquely tight coalescence between the Kremlin and Gazprom has on balance been far less beneficial for the company than is commonly assumed. While the mechanism of control by the presidential administration and feedback from the Nametkina St. HQ is closed to the extreme, it is clear that this 'interoperability' secured for Gazprom its monopoly on the domestic market and export of natural gas. At the same time, this mechanism also denied Gazprom the two crucial advantages of any monopoly: the self-serving control over prices and the strategic planning of developing the captured business. The expected election of Dmitri Medvedev as Russia's third president, while probably adding new features to the Kremlin-Gazprom 'marriage,' would not significantly alter the established pattern. The fundamental failure to develop and modernize the gas industry, vitally important for the country, could be covered up by political connections only for so long, but at the moment of reckoning no amount of scapegoating and cadre reshuffling would bring a miracle solution.

For the European companies doing business with Gazprom, politicians dealing with 'energy security' issues, and consumers depending upon deliveries of Russian gas, this unique symbiosis creates many complications and uncertainties. The companies have to acknowledge that the business logic works only *so far*, since current politics play a crucial role in decision-making in Gazprom, which could not be a trusted or even an understandable partner. Politicians have to reckon with the peculiar mercantilism in the behavior of the Russian leadership, driven by far closer ties with the energy business than those that exist between such European 'champions' as Total, ENI, or StatoilHydro and their respective governments. Consumers have to reconcile themselves with the fact that Russian gas, which cannot be substituted by any other sources, is subject to all sorts of political intrigues and conflicts that could escalate to such a level whereby the Kremlin, which has so far put profits ahead of any ambitions, would indeed consider the 'weaponization' of its energy instruments.

Gazprom, the Prospects of a Gas Cartel, and Europe's Energy Security

Vladimir Socor^{*}

Key Argument: At the Gas-Exporting Countries Forum meeting in Doha in April 2007, the first steps were taken toward creating an intergovernmental gas cartel. Chiefly a Russian initiative, such a cartel would, if realized, admit Russian control over an ever larger share of Europe's gas supply. Cartel members would be able to act collectively regarding price-setting, market division and common development of LNG technology. Central Asian gas exporters would likely be excluded from the GECF cartel, due to Russia's already strong control over the gas exports of these states, however the cartel could provide an instrument for managing competition Russia will likely face from Iran on the European market. The creation of a gas cartel would serve to consolidate Russia's position as the world's largest gas exporter and further undermine the position of European consumer countries.

Policy Implications

- In order to forestall the emergence of a Russia-led gas-cartel, the EU and U.S. should preemptively open direct access to Central Asian gas on competitive terms through the construction of a Trans-Caspian pipeline, which would undermine both Russia's ability to dominate a cartel and the cartel's price-setting power.
- European consumer countries need to prepare for developing Iranian gas fields when this becomes politically possible. Upon the formation of a gas cartel, the entry of Iranian gas to export markets may otherwise well end up being managed by Gazprom.
- Boosting liquefied natural gas development outside Gazprom's influence could be an important means for diversifying supply. LNG from Qatar would play a crucial role in this regard, especially as its close links with the west would probably keep it out of a gas cartel.

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Introduction

The Gas-Exporting Countries's Forum (GECF) is scheduled to meet in April 2008 in Moscow, as a follow-up to the April 2007 meeting held in Doha, Qatar. The group had been dormant until very recently, informal and barely noticed. But the Doha meeting took the first step toward creating a cartel-type system at the inter-governmental level that could control a lion's share of gas supplies to Europe and beyond. Russia is the main factor behind this initiative, and the upcoming meeting in Moscow can be expected to move closer to forming an exporters' cartel.

Media commentators tend to portray this initiative as equivalent to the oil cartel—an “OPEC for gas.” Should it materialize, however, a gas cartel would work in ways different from that of OPEC's; but it would be a cartel-type structure nonetheless, with its specific mode of operation. A group of Western experts reporting to NATO had anticipated in November 2006 that Russia would seek to form a gas cartel in the context of using energy resources to achieve political objectives. NATO refrained from publishing that internal report. The European Union at present does not seem to be considering policies to forestall the formation of such a cartel.

The GECF includes 15 member countries, among which Russia, Iran, Algeria, and Qatar rank as the largest gas exporters and/or estimated-reserve holders worldwide. From its first meeting in Tehran in 2001 until 2007, GECF had disclaimed any intention of controlling prices and volumes of gas supplies to consumer countries. This attitude has changed, however, as most of the group's countries are considering ways and means to form a cartel. Qatar's ultimate position seems uncertain (it had to show even-handedness as host and chair of the Doha meeting).

Western gas-exporting countries—Canada, Norway, and the Netherlands—oppose this initiative, as does the Western-oriented Azerbaijan. The Central Asian countries, lacking alternative export outlets for their gas, could end up in a Russia-led subgroup attached to the cartel. Such a situation would add to Russia's leverage over Central Asian gas-exporting countries, which in turn would compound Russian leverage over European countries. The West can

avoid this predicament by offering Turkmenistan and Kazakhstan direct access to European markets.

One self-evident rationale of the proposed cartel has to do with the pricing of gas. However, Moscow almost certainly thinks farther ahead. It looks at an almost stagnant gas production in Russia, internal consumption and Western demand both rising at the same time, supply shortfalls looming, and Russian export commitments jeopardized in the years ahead. Moscow must anticipate that other suppliers will seek to open or broaden their access to Western markets for pipeline-delivered or liquefied gas. If so, Russia probably envisions managing that process, by means of cartel-type arrangements that Russia could still dominate as the leading exporter by far. Through the proposed cartel, Moscow could obtain a significant say in the relationships between consumer countries and suppliers other than Russia.

Design: From Doha 2007 to Moscow 2008

The Doha meeting decided, behind closed doors, to set up a High-Level Group that would develop a common methodology on the formation of gas export prices and would conduct research on consumer markets. The High-Level Group, consisting of deputy ministers or departmental directors, is to discuss relevant proposals from member governments and submit its proposals for possible decisions at GECF's April 2008 Moscow meeting.

Russian President Vladimir Putin twice made trial-balloon statements of a general nature in favor of creating a gas cartel. Putin spoke from Moscow and again while visiting Qatar in the run-up to the Forum's meeting. He termed this an "interesting idea" that "needed to be examined," involving at a minimum "consultation and coordination" on gas export policies among member countries.¹ Meanwhile, Russian officials are apparently working out a concept of how such a cartel would operate.

Russia stands at the forefront of this initiative by dint of its disproportionate strength, compared to other GECF countries, in terms of gas reserves, field technology, own export potential, control of key transport routes, and presence on lucrative markets. It is also the only GECF member country to

¹ *Interfax*, 1, 2, 14 February 2007; Vladimir Socor, "Gas Supplier's Cartel: Not an OPEC, but Cartel all the Same", *Eurasia Daily Monitor*, 29 March 2007; Vladimir Socor, "Toward a Russia-Led Cartel for Gas?", *Eurasia Daily Monitor*, 30 March, 2007.

have developed a network of bilateral agreements with the other GECF countries on field operations and gas marketing. No other GECF country or group of countries can boast this combination of advantages vis-à-vis the other member countries. Those disproportions could guarantee a Russian coordinating role in a cartel's operations, should such a cartel materialize.

Capitalizing on these advantages, Russia has offered to chair GECF's upcoming meeting in 2008, serve as coordinator of the High-Level Group, lead the market research studies on price formation, and finance a large share of the Group's activities (apparently by covering the shares of impoverished member countries of GECF).

Some of the more radical or impatient governments, such as Venezuela, Bolivia, and Iran, called during the Doha meeting for creating a cartel immediately and then proceeding with research on price formation and market studies as the next step. A more sophisticated Russia, however, supported the sequence of steps that was eventually adopted at the Forum: research first, cartel afterward.

Russia fielded a powerful delegation led by Industry and Energy Minister Viktor Khristenko, Gazprom's president Alexei Miller and Vice-president Alexander Medvedev at the Doha meeting. These officials—as well as Valery Yazev in Moscow, chairman of the Duma's Energy and Transport Committee and president of the Russian Gas Society—hinted then and subsequently, sometimes broadly and sometimes obscurely, at Russia's expectations regarding a cartel-type structure of gas exporters. Those expectations do not presuppose the formation of a full-fledged cartel, but can be pursued through a cartel-type group, with cartel arrangements in selective areas.²

Thus, Russian expectations from a gas cartel seem to focus on:

- Agreeing within the group on common methods of price formation (thereby boosting gas prices to consumers);
- Allocating specific markets in consumer countries or sub-regions to specific gas-exporting countries, by means of understandings among the latter (in effect, dividing market shares among group members);

² Vladimir Socor, "Russia Poised to Lead an Evolving Cartel of Gas-Exporting Countries", *Eurasia Daily Monitor*, 10 April 2007.

- Avoiding competition among the group's countries on consumer markets (an intention that would clash with the European Union's competition policies);
- Ensuring "market reliability" by Russian definition (that is, a long-term lock on sizeable market shares);
- Reaching strategic understandings within the group on gas export volumes and schedules of delivery in various directions (thus to calibrate the levels of supplies to specific destinations);
- Agreeing in advance within the group on new pipeline projects (this would enable a cartel-type group to sustain its own arrangements about market allocation to specific exporters);
- Exploring and developing gas fields in member countries "jointly" (i.e., Russian access to some member countries' gas reserves, with potential Russian control of transportation and influence on those countries' export policy);
- Coordinating member countries' start-ups and production schedules at newly commissioned gas fields (this could mark a first step toward advance planning of overall production levels, relevant to the growing liquefied-gas trade);
- Planning jointly for development of gas liquefaction plants and export of liquefied natural gas (thus enabling Russia to use foreign technology for a massive breakthrough into LNG, the West's presumed antidote to Russian dominance of the pipeline gas trade).

Central Asia: Tied Directly to Russia outside the Proposed Cartel

Putin had first launched the idea of a Russian-led "alliance of gas-exporting countries" in 2002, focusing mainly on Turkmenistan but also on Kazakhstan and Uzbekistan. Putin's proposal triggered a first round of international debate on a mislabeled "OPEC for Gas."³

In essence, Putin's proposal meant that Russia would buy those countries' gas cheaply and re-sell much of it in Europe at a higher price, in a price-scissors' scheme. Or, as a twin option, Russia would use low-priced Central Asian gas for Russia's internal consumption, thus freeing up equivalent volumes of

³ *Wall Street Journal Europe*, 1-3 February, 2002.

Russian gas for high-priced export to Europe. And for a third option, Turkmen gas traded to Ukraine would enrich Gazprom's murky intermediaries Itera, EuralTransGas, and recently RosUkrEnergo.

This exploitative system took shape between Russia and Central Asian countries (preeminently in Turkmenistan) in 2002-2007 under Gazprom's control through bilateral deals outside of any cartel. The policy is to add Central Asian gas resources to those of Russia, in one vast pool under Russia's physical and commercial control. This is a much tighter form of control than Moscow could exercise over the gas exports of any countries in the now-proposed cartel.

Should a cartel be formed, Russia would want to continue buying Central Asian gas cheaply, at far lower prices than a cartel's prices. In such a situation, growing volumes of Central Asian gas not used inside Russia would be re-exportable at cartel-fixed high prices to Europe, again as "Russian" gas. Moscow wants Central Asia's gas resources tied to Russia directly, outside of a cartel.

Unsurprisingly, therefore, Moscow does not mention Central Asian countries as possible members of a GECF-based cartel. There is no public record of participation by Central Asian countries in the Doha meeting or in GECF as such. Moscow would not willingly allow Central Asian countries into an exporters' cartel. Russia would rather maximize its own strength within the proposed cartel by keeping for itself the transport and export of Central Asian gas. Russia's monopsony in that region would lie at the core of this international cartel. Thus, a monopsony-within-a-cartel is a distinctive feature of this design.

Iran: Unwilling Adjunct?

Iran sought to accelerate Russia's cartel initiative in the run-up to the Doha meeting and during the event. Both the Supreme Leader, Ayatollah Ali Khamenei, and President Mahmoud Ahmadinejad spoke out for such a cartel. In a variation on this idea, Minister of Foreign Affairs Manouchehr Mottaki proposed in December 2007 in Moscow the formation of a joint Russo-Iranian company for gas field development and export.⁴

⁴ *Interfax*, 13 December, 2007.

Such proposals are almost certainly a posture (rather than a choice) forced on Iran by a lack of immediate alternatives for developing its gas reserves, which are ranked among the richest worldwide. U.S. sanctions policy has blocked the field development and export of Iranian gas; the same sanctions also constrict Iran's oil production severely.⁵ However, given the increasingly heavy demand on global resources, the development and export, or the start of which at least, of Iranian gas by pipeline and as LNG is only a matter of time.

A gas cartel could help Russia to manage the inevitable entry of Iranian gas on international gas markets. Viewing Iran as a potential competitor on European markets, Russia has encouraged Iranian gas export projects toward Asia. Meanwhile, as Russian internal demand and supply commitments to Europe outpace Russia's production, Moscow might allow limited volumes of Iranian gas to supplement Gazprom's deliveries on certain markets in a carefully controlled process.

Such a process could first be observed in 2007 in Armenia and is potentially repeatable (in its essence, not in specifics) on other markets, whether by direct arrangements or through a cartel's allocations. In Armenia, Gazprom has yielded a portion of the gas market to Iran for several years ahead, starting in 2007. This decision stems partly from circumstances peculiar to Armenia: low-priced sales by Gazprom in a small monopolized market. Before agreeing to share that market with Iran, however, Moscow barred any transit of Iranian gas via Armenia to third countries; and it put Gazprom in control of the newly built transmission pipeline for Iranian gas on Armenian territory.

Even within such limits, Russia's decision to de-monopolize a country's market is unprecedented. It probably reflects the anticipation of a gas deficit, relative to Gazprom's internal and external supply commitments in the years ahead. In that case, it would make sense for Gazprom to plan a partial retrenchment from some of its markets. Russia could decide to yield some market share or niches to other gas suppliers in certain countries. But it would seek to confine the new suppliers' operations within agreed limits; and

⁵ U.S. Congressional Research Service, "The Iran Sanctions Act," *CRS Report for Congress*, updated 12 October 2007.

would give preference to suppliers whose gas export policies Russia could significantly influence.

In that context, Iran could play the role of Gazprom's adjunct, contributing small volumes of gas to supplement Russian stagnant deliveries or offset Russian shortfalls. The U.S. sanctions (along with the impasse on a trans-Caspian pipeline from Turkmenistan) are in effect shielding Russia from strong competition in Europe. Thus, a cartel-type arrangement could help Russia work with various lesser suppliers to coordinate market reallocation processes, in anticipation of tighter supplies by pipeline from Russia and an incremental shift toward LNG.

Mode of Operation: Implications for the West

Between the Doha and Moscow meetings, according to Yazev, "Russia could take up the integrating role in the gas cartel's creation." GECF's April 2008 Moscow meeting might create a standing body, such as an executive agency or a secretariat. That would indicate progress toward forming a cartel.

The widely used term "OPEC for Gas" is of course a misnomer. Oil for the most part is moving freely on the world's oceans and is traded in a global market. Gas, however, moves largely through single-destination pipelines and is therefore traded mostly in sub-regional and national markets (as long as liquefaction remains limited). OPEC can push price levels up or down, in short-term fluctuations; whereas gas supply contracts are, as a rule, longer-term.

A gas cartel's main role would be one that OPEC by definition could not play in the case of oil: namely, determining the destinations and routes of energy supplies from producer to consumer countries, practically allocating certain markets to certain suppliers on a long-term basis. A gas cartel can do that. The essence of a gas cartel would be the division of market shares and apportionment of market niches among its members. Such a cartel could, moreover, introduce quantitative ceilings to exports in specific directions, so as to limit the drawdown on member countries' reserves and maximize the price.

Unlike OPEC, such a cartel could involve a set of regional arrangements that allocate certain markets to certain suppliers, fix prices in those specific

markets, coordinate delivery volumes, and even plan exclusive LNG development projects.

Russia would be strongly placed to set cartel rules for allocating gas markets. To that end it can capitalize on its far superior export potential, its entrenched dominance in some European countries, and its control of several major transport systems and routes to Europe. Given that most gas exports move through single-destination pipelines to sub-regional or national markets (as long as liquefaction remains limited), any cartel-type group could consist of only two or three gas-exporting countries operating effectively in a specific market. For example, Russia's Gazprom could consider "sharing" certain European markets with Algeria's Sonatrach. Conversely—but also as part of cartel-type arrangements—Gazprom and other exporters in this group could agree to stay out of each other's market niches in certain European countries.

Meanwhile, GECF member countries Argentina, Bolivia, and Venezuela (the latter two with anti-U.S., pro-Russia governments) have set up the South American Gas Organization, a would-be regional cartel. Ultimately, an overall cartel that would evolve out of GECF could function as an umbrella organization for regional and subregional cartel-type groupings or arrangements.

If created, such a cartel would be dominated by Russia as the world's largest reserve holder, producer, exporter, and transiter of gas. Russia could shape a gas cartel's behavior to an extent similar to Saudi Arabia's dominant role in OPEC, although with different methods of operation, such as outlined above.

During 2006-2007, Gazprom and other Russian companies entered into gas and oil development projects in Algeria, Libya, Bolivia, and Venezuela (the latter is an up-and-coming exporter of gas). Russia seeks entry into gas projects in Egypt, other Arab countries, and Trinidad & Tobago (a significant exporter of liquefied gas), and is now eyeing the biggest prize: development and transport of Iranian gas from the South Pars fields. Gazprom's agreements (mostly of a preliminary nature) with those countries envisage integrated operations including exploration, field development, transport, and marketing. Such projects undermine the position of European

and North American gas-importing countries, in effect raiding the West's traditional and/or prospective sources of supply.

Possible Countermeasures

The European Union and the United States have several options at their disposal to forestall the emergence of a Russia-led gas cartel. Effective countermeasures are available in Central Asia, Iran, and through LNG development.

Central Asia is a key to diversifying Europe's gas supplies away from overdependence on Russia or a Russia-led cartel. The region's countries still await Western terms more attractive than Russia's exploitative terms for their gas. With an annual export potential well above 100 billion cubic meters from currently operating fields, Central Asia comes close to the order of magnitude of Gazprom's current annual exports to Europe. Turkmenistan alone is exporting nearly 60 billion cubic meters annually at present. Central Asia's potential is probably even higher, taking into account its still untapped (and far from fully estimated) reserves.

At present, almost 90% of Central Asian gas exports go to Russia each year. But these countries do not have long-term or large-scale binding agreements with Russia on gas deliveries. Turkmenistan's binding supply commitments to Russia run out in 2009. The remaining time holds a major, and probably final, chance for the U.S. and EU to encourage major energy companies to form consortia for upstream development in Central Asia and trans-Caspian pipeline construction to reach Europe. Kazakhstan, and potentially Uzbekistan, could add smaller but significant inputs into a westbound trans-Caspian pipeline from Turkmenistan.

Brussels and Washington have wasted six years through inaction on this project. Its reactivation need not be confined (as some suggest) to tapping unproven offshore fields, but can target the onshore reserves on commercially competitive terms. Field development and transport of Central Asian gas is more cost-effective and less subject to local state arbitrariness, compared with gas development and transport projects in Russia. Direct access for Central Asian gas to Europe under distinct commercial agreements would significantly undermine Russia's ability to dominate an exporters' cartel.

Moreover, it could undermine a cartel's price-setting power, thus throwing into question the rationale for creating a cartel.

Iran's entry into a cartel or bilateral arrangement with Russia on gas-export coordination would increase their price-setting power and also their political leverage vis-à-vis the West. Iran's role will become pivotal with the inevitable development of its vast, untapped gas reserves. Keeping Iranian gas locked in the ground cannot be a sustainable policy in the context of rising demand and prices, limited availability, and growing Russian leverage on consumer countries in Europe. In such circumstances, Gazprom may end up managing the entry of Iranian gas to export markets, in small volumes initially, either through bilateral arrangements or via the proposed cartel. Gazprom has earmarked certain sections of the South Pars gas fields and also intends to participate in LNG development in Iran.

Meanwhile, five major European companies have signed agreements of intent with Iran on gas extraction and LNG development, but the projects are stalled by the threat of U.S. sanctions against such companies. The Iran Sanctions Act (adopted in 1996 and renewed in 2006) stipulates U.S. sanctions against companies of any nationality that invest more than \$20 million in one year in Iranian oil and gas projects. This threat prevents Western companies from developing and bringing Iranian gas to markets in competition with Gazprom. The U.S. sanctions policy also reduces Iranian oil production, increases the prices of oil and gas to European and U.S. consumers, and helps enrich the Kremlin indirectly at Western expense.

If Iranian gas could reach Europe directly via Turkey, this could guarantee the long-term viability of the Southern Corridor and related gas supply projects of the EU. The preliminary agreement signed by Turkey and Iran in July 2007 on transshipments of Iranian gas to Europe is a promising first step.

Azerbaijan can kick-start the first phase of the Nabucco pipeline project or the Turkey-Greece-Italy interconnector. But the second-phase volumes would have to be within sight early on during the first phases of these projects in order to ensure their full-scale operation. This necessitates a timely political green light either for the development and delivery of Iranian gas or for the construction of a trans-Caspian pipeline.

Boosting LNG development outside of Gazprom's influence can also be a major countermeasure to a Russian-led cartel. Russia never mastered liquefaction technology on its own. Western development of LNG for sea tanker delivery in a global market can limit or offset Gazprom's expansion into European regional markets for pipeline-delivered gas. That had been a working assumption in the West well before Russia had aired the idea of a gas cartel. This warning should stimulate an acceleration of LNG development as an offsetting strategy.

Qatar could be pivotal in this regard. Since 2006 the Emirate ranks first worldwide for LNG production, with a 15% share of global exports in that year. Qatar shipped nearly 30 million tons of liquefied gas in 2006, expects to produce 47 million tons in 2008, and has set the target at 70 million tons of liquefied gas annually from 2010 onward. Foreign investments—that are projected to total \$60 billion—drive this growth. Investments and operations are shared among U.S., European, and Japanese companies. By agreement among them, LNG deliveries from Qatar are expected to go one third to North America, one third to Europe, and one third to East Asia.⁶ Russia will undoubtedly try to involve Qatar in the preparations for a would-be gas cartel at GECF's April 2008 Moscow meeting. But Qatar's close links with the West would probably keep the Emirate out of such a cartel.

Meanwhile, Russia seems set to acquire Western LNG technology from certain Western companies. Agreements signed during 2007 envisage LNG technology transfers to Gazprom, as part of the compensation for limited access to the Russian gas fields Sakhalin-2, Shtokman, and Kovykta. Thus, Gazprom is planning several gas liquefaction plants, including one near St. Petersburg with a dedicated shipping line to carry LNG via the Baltic Sea. A Russian breakthrough into the LNG trade could reduce the import options of many European consumer countries. Should Gazprom enter into LNG projects in various gas-exporting countries, Russia would try to use the proposed gas cartel for coordinating also LNG export volumes and prices among member countries.

⁶ Qatargas, [www.qatargas.com], accessed on 17 December 2007; *Upstream online*, 17 December 2007.

Gas remains the fuel in highest demand, which continues rising faster in absolute terms than the demand for any other fuel. Within its European strategy, Moscow evidently calculates that gas is the most dependence-inducing type of fuel, by dint of long-term supply contracts and its multiple uses. Inasmuch as those uses include electricity- and heat-generation for entire populations, gas supply is becoming an issue also in the internal politics of a growing number of consumer countries.

Overdependence on Russian supplies is not only an extortionate business proposition—one that some in Europe claim “can’t be refused”—but is also a component of Moscow’s strategy to splinter the Euro-Atlantic community politically. A Russia-led gas cartel would contribute to the pursuit of that goal. The GECF’s meeting in Moscow in April 2008 might not announce the formation of a gas cartel, but may well lay the foundation for one.

Part III: Energy Transit and Supply Diversification

The Role of the Black Sea Region in European Energy Security

Temuri Yakobashvili*

Key Argument: The Black Sea Region has emerged as a nexus of east-west and north-south hydrocarbon transit and is thus a hub connecting Europe, Russia, Central Asia, and the Middle East. This presents several challenges, including a need for the diversification of supply sources and transit routes; competition among suppliers and transit countries for control over energy deliveries to Europe, and concerns over environmental risks, especially in the Bosphorus. A field wherein cooperation has developed with greater ease has been the electricity sector. In this field, several projects are underway for the integration of electricity grids around the Black Sea, potentially reducing vulnerability as well as consumer prices for electricity. Finally, the energy infrastructure around the Black Sea is vulnerable to disruptions in the form of conflict and terrorism. Several of the region's existing pipelines run in close proximity to the region's existing or potential conflict zones, while acts of terrorism targeting pipelines have taken place.

Policy Implications

- The challenges posed by the increasing importance of the Black Sea region as a transit hub for energy underlines the need for additional and diversified supply routes, a significant amount of which need to be developed outside of Russian control.
- The development of an integrated Black Sea electricity grid could significantly reduce European consumer prices, especially as this would allow for purchases of Russian electricity, considerably cheaper due to Russia's low domestic gas prices.
- Disruptions or fear of disruptions of European energy supply due to disturbances caused by eruptions of conflict or terrorist attacks may cause significant energy price increases for European consumers.

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Introduction

This chapter addresses the role of the Black Sea in European energy security. It considers both the Black Sea itself and the littoral states (Georgia, Turkey, Bulgaria, Romania, and Ukraine), and, to some extent, the so-called wider Black Sea region, which includes the Western Balkans, Moldova, Armenia, and Azerbaijan. Russia is, of course, a Black Sea littoral state, and its role in European energy is, indeed, vast. This chapter will however consider Russia only as it bears directly on the topic at hand. It also seeks to maintain a broader perspective, as other chapters in this volume focus on some of the Black Sea region states.

Although European energy security strategy includes energy-efficiency and conservation measures, and efforts to diversify fuels and suppliers, in the near term Europe will almost certainly be increasing its imports of oil and natural gas, for transportation, direct conversion, and electricity generation. Russia, the Middle East, North Africa, and Norway are currently the largest suppliers, and all, with Norway as a partial exception, carry substantial risks of supply disruption, competition, and, in some cases, the exercise of market power as a political weapon. Even were these ideal suppliers, sound energy planning calls for the greater diversification of suppliers and supply routes as a hedge against any unforeseen circumstances and in the interest of a more resilient network.

Energy security consists of a reliable supply of energy resources, at predictable prices, without vulnerability to the manipulations of monopoly providers. There is little chance that Europe will literally run short of energy resources, but—as we have seen recently in Georgia, Ukraine, Lithuania, and even Belarus—there can be considerable financial and political costs to energy insecurity.¹ Governments, regional intergovernmental organizations, international lending organizations, and private companies all have roles to play in promoting the Black Sea region's contribution to European energy security.

¹ In the longer term, energy security is also intimately tied to environmental concerns, which are largely beyond the scope of this paper, with the exception of the danger of oil spills in the Black Sea or along terrestrial pipeline routes.

Oil and Natural Gas

Caspian hydrocarbons are conveyed to European markets by a combination of pipeline, rail, and tanker. See Figure 6 and Figure 7 for schematic maps of these routes that pass through the Black Sea region; note that not all routes are shown, and that the Baku-Tbilisi-Ceyhan (BTC) oil pipeline and the Baku-Tbilisi-Erzurum (BTE)² natural-gas pipelines have been completed. Also note that hydrocarbons from areas other than the Caspian basin may reach Europe transiting the Black Sea region (e.g., Iraqi oil via truck or pipeline to Turkey, or Qatari LNG via a Turkish terminal on the Sea of Marmaris); these flows are likely to remain small compared with Caspian-sourced supplies, but even small sources, on the margin, are important to maintaining supply diversification.

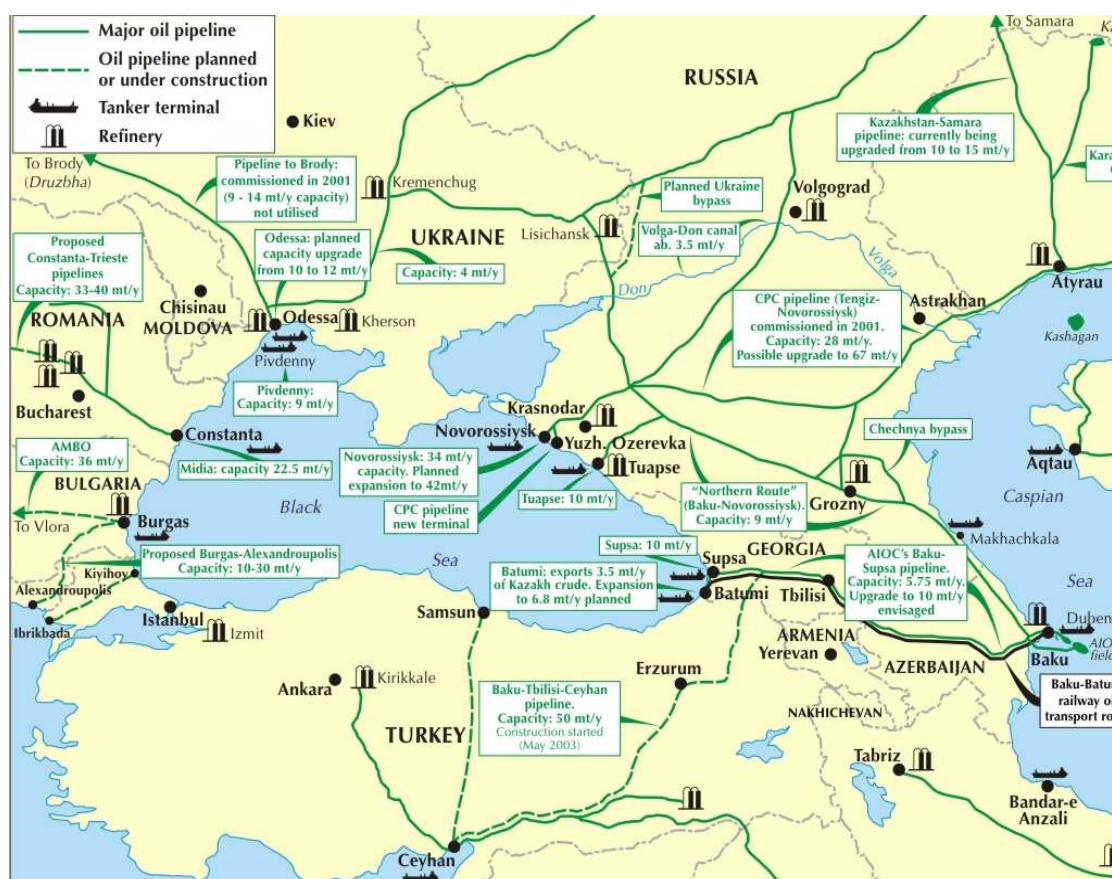


Figure 6: Schematic Map of Black Sea Oil Transit Routes (IEA, 2005).

² Also known as the South Caucasus Pipeline (SCP).



Geography, politics, and the economics of hydrocarbon transport compel European energy consumers to seek transit routes for Caspian oil and natural gas through and around the Black Sea. In addition, Turkey's need for supply diversification leads it to procure natural gas from Russia, through the Black Sea, and Armenia's political situation has required it to receive Russian natural gas via Georgia. The Black Sea region is, then, a nexus of east-west and north-south hydrocarbon transit—the hub connecting Europe, Russia, Central Asia, and the Middle East.

Caspian hydrocarbons are, will be, or might someday be, delivered to Europe, from Caspian Sea terminals, along several principal pathways:³

- Pipeline overland to a European terminal;
- Rail or pipeline to an eastern Black Sea port, then tanker to a western Black Sea port, pipeline to a European terminal;

³ How eastern Caspian basin hydrocarbons are transited to western Caspian Sea terminals will be left to another chapter in this volume.

- Tanker via the Bosphorus to a European Mediterranean port, pipeline to a European terminal;
- Tanker to a southwestern Black Sea port, pipeline bypassing the Bosphorus to a Turkish Aegean port, tanker to a European Mediterranean port, pipeline to a European terminal;
- Pipeline to a Turkish Mediterranean port, tanker to a European Mediterranean port, pipeline to a European terminal;
- Pipeline to a Russian Black Sea terminal, submarine pipeline to a Turkish Black Sea terminal, pipeline to a European terminal;
- Pipeline to an eastern Black Sea terminal, submarine pipeline to a western Black Sea terminal, pipeline to a European terminal.

This panoply of pathways reflects, in part, the need for the diversification of supply sources and transit routes, competition among suppliers and transit countries to control delivery to Europe, concerns about ship congestion and environmental risks in the Black Sea, especially in the Bosphorus, and the insufficient capacity of the least expensive, simplest routes. Diversification has helped to reduce traffic through the Bosphorus, but Caspian production is increasing rapidly (see Figure 8), and new transit capacity will be needed (see Figure 9; note that these data include some non-Caspian-region Russian oil).

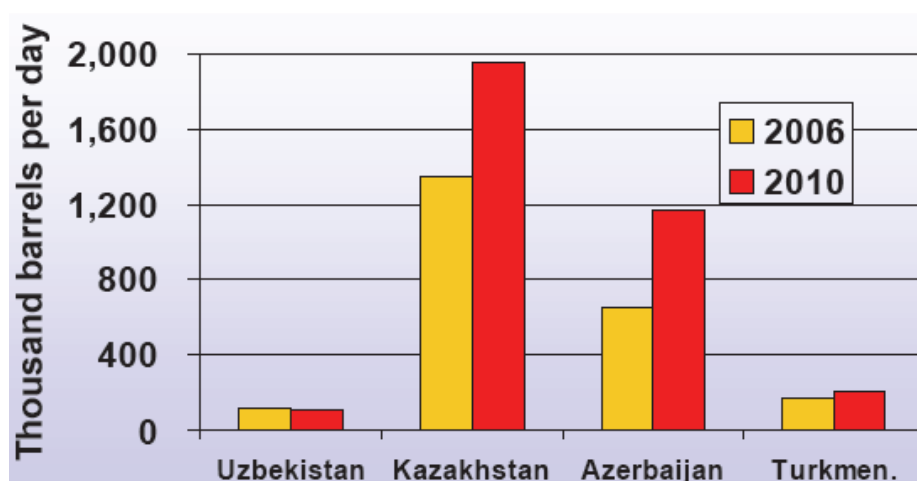


Figure 8: Current and Projected Caspian Basin Oil Production (IEA, 2007).

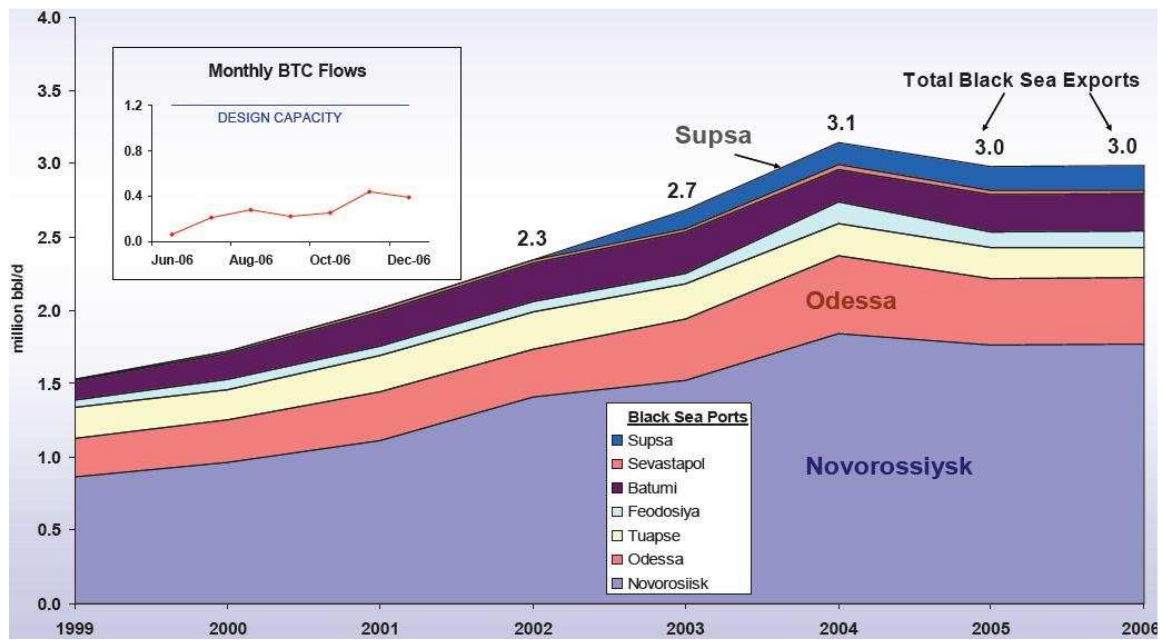


Figure 9: Annual FSU oil exports, by Black Sea point of origin (IEA, 2007).

Concerns about the Bosphorus drive many of the recently completed, in-development, planned, and proposed alternatives, with all countries in the region playing a role. Georgia is the critical link in the BTC and BTE pipelines, which could not traverse the more geographically favorable route through Armenia, because of Armenia's political isolation from Azerbaijan and Turkey. Georgia also carries Russian natural gas south to Armenia (which it has continued to do even as Russia has cut off supplies to Georgia over political disputes). For now, BTE will principally supply Georgia (which is entitled to five percent of the flow in lieu of a tariff, and has rights to purchase a substantial quantity on favorable terms) and Turkey's domestic market.

Bulgaria and Romania both carry gas south from Russia to Turkey, and will be involved in the Nabucco natural gas pipeline, which will connect with the Erzurum hub and terminate in Austria, via Hungary. While filling Nabucco with Caspian (or Middle Eastern, or Egyptian) natural gas would reduce Europe's dependence on Russia, it is also spurring Russia to increase delivery to Europe by many means. Gazprom is seeking to put its natural gas into Nabucco itself, and is holding negotiations with some of the Nabucco

partners to build a separate, roughly parallel⁴ pipeline to supply the same markets.

All three littoral countries are also planning competing oil pipelines to bypass the Bosphorus: Romania, through the northern Balkans to Trieste; Bulgaria, through Macedonia to Vlore, Albania; and Turkey, from Samsun to Ceyhan. Natural gas from Erzurum will also be able to reach Southern European markets, through the newly completed Turkey-Greece pipeline.

Ukraine already has a pipeline that could be used for transporting Caspian oil to European markets; the Odessa-Brody pipeline carries Russian crude *south* to the Black Sea for export through the Mediterranean, although it was originally built in 2002 with the intention of supplying Caspian oil to Poland.⁵ The United States and the EU both encouraged Ukraine to build the pipeline, in order to diversify its supply options and reduce its dependence on Russia. But a combination of Russian political pressure on the leaderships of Ukraine and Kazakhstan, and European reluctance to build the connections to Brody needed to supply European markets led Ukraine to fill the pipeline with Russian oil, headed south. With oil prices now at record highs and Europe becoming more concerned about Russian dominance of its energy supply, several agreements have been reached in the last year to extend Odessa-Brody to refineries in Poland and the Czech Republic.

The Blue Stream pipeline carries gas under the Black Sea, from Russia to Turkey. In addition to the conventional financial motivation, Blue Stream was intended to cement a comprehensive security and commercial relationship between the two countries. It also served the purpose of denying transit fees to Ukraine and Moldova, which are along the existing pipeline route (and which, Russia asserts, illegally siphoned off natural gas in transit). Furthermore, it was intended to be a more attractive alternative to a trans-Caspian pipeline,⁶ which would send eastern Caspian gas to Turkey via BTE—one more weapon in Russia's energy arsenal aimed at denying Georgia

⁴ This route would entail a second section of the Blue Stream pipeline, connecting to a pipeline through Serbia and Croatia to Hungary.

⁵ In particular, low-sulphur Azerbaijani and Kazakhstani crude, which would have been contaminated by sour Russian crude, were it to be transported by Russian pipelines.

⁶ The Trans-Caspian Pipeline has a sorry history, ensnared in legal and political disputes. Although the engineering-economic case for its development is strong, its future remains uncertain.

opportunities for European integration and economic stability. European environmental groups objected to the pipeline, with concerns about leaks on the seabed fouling the sea, and the United States publically objected to its development, exhorting Europe not to become ever more dependent on Russian energy.

The newly proposed South Stream pipeline illustrates the fluidity and uncertainty in Black Sea energy development. In June 2007, Italy and Russia agreed to build a submarine pipeline from Russia to Bulgaria, with two branches extending to terminals in southern and northern Italy, and from there to Austria. It is unclear whether South Stream would obviate the extension of Blue Stream into Bulgaria, and whether this reflects a cooling of Russia's energy partnership with Turkey, and how it would relate to possible Russian participation in Nabucco. What is clear is that Russia has the upper hand in determining who gets natural gas from where, and how. It does not win every contest, but no one in the region can afford to disregard its interests.

Finally (for the time being), expectations of rising natural-gas demand in Europe and huge production increases in Azerbaijan have led to a proposal for a Georgia-Ukraine-EU (GUEU) pipeline. It would branch off from BTE in Georgia, run to Supsa and then undersea⁷ to a Ukrainian Crimean terminal, and then connect with Ukraine's main distribution network for delivery to Poland, Lithuania, and Slovakia. The backers of GUEU take pains to insist that it will not compete with Nabucco or BTE, as demand will be sufficient for all routes to operate at capacity.

Further consideration of GUEU brings us to the issue of Russian control over Black Sea countries' domestic oil- and gas-transmission networks. Despite wielding tremendous power as a supplier, Gazprom can be outplayed when it doesn't own its export routes, as occurred during the pricing dispute with Ukraine in 2006. Since then, Gazprom has launched a northern route, Nord Stream, which runs under the Baltic Sea to Germany, cutting out Ukraine,⁸ as well as South Stream, which cuts out Turkey. In addition to

⁷ The GUEU pipeline would have to cross the Blue Stream pipeline on the seabed, in some of the deepest waters in which a pipeline has ever been laid.

⁸ Some in Poland and the Baltic states have likened Nord Stream to the Nazi-Soviet pact of 1939.

these new ventures, Gazprom seeks to buy and exercise control over domestic pipeline networks, especially in Ukraine and Georgia—which have greatly resisted such efforts⁹—but also in Belarus, Hungary, and Poland. Such ownership not only gives Gazprom more effective control over pricing and a greater share of profits, but as a state-owned company gives Russia political leverage over those countries. Europe has in many areas demonstrated that Georgia and Ukraine play important roles in European and broader regional security, so allowing Russian control over their energy infrastructures poses a potential threat to Europe’s security more generally, not just to its energy supply.

Russian control over Black Sea domestic energy networks concerns Europe not only for the leverage that it gives Russia over those countries, but for the threat that it poses to Europe’s own interests. For instance, Gazprom now owns a controlling stake in Armenia’s domestic gas-distribution network and its pipeline from Iran. Since Iran is a potential supplier of natural gas to Europe (most easily via Nabucco), this ownership allows for Russian-Iranian collusion to reduce competition and keep prices high. Furthermore, it gives Russia even greater influence over Georgia: now that Armenia will get natural gas from Iran, rather than via the pipeline through Georgia, Gazprom will be able to toughen its negotiating tactics even more. If Gazprom bought Georgia’s main trunk pipeline, it could deliver Iranian gas into Russia’s domestic network, for export onward.

Electricity

Black Sea regional cooperation extends to the electricity sector. For many reasons, electricity is less entangled in political concerns than oil and natural gas are, and so cooperation may be more easily achieved. The energy and economic ministers of Southeast Europe have reached agreement on the principles for a Treaty for the Energy Community of South East Europe,¹⁰ which will integrate its market with the EU’s. USAID is supporting this effort, as is the Black Sea Regional Electricity Transmission Planning Project, which is working with BSEC on developing an integrated grid

⁹ Although in Georgia, some diehard advocates of privatization support the sale even of critical infrastructure to the highest bidder—which, for the pipelines, would certainly be Gazprom.

¹⁰ “Treaty establishing the Energy Community,” *European Commission*, 2004. [ec.europa.eu/energy/electricity/south_east/doc/treaty/treaty.pdf].

around the Black Sea (Figure 10). With the leadership of Ukraine, GUAM is considering the Danube Energy Transportation Bridge, which covers all facets of energy security in the region, and specifically addresses improving the integration and reliability of GUAM member electricity networks and their merger with other BSEC members.



Figure 10: Proposed Black Sea Electricity Market (World Bank, 2006).

Numerous connections between neighbors form the basis of larger regional grids. For example, Turkey has interties with Bulgaria and Georgia (and with its eastern neighbors), and a study is underway for large-scale synchronous interconnections through Greece and the Balkans to Western Europe's UCTE network.¹¹ Georgia has interties, as well, with Russia, Azerbaijan, and Armenia, and has the potential for substantial seasonal electricity exports. In September 2007, Georgia and Azerbaijan announced that they had agreed upon a plan for synchronizing their grids, following on

¹¹ Simple physical connections between electricity grids does not in itself allow for full integration, which requires synchronization of alternating current and automatic load balancing (so that instantaneous generation equals instantaneous demand). The current regional infrastructure will require considerable upgrading to allow for unified grid operation.

a similar February agreement between Georgia and Turkey. Through these networks of networks (and UCTE and IPS integration), European customers will be able to negotiate electricity-supply contracts with suppliers as distant as Pakistan, enhancing their energy security.

There is considerable Russian support for electricity integration, as well. At a Balkan energy summit this year, President Putin called for the creation of a Black Sea electricity ring, as the core of a program to synchronize the electricity systems of Western Europe, the Baltic States, and the CIS.¹² While European consumers are naturally wary of greater reliance on Russian energy supplies, there may be some value to grid integration as another option. Natural gas is priced much lower in Russia's domestic market than Gazprom's export prices, due to a variety of Russian domestic political considerations. Whatever other complications this dual pricing may pose to Russia's European energy-trade partners, it presents an opportunity for the purchase of low-cost Russian electricity. While Russia wouldn't price electricity exports so low as to cannibalize its natural-gas exports, it could find that increasing competition from Caspian exports and alternative fuel sources would behoove it to set prices attractive to European customers. Completion of a Black Sea transmission loop could save importing countries on the loop about two billion dollars per year by 2015.¹³

Threats from Conflicts

It would be remiss not to mention potential vulnerabilities of Black Sea region energy infrastructure to conflicts and terrorism. Worldwide, oil and natural-gas extraction and transit is conducted both near to and within potential and actual conflicts; like harsh physical environments, these are factored into prices, and when the price is right someone will be prepared to take the risk. Even so, with narrow production margins for now and the foreseeable future, small disruptions from conflict—or even fears of disruption, could drive energy prices markedly upward.

¹² Vladimir Putin, Speech at the Balkan Energy Cooperation Summit, Zagreb, 24 June 2007. [http://www.kremlin.ru/eng/speeches/2007/06/24/1214_type82912type82914_135740.shtml].

¹³ Dejan Ostojic, "Comments on the Russian energy trade strategy," *World Bank*, 2006. [http://siteresources.worldbank.org/INTRANETTRADE/Resources/WBI-Training/288464-1162851806581/Dejan_Ostojic_2006.pdf].

The South Caucasus countries provide a worrying set of potential vulnerabilities. The BTC and BTE pipelines run near to Nagorno-Karabakh and the Armenian-controlled regions of Azerbaijan.¹⁴ Fueled by revenues from these very pipelines, Azerbaijan is rapidly building its military and some analysts suggest that it is considering a military intervention to retake lost territory. In Georgia, the pipelines run through the restive, mostly ethnic-Armenian region of Javakheti, where many local residents contend that pipelines harm their livelihoods. In Turkey, the pipelines run through the southeastern stronghold of the PKK, which has not fully settled its hostilities with the Turkish government. Georgia's oil ports on the Black Sea are not far from its breakaway region of Abkhazia. And Georgia's electrical interties with Russia are in the volatile North Caucasus republics.

We are not predicting any imminent flare-ups in these conflict zones, nor terrorist attacks on energy infrastructure. Furthermore, resurgent conflicts would not necessarily disrupt supplies to downstream customers. Nonetheless, concerns about violent conflicts are taken into account. The Chechen conflict forced Russia to route the Baku-Novorossiysk pipeline through Dagestan (itself hardly a stable republic). Azerbaijan, Georgia,¹⁵ and Turkey have formed a Joint Pipeline Security Commission to coordinate protection of BTC and BTE, which are buried along most of the route but have aboveground pumping and compressing stations that are vulnerable to attack.

And attacks on infrastructure are not merely hypothetical. In January 2006 explosions severed both the main and reserve natural-gas pipelines (in North Ossetia) and the main electrical cable (in Karchayevo-Cherkessia) from Russia to Georgia. The explosions—which came at a time of mounting tensions between Georgia and Russia—were identified as sabotage, but it remains unclear who the saboteurs were, and what their aims were, with various fingers pointed at Russian security forces, Georgia, local insurgents, and Chechen terrorists. In the decades-long Turkish-Kurdish conflict in Southeast Turkey, the Iran-Turkey pipeline has also been subject to frequent attacks.

¹⁴For a comprehensive assessment of threats to BTC, see Gal Luft, "Baku-Tbilisi-Ceyhan pipeline: Not yet finished and already threatened," *Energy Security*, 4 November 2004. [www.iags.org/n1104041.htm].

¹⁵U.S. and British Special Forces have trained Georgian Interior Ministry anti-terrorist squads that patrol the pipelines. Even the Georgian security authorities acknowledge that they would have no defense against an Iranian missile attack, in the event of a U.S.-Iran confrontation that Georgia gets dragged into.

Turkey's Role in European Energy Security

Volkan Özdemir*

Key Argument: Turkey's geographical position as a bridge between Europe and eastern energy producers makes it indispensable in any energy diversification strategy of the EU, especially concerning natural gas. With the completion of the Baku-Tbilisi-Ceyhan pipeline (BTC) and South Caucasus Pipeline (SCP), Turkey already fulfills an important function in this regard. However, Turkey is also subjected to Russian energy leverage, especially after the completion of the Blue Stream gas pipeline. This in several ways prevents Turkey from pursuing independent energy policies, and could potentially allow Russia to thwart EU diversification strategies involving Turkey.

Policy Implications

- In light of its current dependence on Russian energy, Turkey itself faces a need to diversify its energy supplies. However, consolidating its current political and economical relationship with Russia also holds several advantages, especially if Russia would allow for increased amounts of its gas to be re-exported through Turkey.
- This would further diminish Turkey's room for maneuver in energy politics, in all likelihood thwarting EU strategies for diversified energy imports from the Caspian region, as Russian-sponsored alternatives would remove the rationale of Nabucco and other diversification projects.
- Turkey's future role as a transit hub for either diversified energy supplies to Europe or one for increased Russian-controlled exports is highly dependent on U.S.-Russian competition over Caspian resources, the outcomes of which Turkey's decisions will affect significantly. In turn, Turkey's future positioning in Eurasian energy politics will likely relate closely to its future prospects for EU integration and eventual membership.

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Introduction

With an average economic growth rate of over 7 percent over the last five years, Turkey has become one of the world's rapidly growing energy markets. Turkey has been experiencing a demand explosion in all segments of the energy sector. Its primary energy consumption, which reached ca. 92 million tons of oil equivalent (toe) in 2006, is scheduled to rise to 126 million toe in 2010 and 222 million toe in 2020.¹ In spite of this energy thirst, Turkey is clearly in a situation of energy insecurity since only around 30 percent of its total energy demand is being met by domestic resources, while the rest is being satisfied mainly through imports of oil and natural gas. However, if economic reforms and growth continue, growing national demand for energy will force Turkey to invest in energy production and distribution. Turkey is not rich in oil and gas reserves, and until recently, the country's domestic potential in hydraulic, geothermal, solar, wind, and other renewable energies had been underutilized. In order to soften its dependency on imports and to meet increasing demand that might make electricity supply problematic by 2009, Ankara has undertaken a number of major infrastructural projects.²

The government has sought to stimulate domestic production by guaranteeing the purchase of electricity produced domestically through renewable energy, a reform that met with great interest among potential producers.³ Furthermore, after fifty years of deliberations on the issue, parliament finally passed a bill paving the way for the building of nuclear energy plants. Turkey's first nuclear reactor, requiring 60 percent domestic ownership by law, should be operating by 2013, and would meet 5 percent of the country's energy demand.⁴ All this will not change the fact that Turkey is and will continue to be overwhelmingly dependent on energy imports for the foreseeable future. 90 percent of oil consumption and almost all natural gas consumption is met by imports.

¹ "Turkey's Energy Strategy", Report by the European Commission. [http://ec.europa.eu/enlargement/pdf/european_energy_policy/turkeys_energy_strategy_en.pdf].

² *Sabah*, 3 March, 2007. [<http://www.sabah.com.tr/2007/03/03/eko134.html>].

³ "Herkes Ruzgara Kapildi" [Everyone's falling for the Wind], *Aksam*, November 3, 2007.

⁴ *Zaman*, 29 November 2007. [<http://www.zaman.com.tr/haber.do?haberno=619085>].

Nevertheless, Turkey is geographically located close (to its east) to 71.8 percent of the world's proven gas and 72.7 percent of oil reserves, considering its proximity to the Middle East and the Caspian basin. Its geography is also bounded by one of the world's biggest energy markets, the European Union, to its west. This location provides opportunities for Turkey to secure its own energy demands in an advantageous way, and to become an energy bridge between producers to its east and markets to its west. This is becoming all the more relevant to European energy security, given the decline of European domestic production, in conjunction with rapidly growing demand (particularly of natural gas), which puts EU member states in danger of becoming even more dependent on crude imports from the Middle East and gas imports from Russia. Russia's increasingly reckless foreign policy has heightened European concerns regarding energy security, spurring a quest for alternative gas supplies.⁵ The Caspian region and the Middle East play a crucial role in this context, because they constitute the only potential suppliers capable of serving as key producers for alternative sources of European gas deliveries.

With its strategic location, Turkey plays a crucial role as a natural "Energy Bridge" in plans to transport Caspian and Middle Eastern energy resources to Europe. The main pillar of this emerging reality is the 'multiple pipeline' strategy developed by the U.S. Government in the mid-1990s, with the support of its allies, in order to promote the flow of oil and gas westwards from the Caspian region through Turkey. Without either being a huge market in its own right or having rich energy resources, Turkey has succeeded in becoming an active player in the geopolitics and economics of Eurasian energy by relying on pipelines that would transit the Turkish mainland. Since the selection of pipeline routes confers political muscle on those who have them, pipeline politics is the most important factor for Turkish decision makers in the politics of energy. The general understanding is that control over oil and gas pipeline is at least as important as possession

⁵ See Svante E. Cornell et al, "The Wider Black Sea Region: An Emerging Hub in European Security", Washington: *Central Asia-Caucasus Institute & Silk Road Studies Program*, December 2006, p.73. [http://www.silkroadstudies.org/new/docs/Silkroadpapers/0612Blacksea_P.pdf].

of oil and gas resources, because whoever controls the lifeline of transportation in fact controls the energy resources.⁶

Oil Transiting and Bypassing Turkey

As far as the transportation of oil is concerned, Turkey holds particular importance already. As the first component of the East-West Energy Corridor, the Baku-Tbilisi-Ceyhan (BTC) pipeline, with a transport capacity of 50 million tons of oil per year, became operative in mid-2006. The BTC pipeline made Turkey an important energy hub for Europe, since Azerbaijani oil transported through the pipeline is imported mainly to Italy by tanker after being processed at the Turkish Mediterranean Ceyhan terminal. Moreover, Kazakhstan has officially declared its intention to join the BTC pipeline. In a June 2006 intergovernmental agreement between Kazakhstan and Azerbaijan, Astana agreed to ship annually 20 million tons of oil from the supergiant Kashagan field across the Caspian Sea to Baku in order to be pumped through the BTC pipeline.⁷

In addition to the BTC pipeline, nearly 4 percent of the world's daily oil consumption is shipped through the Turkish Straits. 8,000 ships passed through the straits in 2003, double the 1996 figure, carrying some 150 million tons of oil and petroleum products of mainly Russian origin.⁸ The dramatically growing tanker flow through the narrow Bosphorus, which passes through the middle of Istanbul with a population of 12 million, has reached such a level that further increases are untenable. Turkey has suggested resolving this problem through building bypass pipelines that would ease the traffic. But in conceiving bypass options, Turkey has sought to avoid losing its upper hand in oil transportation. Hence Turkey proposed a new route for Russian oil deliveries in the 1990s: the Trans-Thrace or Kiyikoy-Ibrice oil pipeline project. But this shorter and more efficient project was abandoned by the current Turkish AKP government in favor

⁶ Guo Xuetang, "The Energy Security in Central Eurasia: the Geopolitical Implications to China's Energy Strategy", *The China and Eurasia Forum Quarterly*, vol. 4, no. 4, November 2006, p. 126.

⁷ Vladimir Socor, "Kazakhstan-Azerbaijan Oil Transport Agreement: Not Yet Historic, But Might Become So", *Eurasia Daily Monitor*, Volume 3, no. 118, 19 January 2006.

⁸ K. Gajendra Singh, "Putin's visit to Ankara: Bear comes calling on grey wolf" *Turkish Daily News*, 30 August 2004.

of promoting another line, the Trans-Anatolia or Samsun-Ceyhan pipeline project.

The route change caused significant debate, mainly due to the government's decision to grant the project to the ÇALIK Energy company, without competitive bidding.⁹ The government's declared aim is to make Ceyhan an international oil terminal to which Azerbaijani, Iraqi, Kazakh, and Russian oil will flow simultaneously under Turkish control. Besides Caspian oil, Ceyhan is also the end point of the Kirkuk-Yumurtalik pipeline, which has the capacity of transmitting 70 million tons of Iraqi oil yearly. Rebel attacks and the ongoing turmoil in Iraq have nevertheless impeded the operation of this pipeline. However, Ceyhan's role as an energy hub was put on hold given the Russian government's decision not to opt in favor of Samsun-Ceyhan among several Bosphorus by-pass alternatives. Rather, it chose the Burgas-Alexandropolis pipeline (BAP), which is scheduled to convey 50 million tons of Russian oil per year from the Black Sea to the Aegean through Bulgaria and Greece. This deal is especially striking since the BAP pipeline will become the only pipeline on EU and NATO territory controlled by Russia, as Gazprom will hold a 51 percent stake in the operation. Hence Russia seems not only to have intended to by-pass the Turkish straits for environmental reasons, but also aimed to diminish Turkey's strategy to establish itself as a major transit country regarding oil.

A Potential Gas Hub for Europe?

As important as oil transportation might be, the leading component of Turkey's role as an energy hub is the transmission of natural gas. Natural gas differs from oil, as there is no global spot market for gas. Supplies of natural gas are normally conducted through long-term contracts between producers and consumers. Moreover, natural gas is difficult to transport across oceans, a process that requires liquefying natural gas (LNG). The LNG supply chain is expensive, requiring huge investments, with liquefaction and shipping dominating costs downstream from the wellhead.¹⁰ Pipelines directly linking

⁹ Metin Munir, "Samsun-Ceyhan Kulah Hatti!", *Milliyet*, 4 April 2007.

¹⁰ Donald A. Juckett and Michelle Michot Foss, "Can a Global Natural Gas Market Be Achieved?", in Jan H. Kalicki and David L. Goldwyn (eds.), *Energy and Security: Toward a New Foreign Policy Strategy*, Washington, D.C.: Woodrow Wilson Center Press, 2005, p.535.

producers and suppliers are therefore the usual form of transporting gas. This in turn is the basis for Turkey's potential role as a gas hub for Europe.

Through building a westward flow of gas from the Caspian and the Middle East, Turkey's goal is to become Europe's fourth main artery for natural gas after Russia, Algeria, and Norway, which Turkey also believes will help it to realize its main foreign policy aim; that is becoming a full member of the European Union.¹¹ However, Turkey's goal of becoming a fourth artery of gas is directly related to the realization of a number of projects envisaged to bring gas to and via Turkey. The country already has a well-integrated domestic gas network from north to south and east to west, although the throughput capacity needs to be upgraded in order to feed EU markets with larger volumes. There are currently four trans-boundary gas pipelines that cross Turkey's borders:

- From the west, the Russia-Turkey western pipeline, carrying Russian gas, with a capacity of 14 billion cubic meters (bcm) per year;
- From the north, the Blue Stream pipeline, carrying Russian gas, with a capacity of 16 bcm per year;
- From the east, the South Caucasus Pipeline, carrying Azerbaijani gas, with a capacity of 8 bcm per year presently, but upgradable to over 20 bcm;
- From the east, the Tebriz-Erzurum pipeline, carrying Iranian gas, with a capacity of 20 bcm.

As one of the main pillars of the East-West Energy Corridor project, the South Caucasus Pipeline (SCP) (operational since early 2007) is of particular importance. The SCP was constructed in parallel to the BTC oil pipeline, and at full capacity, it is designed to carry up to 20 bcm. According to the gas supply agreement for 2007, Turkey was allocated to purchase nearly 3 billion cubic meters per year through the SCP. Moreover, within the framework of the Oil and Gas Transport to Europe (Inogate) project, gas from SCP was delivered to Greece in November 2007, marking the first occasion on which Caspian gas reached the EU without passing Russian territory. It is also the

¹¹ Nadir Devlet, "Turkey's Energy Policy in the Next Decade", *Perceptions*, Vol.9 Winter 2004-2005, p.81.

first instance of Turkish re-exportation of imported gas.¹² The Gas Sales Agreement was signed in December 2003, foreseeing initial volumes of 0.75 bcm delivered to Greece, rising gradually to 3 bcm. The pipeline is expected to eventually transport an additional volume of 8 bcm further on to Italy.

The inauguration of the SCP paved the way for possible future East-West energy projects, such as the Trans-Caspian Natural Gas Pipeline, which would make the considerable natural gas reserves of Turkmenistan and Kazakhstan available for direct transportation to Europe. SCP contributes directly to European energy security, since the realization of this pipeline has also strengthened the prospects of the Nabucco pipeline project, which is scheduled to connect Austria with Turkey, and the Italy-Greece-Turkey gas inter-connector.

The Nabucco project, described in greater detail in Nicklas Norling's contribution to this volume, is of particular importance, as it is the main single project designed to bring large quantities of Caspian and Middle Eastern gas to the EU. That would in turn create a new integrated system of natural gas transportation ranging from Turkmenistan to Austria via Turkey, as an addition and alternative to the current Russo-European system. The problem has been to find significant sources of gas to feed into the pipeline in Turkey. The collapse of the Trans-Caspian Pipeline project (TCP) in the late 1990s hence poses the major obstacle for Nabucco. TCP, the only major element of the East-West energy transportation corridor that has not materialized, was derailed for a variety of reasons. One was the erratic policies of Turkmenistan's former president, Saparmurad Niyazov, who was in turn under strong Russian pressure not to accede to the project. Another was Azerbaijan's discovery of significant natural gas reserves of its own, at Shah Deniz, and a third was Turkey's own decision to go ahead with the Blue Stream project.¹³

Nevertheless, with the EU's renewed concern over gas interruptions and Russian assertiveness, this project has gradually been revitalized, as discussed in Svante Cornell's contribution to this volume. After the completion of the SCP, which could be considered a part of the original project, the missing

¹² 'Ilk gaz ihracina super zirve' [Super summit for first gas export], *Zaman*, 18 November 2007.

¹³ John Roberts, "Pipeline Politics" in Shirin Akiner (ed.), *The Caspian: Politics, Energy and Security*, Oxford: RoutledgeCurzon, 2004, p. 86.

link is the connection across the Caspian Sea, connecting Turkmenistan or Kazakhstan to Azerbaijan. This is nevertheless still impeded by a variety of factors, including Russia's strong lobbying for an additional pipeline connecting Central Asian gas resources northwards, as well as the conflict between Azerbaijan and Turkmenistan on border delimitation in the Caspian Sea. Turkey actively supports the resolution of the Azerbaijani-Turkmen dispute in order to realize this project, and Nabucco was at the top of the agenda during President Abdullah Gul's visit to Turkmenistan in late 2007.¹⁴

Aside from Caspian suppliers, Turkey is also conducting discussions with various potential gas suppliers in the Middle East to fill the proposed Nabucco and Turkey-Greece-Italy projects. The most important is probably Iran, since Tehran has already been discussing deliveries of gas to the EU via Turkey, whilst EU officials have spoken of Iran as a long-term gas supplier to EU member states. According to a Memorandum of Understanding signed between Iran and Turkey in July 2007, Iran will be able to export its gas to Europe via Turkey, and incorporating Turkmen gas into the same system will be possible.¹⁵ However, the U.S. Iran-Libya Sanctions Act is the main obstacle to this project being realized. Turkish officials also continue to discuss with their Iraqi counterparts the prospect of an 'Iraq Integrated Natural Gas Pipeline Project,' by which they hope to see a Turkish-Iraqi consortium created—which would, under a framework agreement originally signed with Baghdad in 1996, bring some 10 bcm annually into the Turkish system. The Turkish Petroleum Corporation (TPAO) has sought the rights to develop a gas field near Mansuriya, in Northern Iraq. However, the ongoing turmoil in Iraq and Turkey's approach of seeking to negotiate with the central government has impeded this prospect, making it impossible at the time of writing to sign a working agreement with the de facto Kurdish authorities in Northern Iraq.¹⁶

¹⁴ "Gul Turkmenistan'da enerjiji gorusecek" [Gul will discuss energy in Turmenistan], *Dunya*, 6 December 2007.

[http://www.cnnturk.com/DUNYA/haber_detay.asp?PID=319&haberID=409545].

¹⁵ "Gizli Ziyarete Iran'la Gaz Anlasmasi yapildi" [Gas Agreement was signed with Iran in Secret Meeting], *Sabah*, 15 July 2007.

¹⁶ "Iraq: Focusing on the non-oil sector", *The Free Library*, 15 May, 2006.

[<http://www.thefreelibrary.com/IRAQ+-+Focusing+On+The+Non-Oil+Sector+-+Part+6-W+-+Turkey-a0145789051>].

Turkey is also active in working for the transportation of Egyptian gas to its territory. Ministers from the two countries signed a Memorandum of Understanding in February 2006 to transport 4 bcm of Egyptian gas to Turkey. The project aims to transport an additional 8-10 bcm to Europe by the way of Turkey. There is already a constructed pipeline between Egypt, Jordan, and Syria, which ends 70 kilometers from the southern Turkish border. Construction of this missing section will be completed in 2008, and Egyptian gas is scheduled to arrive to Turkey in 2009.¹⁷ Saudi Arabia is also a potential supply alternative, as there are major gas reserves in the north of the Kingdom which could easily be connected to the Egypt-Jordan-Syria-Turkey line.

Why is Turkey a Must in EU Energy Security?

Based solely on market analysis, one could assert that Europe has alternatives to importing gas via Turkey. LNG from African, Gulf, and Caribbean suppliers are counted among the EU's alternatives in the long term. Such a prospect would diminish Turkey's role as a transit country. However, one should keep in mind the fact that energy security in today's world is not an end in itself, and to reduce its scope only to domestic economic affairs is deceptive. Rather, it is at the cornerstone of the security, economic, and foreign policy agendas of all states. Indeed, the interaction of strategic interests and energy security makes the case more forcefully for energy transit from the Caspian through Turkey.

The Caspian states seek multiple pipeline options to gain access to different markets and consumers in Europe and Asia. They do so partly to increase their revenue and to escape Gazprom's monopoly over the gas market. But a major reason is political: to consolidate their political independence from Russia. Through economic growth—that is only possible by direct access to various energy markets, Caspian states could boost their viability, providing security to a region that is highly vulnerable to soft security threats such as organized crime, religious fundamentalism, and drug trafficking. Put in more simple terms, for the Caspian states, diversification of energy exports and gaining material benefits is not an end in itself, but a means to achieve more

¹⁷ "Avrupa'ya Turkiye uzerinden Tasinacak Misir Gazinda Suriye Endisesi" [Syrian Concern for Transportation of Egyptian Gas to Europe via Turkey] *Dunya*, November 2007.

general goals of independence and stability. Turkey is ideally placed to match both the interests of the EU and those of the Caspian states. While providing diversification of resources to European countries, it would also contribute to spreading European influence into a wider area to its east, something that could be termed diversification with Europeanization through Turkey.

In fact, Turkey has already exercised this role. In late 2006, Russia used its energy leverage as blackmail to punish Georgia's pro-western foreign policy orientation, just as had been the case in Ukraine a year earlier. Gazprom asked for the doubling of gas prices for Georgian imports of Russian gas, from US\$110 to US\$230 per thousand cubic meters (tcm).¹⁸ Georgia sought Turkish and Azerbaijani help to overcome the crisis.

Through an agreement signed by Azerbaijan, Georgia, and Turkey for the redistribution of the quotas from the Shah-Deniz pipeline, and in spite of strong Russian pressure to desist from the deal, Turkey lent its quota of 800 mcm to Georgia. The unit price for this volume was not disclosed, but was reportedly \$120 per 1,000 cubic meters.¹⁹ Turkey hence relinquished the advantageous right to buy Azerbaijani gas at US\$120 dollars per tcm, compared to its imports from Russia at almost US\$300. Given its strategic goal of becoming an energy hub connecting the EU and the Caspian states, Turkey secured the stability and sustainability of its neighbor, in spite of suffering from high gas import costs. Of course, it would be impossible for Turkey, itself highly dependent on Russia, to take this decision had it not been for active American support and encouragement. This is a clear example of the common strategic interests of the U.S., EU, Turkey, Georgia, and Azerbaijan in the sphere of energy.

The Turco-Russian Rapprochement and its Possible Implications

A possible challenge to Turkey's transit role is the recent Turco-Russian rapprochement.²⁰ Unlike during the Cold War, significant cooperation has

¹⁸ Rovshan Ibrahimov, "Energy Potential Of Azerbaijan: Can It Be Used As Alternative For Russia?" *The Journal of Turkish Weekly Opinion*, 4 February 2007. [<http://www.turkishweekly.net/comments.php?id=2460>].

¹⁹ Vladimir Socor, "Shah-Deniz gas Buttressing Georgia, Azerbaijan economically and politically", *Eurasia Daily Monitor*, Volume 4, Issue 12, 17 January 2007.

²⁰ Fiona Hill and Omer Taspinar, "Turkey and Russia: Axis of the Unwanted?", *Survival* vol 48, no 1, Spring 2006.

developed between Turkey and Russia in the past ten years. Bilateral trade is expected to reach over US\$25 billion in 2007, making Russia Turkey's second largest trade partner—with a huge surplus in Russia's favor thanks to natural gas sales.²¹ Turkey currently meets over two thirds of its total gas consumption with Russian deliveries. Based on exaggerated projections for domestic gas consumption, Turkey became overcommitted in terms of gas deliveries, many of which were signed as take-or-pay contracts. Now Turkey risks paying significant amounts for gas that Turkey will be unable to consume, mainly as a result of committing to the Blue Stream pipeline, completed in 2003.²²

Although Turkey's dependency on Russian gas was obvious even before the construction of the Blue Stream pipeline, the way in which the Turkish energy ministry opted in favor of Blue Stream at the expense of the country's national interests brought a number of question marks and subsequent allegations of corruption and lawsuits against high government figures, some of which are still ongoing.²³

Ankara's energy policy during the past decade has suffered from the lack of a comprehensive strategic plan, and with limited integration of energy issues into Turkey's overall foreign, economic, and security policies.

Turkey's self-inflicted dependence on Russia has also been a clear strategic mistake, given the fact that Turkish and Russian interests in energy geopolitics are not compatible. Moreover, Turkey has accepted rather unbeneficial terms in this relationship, as several gas-fired power plants were constructed and have been given gas supply and electricity purchase guarantees. These private plants are selling electricity to state-run distribution companies at tremendously high prices. The disadvantageous clauses of signed gas sales and purchase agreements are difficult to renegotiate, and Russia is naturally demanding incentives to do so. This could be in the form of "exclusive" rights in constructing and operating (or

²¹ Suat Kiniklioglu, "The Anatomy of Turkish Russian Relations", Sakip Sabanci International Research Award, *Brookings Institution and German Marshall Fund*, 2006, p.6.

²² For detailed information about the project see, Volkan Özdemir, "The Blue Stream Natural Gas Pipeline: Implications on Energy Security and Foreign Policy", *Journal of Central Asian & Caucasian Studies*, Vol 2, No 3, autumn 2007.

²³ Harun Kazaz, "Blue Stream May be a Green Stream for Some Pockets", *Turkish Daily News*, 6 November 1999.

having a large stake in) underground gas storage facilities; receiving exclusive rights in the privatization of local gas distribution networks; or by transferring gas import rights to their subsidiary/affiliated companies.²⁴ Not surprisingly, after BOTAS's decision to liberalize the market for imported natural gas aiming to end the government's monopoly in the sector, a Gazprom partnership—Bosphorus Gas Corporation—was the first company to be awarded a contract for natural gas imports.²⁵

On a broader level, Turkish foreign policy in Eurasia has been substantially harmed because of its heavy dependence on Russia in energy terms. Policies that gave priority to the Blue Stream project posed strategic as well as economic problems for Turkey, as it provided Russia with advantages in all scenarios, while risking Turkey's own role as an energy hub for the EU. While some Turkish elite circles have tended to view Russia as an alternative or source of balance vis-à-vis the EU, this is clearly unrealistic. This is the case for the simple reason that Russia is in many ways a rival to Turkey's interests in Eurasia; and it can therefore not be a balancing card as long as Turkey is at the same time asymmetrically dependent upon Russia.

At the end of the day, Russia has managed to achieve a foreign policy success that the Soviet Union failed to achieve: a disruption in the Western alliance. Turkey did not deviate from the U.S. sphere of interest during the Cold War, but now the situation has changed. Russia's influence over Turkey's economic lifeline has entailed that Turkey cannot easily take steps in its foreign policymaking without taking Russian interests and reactions into consideration.

The EU's Attitude: Alienating or Embracing Turkey?

Turkey's transit role and its position in European energy security is also related to the nature of the gas contracts it has signed with partner states. Turkey's transit role in European energy security will depend on whether or not it can re-export the gas that it imports from other sources. Turkey has the right to re-export gas from Azerbaijan to other European customers. On

²⁴ Necdet Pamir, "Energy (In)Security and the Most Recent Lesson: The Russia-Ukraine gas Crisis", *Center for Eurasian Strategic Studies*, 22 September 2006. [<http://www.asam.org.tr/tr/yazigoster.asp?ID=1152&katz=4>].

²⁵ "Dogal Gaz Ithalat Sozlesmelerinin Devri" [Transfer of Natural Gas import Contracts] *Hurriyet*, 31 October 2007.

the other hand, agreements for the purchase of Russian and Iranian gas lack resale clauses. This might not constitute a significant problem with regard to the eventual onward selling of Iranian gas, since Tehran is eager to see its gas enter European markets via Turkey. Russia, however, is opposed to the Turkish resale of Russian gas to European markets.

Nonetheless, there have been discussions, developed by Gazprom, to sell gas to Turkey and give it the right to re-export the gas. Gazprom took this step in order to undermine the Nabucco project, proposing an alternative means of carrying gas via Turkey to southeastern and southern Europe through a second Blue Stream pipeline. President Putin personally raised this possibility in 2006.²⁶ However, the Turkish-Russian relationship has suffered lately, mostly because of Russia's decision to favor the BAP project at the expense of Samsun-Ceyhan, and Turkey's active support for Nabucco. Undoubtedly, Turkey expected Russia to favor Samsun-Ceyhan for the transmission of Russian oil, even though Russia was not offered majority control of the pipeline. The Kremlin, however, supported a more advantageous alternative. This indicates Russia's concern of not contributing to Turkey's role in Eurasian energy politics.

Indeed, Turkey's eagerness to see Russia as a strategic partner in energy is not shared by Russia. Instead, Russian decision-makers pursue an opportunistic policy, seeking to woo Turkey from the Western energy alliance. Furthermore, Russia now intends to build yet another bypass gas pipeline, called South Stream, across the Black Sea to Bulgaria, which would also bypass Turkey. An agreement between ENI and Gazprom was signed to this effect, with the support of the European Commission.²⁷ However, there is still room for a Turkish adoption of Gazprom's offer to become a transit state for additional Russian gas to Europe.

The future of European supply alternatives routed through Turkey is tied with the outcome of the U.S.-Russian struggle over Eurasian gas development. Whereas Washington supports the diversification of energy supplies by promoting a multi-pipeline strategy that will transport Caspian

²⁶ Vladimir Milov, "Energo Dialog Rossiya-EC: Zapolnit' Vakuum," [Russia-EU Energy Dialogue: Filling a Vacuum], *Rossiya v Global'noy Politike*, vol.5, no.5, October-December 2007.

²⁷ "Turkiye'nin AB Icin Enerji Koridoru Olmasi Giderek Zayifliyor" [Turkish Energy Corridor for the EU is Gradually Decreasing], *Radikal*, 26 June, 2007.

energy to markets through an east-west corridor, Russia seeks the consolidation and expansion of the Soviet-era north-south energy infrastructure, sustaining thereby its position as Central Asia's dominant energy supplier to markets. With Turkey being positioned at the center of these conflicting interests, its decisions will significantly affect this competition.

In this light, Ankara's stance is somewhat ambivalent. Turkey could serve either as an EU lever against Russia, or as the exact opposite. On the one hand, in order to guarantee its own energy security and play a role in diversifying Europe's energy supplies, Turkey needs to import additional energy resources from states other than Russia. On the other hand, relying primarily on Russian gas and even consolidating the ongoing trend can open new windows of opportunity for Turkey to form a special economic and political relationship with Russia. Ankara could conceivably follow the German lead in establishing a bilateral partnership with Moscow to balance the benefits and costs of playing a role in the EU's energy diversification policies. If alienated by the EU, it is possible, and even likely, that Turkey would choose this option.

The key point here is Europe's evolving stance on Turkey's accession to the EU, and the kind of integration that Brussels will be offering Turkey. Turkey's energy transit role has the potential to affect the evolving balances of power in the international system. In fact, the situation is reminiscent of the post-1945 era, where Turkey entered into the Western alliance mainly due to the Soviet threat. Even Khrushchev blamed Stalin for pushing Turkey into the hands of the West by adopting a hostile attitude and threatening it unnecessarily, causing the USSR to lose a vital state.²⁸ Instead, Turkey decided to ally with the West and played a key strategic role during the Cold War. At this point, the EU's attitude regarding Turkish full membership, and its transit role as an energy hub, could either spell continuity in Turkey's stance, or lead to the reversal of the half-century old strategy.

²⁸ William Hale, "Turk Dis Politikasi 1774-2000" [Turkish Foreign policy 1774-2000] (translated by. Petek Demir), Istanbul: *Mozaik*, 2003, p.121.

Figure 11: Turkey: Current Cross-Border Oil and Gas pipelines



Table 3: Supply potential of EU via Turkey²⁹

Country	Volume	Transit country	Potential by 2015	Existing system
Iran	10 bcm	Turkey	20-30bcm	3-10 bcm
Turkmenistan	13 bcm	Iran/Turkey	30 bcm	13 bcm
Turkmenistan	16 bcm	Aze.Geo/Turkey	30 bcm	None
Saudi Arabia	10-20 bcm	Jordan/Syria/Turkey	20 bcm	None
Azerbaijan	8 bcm	Turkey	20 bcm	8 bcm
Iraq	10 bcm	Turkey	10 bcm	None
Egypt	4 bcm	Jordan/Syria	10 bcm	Link to Syria

²⁹ John Roberts, "The Turkish Gate. Energy Transit and Security Issues", *EU-Turkey Working Papers*, No. 11, October 2004.

Table 4: Turkey's Natural Gas Sale and Purchase³⁰

Agreements	Volume BCMA (During the Plateau Period)	Date of Signature	Duration (Years)	Status
Russian Fed. (Westward)	6	14 February 1986	25	In operation
Algeria (LNG)	4	14 April 1988	20	In operation
Nigeria (LNG)	1.2	9 November 1995	22	In operation
Iran	10	8 August 1996	25	In operation
Russian Fed. (Black Sea)	16	15 December 1997	25	In operation
Russian Fed. (Westward)	8	18 February 1998	23	In operation
Turkmenistan	16	21 May 1999	30	-
Azerbaijan	6.6	12 March 2001	15	-

³⁰ BOTAS Website: [http://www.botas.gov.tr/eng/naturalgas/ng_buy_ant.asp].

Azerbaijan – A Partner for Europe in Energy Security

Elin Süleymanov*

Key Argument: Azerbaijan has over the last few years emerged as a key partner in European energy security, especially through the construction of the Baku-Tbilisi-Ceyhan and Baku-Tbilisi-Erzurum oil and gas pipelines. Energy wealth has also enabled Azerbaijan to pursue an independent foreign policy, contribute significantly to regional cooperation and increasingly being viewed as a reliable partner by the U.S. and European states. However, the escalating assertiveness of Azerbaijan's neighbors, Russia and Iran, highlights the need for increased EU support for Azerbaijan and the South Caucasian states. This should take the form of both new energy projects and engagement in improving the region's broader security context.

Policy Implications

- For a more comprehensive integration of the South Caucasus with the EU, more direct European involvement is needed in the energy and security areas. European support for Caspian energy projects and highlighting the importance of the region's energy resources for diversification of European energy supply should be priority areas.
- The EU could take steps to connect the East Caspian fields to the existing energy infrastructure in the Central and Western parts of the Caspian Sea, thus evading many controversies coupled with linking the Eastern and Western shores. Such an approach would also help fostering cooperative relationships between the Caspian neighbors.
- Other steps toward increased EU commitment may include engagement with GUAM and its individual members, establishing meaningful economic ties with the nations of the region, active involvement in conflict resolution and support for regional transportation initiatives.

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Azerbaijan's Strategic Role in European Energy Security

Azerbaijan, which has pioneered the practice of legislative guarantees to Production Sharing Agreements (PSA), has been a reliable partner for international energy companies for over a decade. For instance, the Azerbaijani government has been observing the terms of the 1994 “Deal of the Century,” the first major contract with international partners in the energy sphere and the largest single investment in the former USSR at the time. This is the case in spite of the fact that the price of oil, the circumstances and the position of Azerbaijan have changed dramatically since that 30-year agreement was signed. Still, even though some mutually agreed modifications have been made, Azerbaijan has been delivering on its part of the deal for 14 years and continues to do so. This stands in stark contrast with Gazprom's ever-changing approach to the terms of agreements it has signed. There are other cases as well, when, under pressure, international companies were forced to re-negotiate earlier agreements with their regional counterparts.

Oil produced as a result of the “Deal of the Century” is now being transported by the Baku-Tbilisi-Ceyhan pipeline, a project spearheaded by BP, to the Mediterranean. Frivolously described by some as a “pipe-dream” in the 1990s, the BTC pipeline stands as a vital element of the regional infrastructure and a success of Western policy. Incidentally, this pipeline, which brings non-OPEC oil from a Western-friendly producer to an open sea port in a NATO ally, provides a sizeable portion of Israel's imports.

Similarly, Azerbaijani natural gas now flows via the Baku-Tbilisi-Erzurum pipeline. Neighboring Georgia experienced how vital the Azerbaijani gas supplies were, when Gazprom decided to stop its deliveries to Georgian recipients during the coldest months of winter of 2006-07. The importance of the natural gas supplies from Azerbaijan and in the future from the Caspian region as a whole is bound to rise as Europe expects to increase its gas consumption. Caspian supplies, specifically those from Azerbaijan in the medium term, can help the Europeans both to increase their access to natural gas and move towards some degree of supply diversification.

This reflects an important point – it is not the resources and location alone, which have elevated Azerbaijan's profile, but also the policy choices made by

Baku early on under rather complicated circumstances. Baku, although market-driven, sees development of energy resources as within a comprehensive framework of building an integrated, prosperous and secure region. Therefore, Azerbaijan currently combines rare attributes as an energy producer and a regional partner, which shares the European outlook and has clear European aspirations. Moreover, Azerbaijan's position as a link between the Caucasus and Central Asia and the Government's policy aimed at strengthening cross-Caspian cooperation, too, provide rather unique opportunities for building bridges of integration between the Black Sea-Caucasus region and Central Asia. This policy has wide support across the political spectrum. Since the Central Asian nations are emerging as increasingly substantial energy producers and vocal regional players, engaging them more actively at this time may establish a strong foundation for further expanding and solidifying the East-West corridor framework. This, in turn, would contribute to Europe's energy security on the one hand, and facilitate cooperation among the nations of Central Asia, on the other.

Azerbaijan's Energy Policies in a Regional Context

In a region long viewed as a playground for external players, Azerbaijan's staunchly independent stance has, on occasion, raised neighboring eyebrows. A prominent and well-connected Moscow-based analyst recently enumerated complaints he had against Baku, which ranged from construction of the BTC and supplying gas to Georgia to participation in NATO's Partnership for Peace program and in GUAM. Not surprisingly, Russia continues to enhance its military alliance with Armenia, which occupies close to 20 percent of the Azerbaijani territory, and decided to double the price of natural gas Gazprom was supplying to Azerbaijan. Perhaps unexpectedly for Moscow and yet, in holding with Azerbaijan's increased confidence, Baku refused deliveries of Russian gas altogether and continued to supply its neighbor, Georgia, at a discount price. In a telling footnote, Azerbaijan's Foreign Minister Elmar Mammadyarov published a *Wall Street Journal* op-ed titled "Protect Us Against Bullies."¹ As Mammadyarov asserted, "It is Azerbaijan's sincere wish to have a pragmatic, market-driven relationship with Russia, but as an independent state we are guided by our national interest."

¹ Elmar Mammadyarov, "Protect Us Against Bullies", *Wall Street Journal*, 19 January 2007.

Iran, a major neighbor to Azerbaijan's south, also at times seems irked by Baku's close ties to Western partners. The most recent reminder came when a group of religious extremists was detained in Baku planning to attack Western targets. An investigation revealed a connection to Iranian state institutions.

For Azerbaijan, which has pursued the policy of pragmatic balance in its foreign policy, this renewed assertiveness on the part of its neighbors may mean less room for its trademark balanced approach. On the positive side, under Ilham Aliyev's leadership, Azerbaijan has turned its strengthened and stable internal structure into a fundamental element of such a balance. In other words, in this strategically important part of the world, Azerbaijan is no longer a mere consumer of Western support but rather a keystone for regional partnerships and a vital engine for development.

Azerbaijani servicemen serve along their NATO counterparts in Afghanistan, the Balkans and in Iraq. In fact, Azerbaijan just doubled the number of its soldiers in Afghanistan. Furthermore, Baku has taken a proactive approach to combating terrorism and curbing the spread of radicalism, a growing threat in the region. In terms of security cooperation, Azerbaijan works closely with its Western partners and has stepped up its cooperation with fellow members in GUAM, Georgia, Ukraine and Moldova.

Speaking in Baku recently, U.S. Senator Richard Lugar called on President Bush to appoint a special coordinator for Caspian energy issues. This is a somewhat belated recognition that other players employ clearly aggressive tactics in promoting their perceived interests and that in this part of the world, being an ally of the West comes with a certain price. In spite of the pressure from Russia and persistent suggestions from Iran, Azerbaijan has pursued a strongly independent energy policy, becoming a net exporter of natural gas and commencing its first deliveries of natural gas to the European Union market via the Turkey-Greece gas pipeline at the end of 2007. More recently, Azerbaijan moved to improve its relations with Turkmenistan, which has indicated hints of openness and moving towards more constructive policies.

The United States has repeatedly highlighted the importance of the joint projects involving the East Caspian energy producers, including possible

Trans-Caspian arrangements. For Azerbaijan the East-West Corridor is, naturally, the best conduit for transporting East Caspian hydrocarbons. In fact, Azerbaijan has over the years worked with both Kazakhstan and Turkmenistan on projects aiming at delivering their oil and gas to world markets through its territory. At the same time, should a Trans-Caspian conduit be established, Azerbaijan will serve as the key transit nation. Just as was the case with BTC and BTE, where the determination of the Azerbaijani leadership played a key role in the success of the projects, the East Caspian producers need to be the most vocal and determined proponents of Trans-Caspian initiatives. Azerbaijan will certainly be a pro-active participant should these projects move forward, but cannot realistically be a driving force in projects whose primary beneficiaries will be Europe on the one hand, and East Caspian producers on the other.

Domestically, for Azerbaijan, the energy projects provided the basis for improving living conditions of citizens and re-investing the oil income into diversifying the economy as a whole. The economic impact on Georgia and even on parts of Eastern Turkey has been visibly positive as well. Of course, the jury is still out whether Azerbaijan will succeed in lessening its dependence on the energy sector, which, over the last two years has fueled the world fastest growing GDP. The numbers suggest continuous domination of the oil sector, perhaps a natural result given the current energy prices. There are some reasons for optimism, however, both because of significant relative growth in other sectors and because of the way Baku uses its oil money. For instance, Azerbaijan used the money partially to finance its share in the BTC project and issued a loan to pay for the Kars-Akhalkalaki-Tbilisi-Baku (KATB) railway's Georgian section. Other reasons for optimism include the exemplary record of Azerbaijan's State Oil Fund, which recently became the first institution in Eastern Europe to receive the prestigious UN prize for transparency in the public sector, and the Government's recent initiative to finance the education of 15,000 Azerbaijani students abroad. Importantly, the Government has been able to move all of the IDPs and refugees from the Karabakh war from tent camps to more adequate temporary housing. For a nation where almost 1 person in 8 fled their homes as a result of Armenia's occupation, this is no small feat. While the sheer magnitude of Azerbaijan's IDP and refugee problem is still

overwhelming and hundreds of thousands are still waiting to return to their native homes currently under Armenian occupation, the fact that some of the early oil revenues are being directed at addressing the needs of displaced communities reflects an important trend.

Certainly, for Azerbaijan and Georgia, the unresolved territorial conflicts remain the main challenge. They also represent an ongoing threat to regional peace and security and can be exploited to exert pressure on both nations. Furthermore, the unresolved nature of the Armenia-Azerbaijan conflict has led to Armenia's self-imposed isolation from the region's most promising projects and its almost complete dependence on external players. The integration of the South Caucasus into the European space can happen only on the basis of respect for international law, recognition of the value of diversity and rejection of ethnic cleansing and violence against civilians. Hopefully, in the future, if one follows Europe's example, respect for each other's sovereignty translates into borders and differences becoming less and less relevant. In addition, in order for the South Caucasus to become an integrated region, which is the only option for fulfilling its potential, the disputes and disagreements must be addressed as a part of the overall regional architecture, not at its expense. In this respect, Azerbaijan's and Georgia's future-oriented vision is in strong contrast with the past-oriented single ethnicity-based policies of Armenia. In fact, Yerevan's approach undermines Armenia's own future and continues to weaken the region as a whole. The Europeans can and should step up their encouragement for Armenia to take a more pragmatic and contemporary approach. Certainly, the European effort to promote civil society will be strongly amplified once the South Caucasus is an integrated region and Armenia ends its self-inflicted exclusion.

The Need for EU and US Engagement

Over the last several years, the world has witnessed a sharp increase in the price of hydrocarbons, while in Europe the Russian gas monopoly, Gazprom, has moved aggressively to expand and simultaneously consolidate its presence on the natural gas market. Coupled with Gazprom's occasional use of wintertime gas supplies as an element of pressure on consumers for a variety of reasons, this raises a legitimate concern regarding Europe's energy

security. As any other commodity, the key to energy security lies with the diversity of sources. There are, of course, natural limitations to such diversity when it comes to energy resources. Yet Europe has not forcefully enough explored the opportunities offered by the Caspian region, one of the world's oldest oil and gas producing regions.

Energy is not the only area, where Europe shied away from pursuit of potentially beneficial partnerships. The ambitious TRACECA (Transportation Corridor Europe-Caucasus-Asia) project launched a decade ago remains a largely unfulfilled promise. On a variety of other regional initiatives, Europe has followed its American partners rather than taking the lead itself. Developments in the Caucasus and Central Asia regions are frequently described as a “new great game” – a label that implies confrontation, and is likely to cause concern for a European in the post-Cold War environment. Such a characterization is, however, misleading. While a degree of competition between various influential players exists, the area's development is very much shaped by the decisions made by the leaders of the regional states, which are growing increasingly confident and independent. Such a variety of regional players both necessitates a much more diversified policy from external partners and provides a historic opportunity in a part of the world undergoing a fundamental and yet rapid transformation.

The United States' strong engagement in promoting the East-West transportation corridor in general, and the Baku-Tbilisi-Ceyhan oil pipeline in particular, serves as an example of a transformative regional partnership. If America's involvement has been no secret and, in fact, has often been exaggerated, the strong political and popular support for the project in both Azerbaijan and Georgia has often been overlooked or not taken seriously. However, it has been this combination of external and domestic support in the nations of the region that fueled the East-West corridor's successes to date. In addition to diversifying international energy supplies – in spite of once-fashionable skepticism – both the BTC oil and the BTE gas pipeline projects have contributed to regional cooperation and accelerated the integration of the South Caucasus with the Euro-Atlantic community. Similarly, the Kars-Akhalkalaki-Tbilisi-Baku (KATB) railway project, a major Eurasian transportation link, is bound to deepen these processes. Incidentally, this project of a rather significant inter-regional consequence

was launched by Azerbaijan, Georgia and Turkey without much external support and, in fact, over the objections of a special-interest driven group in the U.S. Congress.

The situation with the KATB railway project is illustrative of a recent reality: with America's focus distracted by the war in Iraq and domestic developments, the European Union is yet to take on a more active role in the region. Of course, participants of this and similar projects are moving forward without external support; still one can only imagine the impact of the vision of the regional leaders being complemented by strong European and American support.

Another key element that proved a key to the success of the earlier energy projects was the hands-on involvement and encouragement of the U.S. Government. Without such a strong commitment as well as the active participation of the consumer countries, the success of Trans-Caspian initiatives remains a very promising, yet distant possibility.

More feasible arrangements can link the East Caspian fields to the existing energy infrastructure in Central and Western parts of the Caspian Sea without actually linking the Eastern and Western shores. Such an arrangement can connect, for instance, an oil or gas field in either the Kazakh or Turkmen sector of the Caspian Sea to an already functional pipeline linking an Azerbaijani field with the shore, without the redundancy of building additional pipelines to the Eastern shore. This, too, would require determination and creativity on the part of the producers and strong partnership with the consumer nations. If anything, this could also be helpful in promoting cooperative relationships between the Caspian neighbors. All of this could turn out to be a hypothetical discussion, of course, should Gazprom succeed in its forceful and accelerated efforts to further secure exclusive arrangements for deliveries of Kazakh and Turkmen gas. And, although the Western nations are still searching for ways to engage Iran into a less confrontational debate, a potential deal between Russia and Iran on the joint development and delivery of Iranian natural gas to the world markets would hardly constitute a contribution to energy security.

Azerbaijan's leadership in turning the Caspian resources into an important alternative source of energy for Europe has helped Baku to strengthen and

expand its partnerships. Azerbaijan's President Ilham Aliyev was a key participant at the October 2007 Vilnius Energy Summit; in June of the same year, Baku hosted the 10th anniversary GUAM Summit in Baku. Moreover, if the post-Soviet space is well-known for disputes among the new states, the strong Azerbaijani-Georgian partnership stands out as, perhaps, the best example of positive and mutually beneficial regional cooperation. This partnership also serves as the backbone of GUAM – a forward-looking group of pro-Western nations, which work together to promote common interests and to address shared concerns. There is little doubt that should the EU be more vocal in its support for both GUAM and the individual nations, the positive impact of regional cooperative arrangements would be much greater.

Europeans have been deeply involved in providing the region with humanitarian and democracy-oriented support. Both are valuable and necessary dimensions for integrating the South Caucasus with the EU. The EU has also recently launched the European Neighborhood Policy, another excellent integrative initiative. Yet, one could argue that the South Caucasus is more than a “neighborhood,” and for a more comprehensive integration more direct European involvement in energy and security areas would be most welcome. Specifically, European support to Caspian projects and highlighting the importance of the region's energy supplies for diversification of Europe's sources should be a priority area. This is even more important as America's preoccupation with the Middle East shifts its international attention elsewhere. With both Russia and Iran sharply increasing the assertiveness of their regional policies, the current presence of either the US or the EU is clearly insufficient to balance the pressures on the regional countries.

Conclusion

To capitalize on the existing opportunities, Europe needs to have a clear vision for its own energy security and for the Black Sea- Caspian region's future. Tangible results of such a vision demonstrated by the United States in 1990s contributed to the increasing diversity of energy supplies and transformed Eurasia. Today, some European nations, led by Poland, Romania and the Baltic nations, are actively building partnerships of the future with Azerbaijan and Georgia. Notably, Lithuanian President Adamkus issued a statement during the 2007 Vilnius summit for all European leaders to join him as *Friends of GUAM*. Engaging GUAM as a group and as individual nations can be one sign of Europe's commitment. Other steps may include establishment of meaningful economic ties with the nations of the region, actions aimed at bringing an end to unresolved conflicts and support for regional energy and transportation initiatives. Certainly, European participation in potential projects bringing either Kazakh and/or Turkmen energy resources directly to Europe's market would increase supply diversity.

Part IV: Achieving Access to Supplies: Key Projects

The Nabucco Pipeline: Reemerging Momentum in Europe's Front Yard

Nicklas Norling*

Key argument: The Nabucco natural gas pipeline may become the backbone in Europe's push for natural gas diversification. Due to uncertainty over supplies, the pipeline's viability has so far been questioned by investors. These uncertainties pertain particularly to the role of Iran and Turkmenistan in the project. The 2006 leadership transition in Turkmenistan, combined with improved Azerbaijani-Turkmen relations, have increased the likelihood of bringing gas from both shores of the Caspian Sea to Europe. Although many obstacles for the project's realization remain, these are not insurmountable—particularly provided trans-Atlantic unity on the issue.

Policy Implications

- A precondition for securing funding for Nabucco is providing clarity and strong political support. As Azerbaijan and Turkmenistan have the capability to fill the bulk of the pipeline, a joint push from Europe and the U.S. in realizing this would likely be far more positively received among investors than relying on Iranian gas.
- The U.S. has demonstrated its commitment in supporting the trans-Caspian pipeline financially and politically. This is an essential link in the East-West corridor and Europe can scarcely afford to align its strategy differently. The construction of Nabucco would also reignite the urgency of a trans-Caspian pipeline, and in the end, these two projects stand or fall together.
- Even Russia and Iran would benefit from the realization of these two projects. Greater competition will compel Russia to invest further in its energy industry. Iran, for its part, could focus its efforts on developing its LNG industry, which has far greater significance for both Europe and Iran in the longer term.

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Introduction

The announcement on November 14, 2007, that Azerbaijan and Turkmenistan will soon meet to begin demarcating their maritime borders in the Caspian Sea is an event which may have far-reaching implications.¹ A final resolution of this issue would be a major step forward in building a trans-Caspian natural gas pipeline and developing the so-far unexplored offshore Kyapaz/Serdar field lying in between these two countries. For Turkmenistan, a settlement of the dispute would likely imply that it could begin exporting gas westward on a route through the Caucasus bypassing Russian pipelines. The potentials for Europe are no less significant since the combined gas reserves of Turkmenistan and Azerbaijan would justify the construction of a gas pipeline from the Caspian Sea region to continental Europe, thus relieving Europe's strategic dependence on Russian gas. Had this meeting occurred a few years ago, it would likely have passed unnoticed.

Today, the geopolitical situation in the Caspian Sea region is remarkably different and a number of events in the last two years warrant this latest initiative to be taken seriously. These include the death of former Turkmen President Niyazov and the appointment of his successor Gurbanguly Berdimukhammedov, the completion of the parallel Baku-Erzurum gas- (also known as the South Caucasus Pipeline, SCP) and Baku-Tbilisi-Ceyhan (BTC) oil pipelines running from Azerbaijan to Turkey, and signaled intentions of the states in the Central Eurasian region that they want to explore other options than those presented by Russia.

Such options are also presenting themselves. The Nabucco pipeline—planned to run from Turkey to Austria, via Bulgaria, Romania, and Hungary—is currently regaining momentum after years of foot-dragging. Even if Gazprom recently has stepped up competition with Nabucco for the European market, this does not necessarily reduce the potential for Nabucco's construction *if* a speedy implementation of the project can be accomplished.

The major reasons for the impetus of Nabucco are the factors mentioned above, but also a growing realization within Europe that an overdependence

¹ "Azerbaijan and Turkmenistan will discuss in Ashgabat Caspian Sea status", *Gazeta*, 14 November 2007.

on Russia and Gazprom is strategically harmful, let alone the economic costs involved with being dependent on a monopolistic supplier. The completion of the SCP gas-pipeline in 2005 set a precedent for alleviating this dependence while the basis for constructing Nabucco was also strengthened. SCP currently transports gas from the Caspian Sea region and Azerbaijan's offshore Shah Deniz field to southern Europe, but there is still no pipeline connecting Turkey with Central and Northern Europe. Leaving this link incomplete not only impedes Europe's gas import diversification, but also prevents Europe from assisting the Caucasian and Central Asian states in pursuing a more balanced foreign policy independent from Moscow's purview.

Due to uncertainty over supplies and controversies over the participation of Iran in the project, the Nabucco pipeline has been consistently postponed. It is clear today that without Turkmen gas and a trans-Caspian pipeline, Nabucco's later stages make little sense since Iran's export capacity is very small. Equally, without Nabucco, the rationale behind the construction of a trans-Caspian pipeline would be hard to justify since gas would not be able to reach Europe. That is why these two pipeline projects stand or fall together. Now, and for the first time since the Nabucco pipeline was conceived in 2002, Azerbaijan and Turkmenistan seem intent on resolving their differences, which also opens up the opportunity for these two states to be the key suppliers for Nabucco. It also raises the possibility of a strong partnership between the U.S., EU, and associated export-credit banks to further jointly develop this alternative gas supply corridor. However, the policies of some European states, most notably Germany, Italy, France, and Turkey, have so far, and to varying degrees, hewed to Gazprom and Iran rather than been aligned with those of the U.S. This pertains both to investments from these states into the energy sector of Iran (and, in effect, undermining the U.S. sanctions regime toward the country) and also to a demonstrated indifference to Gazprom's dominance over Europe's gas imports while persistently ignoring the potentials of alternative supply corridors. This misaligned policy is a paradox since the U.S. interest in developing Caspian Sea energy resources, in the first place, was driven partially by a willingness to assist Europe in diversifying energy supplies.

The Nabucco Pipeline: Potentials and Impediments

This commitment ultimately resulted in the construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline in 2005. This pipeline represents no less than a milestone in Eurasian energy security—for two reasons. Not only does it tap into one of the few existing energy reserves outside the control of OPEC and Russia, but it has also set a precedent for the construction of other pipelines. One year later, in 2006, the SCP gas pipeline running parallel to BTC was inaugurated. This pipeline today supplies the Turkey-Greece-(Italy) *Interconnector* pipeline² and the South European market with gas. More importantly, the Central Asian and Caucasian states saw a light at the end of the tunnel in terms of ending Russia's anachronistic way of doing business with them. These two pipelines, together with the development of the Azeri-Chirag-Gunashli oilfield and the Shah Deniz gas field, form part of a strategic corridor called the Azerbaijan-Turkey-Georgia pipelines system, or the "East-West Corridor". This corridor is not primarily of European making, but nevertheless gives European countries the opportunity to utilize it. When completed, this corridor will transport energy supplies from Kazakhstan and Turkmenistan across the Caspian to Azerbaijan, from where it will be piped through Georgia, Turkey, and eventually end up in European markets.

The Nabucco pipeline project forms an indispensable part in this corridor, since gas from the Caspian Sea region will fail to reach Europe in any significant quantity unless the pipeline is in place. Though the project has yet to take off, the tentative timeline aims to have the first phase of the pipeline in operation by around 2012. In the first construction phase, a link will be built between Baumgarten in Austria and Ankara in Turkey. When this phase is completed, the already existing pipeline links between the Turkish/Georgian and Iranian borders will be used to allow the pipeline to start operation. The second construction phase will begin in 2012 and be ongoing until the end of 2013, when the links between the Turkish border to Georgia and Iran are expected to be completed.³

² The Interconnector pipeline, stretching from Turkey to Greece and with a planned extension to Italy, came into operation on 10 August 2007. The pipeline will have an initial capacity of transporting 8 bcm per year but could potentially be upgraded to 22 bcm; supplies will mainly come from Shah Deniz.

³ See [www.nabucco-pipeline.com].

Nabucco has been endorsed as a priority project by the European Commission and recent events indicate that many other important actors are pushing for its realization. For example, only a few days after the Budapest conference on Nabucco in mid-September, the UK's energy minister, Malcolm Wicks, paid visits to both Turkmenistan and Azerbaijan, thereby indicating the emerging roles of Turkmenistan and Azerbaijan as the central suppliers to the pipeline. This was followed with a visit by Austria's Economics Minister Martin Bartenstein to the very same countries; Austria's OMV is the leading stakeholder in the Nabucco consortium. Moreover, in October 2007, EU foreign policy chief Javier Solana visited Ashgabat to start negotiations on Nabucco.⁴

But despite these positive signs the project still has an air of uncertainty to it. This is partly due to redoubled attempts from Gazprom to undermine the relevance of the pipeline: by launching the competing South Stream gas pipeline project, courting some of the Central European countries in the Nabucco consortium, and tying up most of Turkmenistan's and other Central Asian states' gas reserves, Russia seeks to block Europe's diversification of gas to the Caspian Sea region.

Gazprom's offensive has been particularly pronounced in early 2008. First, the company signed a major natural gas deal with Bulgaria on January 18 committing the country to the South Stream pipeline. A few days later it purchased a 51 percent stake in Serbia's NIS oil and natural gas company, which, in effect, also will tie it to the South Stream pipeline project. Moreover, on January 25, it was announced that Gazprom had acquired a 50 percent stake in OMV's natural gas-hub in Baumgarten Austria, the planned distribution center of the Nabucco pipeline.⁵

But this does not automatically imply that Nabucco is dead, especially since there is demand for both.⁶ However, it does imply that Russia gradually increases its leverage over the Central European participants in the Nabucco

⁴ "EU in talks on Nabucco gas project", *Gulf Times*, 10 October 2007.

⁵ See "Moscow gets direct pipeline to Europe," *International Herald Tribune*, 19-20 January 2008 (print edition) and "A 'pipeline war' victory for Russia," *International Herald Tribune*, 26-27 January 2008 (print edition).

⁶ See for instance, "Moscow gets direct pipeline to Europe," *International Herald Tribune*, 19-20 January 2008 (print edition).

consortium which will make it harder for them to pursue the Nabucco pipeline.

At the same time, blaming Russia solely for Europe's inaction is a very tendentious approach to the issue. Rather, many European states have themselves to blame for ending up in this strategic dependence on Russian gas. This pertains particularly to Western European states which have more room to bargain with Gazprom than the East or Central European states.

So far, many of the former have preferred striking bilateral deals with Gazprom rather than supporting energy diversification to the Caspian Sea region. Germany under Schröder, Italy under Berlusconi, and France under Chirac are some recent examples of this. Gerhard Schröder, for instance, has referred to Nabucco and Europe's supply diversification to the Caspian Sea as "nonsense"—an unsurprising standpoint considering his close affiliations with Gazprom. Leadership transitions in these countries and growing concern at the EU level about energy security have, however, spurred increased interest in Nabucco's construction.

Europe's potential in importing gas from the South Caspian Sea region is also astounding: 80% of world natural gas supplies are located within a radius of 4,500 km from Central Europe, while four-fifths of these supplies are located in Western Siberia, North Africa (plus Nigeria), the South Caspian/Gulf region, and in Europe. Still only 1% of Europe's gas imports originate in the Middle East and the South Caspian Sea. This is in spite of the fact that the Middle East and the South Caspian Sea region can produce cheaper gas and are closer than Western Siberia.⁷

Although Nabucco initially was primarily intended to pipe gas from Iran and the Middle East, the construction of the SCP gas pipeline and the development of Shah Deniz have made Azerbaijani supplies more attractive in the short run. The re-emergence of Turkmenistan on the strategic maps of Europe and the U.S. has also made this country a potential lynchpin in the project next to Azerbaijan and, as conceived by the Nabucco consortium, Iran. Other actors interested in supplying Nabucco today include Egypt, Iraq, Libya; but the lack of infrastructure combined with uncertainty over gas

⁷ Friedemann Muller, "The Role of Iran and the Region for global energy supply" in Eugene Whitlock (Ed.), *Iran and its Neighbors: Diverging Views on a Strategic Region*, German Institute for International and Security Affairs, July 2003, p. 69.

supplies impede these states from filling it. The main focus below will therefore be on Azerbaijan, Turkmenistan, and Iran.

An Assessment of the Suppliers: Azerbaijan, Iran, and Turkmenistan

Azerbaijan is the country, among the states surrounding the Caspian Sea, which has gone the farthest in supplying Europe with gas and is also the only country which has concluded an agreement on supplying Nabucco.⁸ Though the Shah Deniz field has the potential to fill the first phase of the project, its capacity will be limited to the production of around 8-12 bcm of natural gas per year in 2011-2012. As such, Azerbaijan will be unable to fill both the Interconnector Turkey-Greece-(Italy) and Nabucco alone unless additional supplies are developed. The fields of Nachchivan and Gunashli or untapped gas reserves under the Azeri-Chirag-Guneshli offshore oilfields represent particular potential in these endeavors. Also, recent discoveries in the Shah Deniz field which may double the field's output should not be disregarded.⁹

Second to Azerbaijan, Iranian gas has been regarded as the most likely option to fill Nabucco; but the circumstances surrounding its nuclear program have made Iran an uncertain factor.¹⁰ An additional factor of uncertainty is that Iran does not currently have any export capacity as a result of its high domestic consumption. As such, Iran will likely have a hard time even filling the 2.8 bcm per year it promised to allocate to Nabucco in 2005. Turkey is currently Iran's only export outlet for natural gas but the flow has so far been uneven. The 20 bcm Tabriz-Erzurum pipeline operates far below full capacity and is currently only delivering around 7 bcm per year.¹¹ The Tabriz-Erzurum pipeline has also been vulnerable to attacks by PKK militants and numerous explosions have disrupted its operation. As recently as September 10, 2007, the pipeline's operation was again disrupted by an explosion 5 km

⁸ Thomas Kreyenbuhl, "Iran-Turkey Gas Deal Gives new Hope for EU Nabucco Pipeline", *World Politics Review*, 9 October 2007.

⁹ "StatoilHydro upbeat on BP's Shah Deniz discovery, Reuters, 14 November 2007.

¹⁰ Vladimir Socor, "Strategic Issues Facing the Nabucco Project", *Eurasia Daily Monitor*, 20 September 2007.

¹¹ "Iran listens for pipes of peace", *Petroleum Economist*, February 2007.

inside of the Turkish border.¹² It is uncertain how the Nabucco consortium could sustain yet another pipeline linking Turkey with the Iranian border.¹³

Iran's major gas fields are located in the Persian Gulf and mainly in the giant South Pars field. In consequence, European investments will be needed to improve the development, efficiency, and transportation from these fields in the longer term if intended for Nabucco. But this is also beset with problems since the development of South Pars is primarily intended for domestic consumption and LNG exports. Iran currently has a north-south gas infrastructure from the Persian Gulf to northern Iran, but this is already fully committed to supplying Iran's domestic gas needs. Indeed, this Soviet-era trunk line could only be sustained for 10 years as a result of growing domestic needs. To relieve these supply deficits in Northern Iran, Tehran has even held discussions with Azerbaijan on importing natural gas from the country.

Indeed, despite having the second largest gas-reserves in the world, Iran is a net gas *importer*. In 2005, and with a domestic consumption reaching as high as 243 mcm/d, Iran was a net-importer of roughly 5.6 mcm/d, and domestic demand is expected to grow by 7% annually in the next decade.¹⁴ These growing domestic needs have also affected the flow in the Tabriz-Erzurum pipeline. In early January 2007, exports through Tabriz-Erzurum dropped to naught following cold weather and increased domestic consumption in Iran. These disruptions have been repeated during the cold winter of 2007-2008.

It is unclear which calculations the Nabucco consortium used when assessing Iran's export potentials. Some partners in the Nabucco project have lately also questioned why Iran is conceived to be a main supplier when its participation has so many unfulfilled preconditions. For example, Balazs Felsmann, state secretary in charge of energy issues at the Hungarian Economics ministry, recently stated that Iran's participation is financially unviable since "Iran would need to build an extensive pipeline system to be able to supply Nabucco."¹⁵ Moreover, Austria's energy minister, Martin

¹² "Iran-Turkey pipeline blast cuts gas flow", *Reuters*, 10 September 2007.

¹³ See [<http://www.nabucco-pipeline.com/project/project-timeline/index.html>]

¹⁴ Iran Stuck in Neutral: Energy Geopolitics Hinder Iran's Oil and Gas Industry's Development", *Energy Tribune*, 11 December 2006.

¹⁵ "Hungary Has Serious Doubts On Iran's Nabucco Role -Official", *Dow Jones*, 21 November 2007.

Bartenstein, referred to involving Iran in Nabucco as a “no go” and that “the support which the US has shown for Nabucco should not be put at risk by involving Iran in the project.”¹⁶

Nonetheless, plans for building an additional connection to the Iranian/Turkish border exist.¹⁷ This may partly be motivated by the prospects of routing Turkmen supplies overland via northern Iran. Here, the Korpeje-Kurt Kui gas pipeline, running from Turkmenistan to Iran with a maximum capacity of 13 bcm, is currently underutilized and could potentially connect in northern Iran with the 20 bcm Tabriz-Erzurum pipeline or the Nabucco pipeline planned to link with the Iranian border.¹⁸

But such a solution also has its problems. According to Seyyed Reza Kasaiizadeh, the managing director of the National Iranian Gas Company (NIGC), annual gas imports from Turkmenistan will also increase from the current 6 bcm to possibly reach 14 bcm in 2008, in order to sustain growing Iranian domestic demand. As such, there will not be enough room in the Korpeje-Kurt Kui gas pipeline which will necessitate the construction of a new parallel pipeline, which, in turn, is unlikely when the Iran-Libya Sanctions Act is still in place.

Turkmenistan, in contrast, has emerged as the most likely candidate in filling Nabucco next to Azerbaijan, if supplies can be piped across the Caspian or from Turkmenistan's off-shore fields. The shift of leadership in Turkmenistan has also removed the main stumbling block to the trans-Caspian pipeline: both in terms of a potential opening up of Turkmenistan's gas reserves to other customers than Russia, but also through Turkmen president Berdymukhamedov's demonstrated readiness for an Azerbaijan-Turkmenistan rapprochement. Coinciding with the CIS summit in St Petersburg in June 2007, Turkmenistan announced that it would reopen its embassy in Baku while both parties also expressed their wish to jointly

¹⁶ “Iran involvement a ‘no go’ for Nabucco pipeline project”, *Thomson Financial*, 22 November 2007.

¹⁷ See the website of the Nabucco Consortium: [<http://www.nabucco-pipeline.com/project/project-timeline/index.html>].

¹⁸ Vladimir Socor, “Turkey Offers Route to Europe for Iranian and Turkmen Gas”, *Eurasia Daily Monitor*, 19 July 2007.

explore the Kyapaz/Serdar field.¹⁹ Should this conflict be resolved, Kyapaz/Serdar, with estimated resources of up to 3-4 bboe of mainly gas and condensate,²⁰ has the potential, together with Turkmenistan's off-shore Block 1 field, to fill Nabucco. Block 1 could also connect with the Azeri-Chirag-Ghuneshli field if an undersea pipeline is built between the respective off-shore platforms. Such a solution would also avert the need for a coast-to-coast pipeline, which, in turn, would circumvent Russia from protesting against the project on "legal grounds."²¹ These recent events combined with an improvement in bilateral relations between Turkmenistan and Azerbaijan also explain the recent visits of high-level officials to these countries.

Implications: Iran and Europe

Choosing between continued reliance on Gazprom, engaging Iran, or disengaging from both Iran and Russia, will inadvertently involve both benefits and costs. Yet this paper argues that the single most important factor is that Europe and the U.S. pursue a coherent strategy, involving some degree of new thinking. So far, Europe has shown little commitment to either.

While the U.S. has demonstrated dedication to the further development of the East-West energy corridor, Europe has been indecisive and demonstrated little political will to diversify energy supplies. This is ironic since the U.S.'s primary concern with developing the East-West corridor in the first place was to assist Europe to diversify energy away from Russia. European policymakers have shown little appreciation of this, while Gazprom has strengthened its dominance over Europe's gas supply. Hence a fundamental change in Europe's strategy seems long overdue.

Before Europe can come to terms with which strategic decisions need to be taken, it is first necessary to appreciate what does *not* need to be debated. This pertains to no less than one of the project's perceived backbones. It is incomprehensible how the issue of Iran has been able to determine the debate on Nabucco when Iran has so little capacity to support it.

¹⁹ Rovshan Ismayilov, "Azerbaijan and Turkmenistan Probe Rapprochement", *Eurasianet*, 18 June 2007.

²⁰ Personal communication, Gas industry expert.

²¹ Vladimir Socor, "Caspian Gas Plentiful Now for Nabucco Pipeline Project", *Eurasia Daily Monitor*, 10 May 2007.

It should be acknowledged that Iran's gas reserves will make it a serious long-term option for Europe *if* Iran ceases its pursuit of the full nuclear cycle and improves its domestic political climate. This may very well happen in the near future. The results of the 2008 parliamentary elections and 2009 presidential elections will for sure be interesting to follow, especially since reformist forces are regaining strength after the defeat of Khatami in 2005.²² Nonetheless, even if this would happen and a compromise is reached over Iran's nuclear program, it will take decades before Iran is a major gas exporter.

In spite of this, the debate on Nabucco has largely been guided by Iran's participation. The U.S. has vehemently opposed Iran supplying Nabucco with gas, which has caused strains on the trans-Atlantic relationship. As put by Deputy US Assistant Secretary of State Matthew Bryza: "We support Nabucco as a way to help Europe diversify with Caspian gas – but not Iranian gas."²³ The European Union, for its part, seems unable to acknowledge the lack of Iranian gas for export and conceives the sole impediment to be political. For instance, European Commission energy spokesman Ferran Tarradellas Espuny recently stated that: "In 2011, we hope that the situation in Iran is going to get better than it is now so we can get gas from Iran."²⁴ Moreover, the Nabucco Consortium has listed the potential suppliers, among which Iran is conceived to be a primary one, but has so far avoided the question of how Iran ultimately will free up gas for export, let alone the political consequences caused by its involvement.

In the center of this misguided debate stands the European Investment Bank (EIB), confounded by the mixed messages and how it should finance a project involving Iran. As put by Thomas Barrett, a senior official at the EIB, on the question of Iran's inclusion: "We need clarity." Other statements by the EIB also indicate how the question of Iran impacts thinking within the institution. In referring to Iran, Dusan Ondrejicka, a spokesman for the EIB stated: "This Nabucco project will be fully operational [only] in the second

²² As seen, for instance, in the 2006 local council election in which reformist forces scored victories.

²³ Quoted by Judy Dempsey, "Guessing Game Focuses on European Energy", *IHT*, 21 September 2007.

²⁴ Kostis Geropoulos, "EU Bets all on Nabucco, Shrugs off South Stream", *New Europe News*, issue 736, 30 June 2007.

decade of the present century, and many people hope that by that time, many of these [political] issues will be solved."²⁵

The time has come when the U.S. and the EU should re-align their strategies for the Caspian Sea region and focus on Turkmenistan and Azerbaijan as the main suppliers for Nabucco. Though trade in natural gas can be a major incentive when more moderate forces come to power in Iran, there are few reasons why the EU should conceive of it as a viable supply alternative for Nabucco in the short run.

It is a paradox that the Nabucco project's postponement and Iran's participation largely is the result of a non-issue. The consequences are also uniformly unfortunate for all actors involved. It has both caused a trans-Atlantic rift over the issue while U.S.-Turkey relations have also deteriorated. At the same time, other options, such as that of a trans-Caspian pipeline, have been overshadowed by Iran's unrealistic participation. True, Azerbaijan is also currently a net importer of gas, but in contrast to Iran, Azerbaijan has fields which are currently being developed as well as infrastructure to transport gas from the Caspian Sea to Turkey. Iran has infrastructure from Tabriz to Erzurum, but not gas to sustain it, which makes it a less likely supply alternative to Europe's energy security in the short term.

This is not to say that Iran's shipment of LNG to Europe in the future should be precluded. Purchasing energy from Iran may certainly become an important component to reward moderation in Iran, by both the U.S. and the EU. Rather the issue here is that Iran's export of natural gas northward to Europe is a question which, at this point, should be set apart from the Nabucco project.

The slow pace by which the European countries have pursued their interests in the Central Eurasian region is regrettable. Not least since the region's states have been signalling for years that a commitment from the West to their energy and security-sector development would be met with a favorable response—both as a balance to Russia's hegemony and for solely commercial purposes. Should Europe demonstrate a greater commitment to counter the Russian hegemony over these states by constructing pipeline links to the

²⁵ Quoted in "Caspian: EU invests in New Pipeline", *RFE/RL*, 27 June 2006.

region, and assist in developing their energy resources, it would be a true win-win situation. The states of Central Eurasia, primarily Azerbaijan, Turkmenistan, and Kazakhstan would have far greater latitude in determining their political processes and domestic economies while the European states, in turn, would relieve Gazprom's dominance over European energy supplies. The slowness of the project and its implications were perhaps best expressed by Hungarian Prime Minister Gyurcsany: "The Nabucco has been a long dream and an old plan. But we don't need dreams. We need projects."²⁶

By not exploring the potentials of alternative gas supplies in the Caspian Sea region, a significant opportunity cost is also incurred on the potential suppliers, the transit states, the consortium, and most European states—especially the Central European states. These opportunity costs are both monetary and strategic. Both Azerbaijan and Turkmenistan will continue to receive a far lower price for their gas and oil if further outlets are not built. The transit states, in this case the Central European countries, along with Turkey and Georgia, will miss out on significant transit fees which potentially could accrue them. The Baku-Ceyhan pipeline already generates \$50 million yearly for the Georgian government, which could serve as a useful example of the potential benefits involved.²⁷ The European countries, in turn, would not only get cheaper gas but also improve Europe's long-term energy security by diversifying supplies. The Central European states, whose dependence on Gazprom—in terms of gas imports—is in some cases almost 100 percent, will enjoy more room for maneuver vis-à-vis Russia although this dependence is unlikely to change any time soon. In short, there are substantial benefits to reap for all actors involved. These may very well be seen through the prism of geopolitics but it ultimately relates to the Soviet successor states' ability to explore all options available to them. Competition and the subsequent opening up of additional markets will, in turn, raise efficiency and reduce the harmful effects of monopolies, which tend to use advantages of scale irresponsibly: Gazprom is no exception to this.

²⁶ "Hungary PM says Nabucco pipeline too slow –report", *Reuters*, 22 March 2007.

²⁷ World Bank, "Infrastructure in Europe and Central Asia Region: Approaches to Sustainable Services", June 2006, p 79. [<http://siteresources.worldbank.org/INTECAREGTOPENENERGY/Resources/flagship-main-june-1-06.pdf>], accessed on January 30, 2006, p. 74].

Conclusion

1. To realize Nabucco there is a need to redouble efforts to find financing for the project. A precondition for this to happen is clarity and strong political support. Clarity, in turn, requires a clear assessment of where gas would come from, how much each actor would contribute to filling the pipeline, and when. Azerbaijan and Turkmenistan have the capability to fill a bulk of the pipeline (although any exact figures today are unavailable). A joint push from Europe and the U.S. in realizing this would also likely be met by a far more positive response among investors than relying on Iranian gas, which is far more uncertain. The prevailing air of uncertainty has made the EIB, EBRD, export credit agencies, and others apprehensive of the seriousness of the project.
2. The U.S. has demonstrated its commitment in supporting the trans-Caspian pipeline financially and politically. Since this, like Nabucco, is an essential link in the East-West corridor, Europe can scarcely afford to align its strategy differently. Absent a link to Turkmen (and also Kazakh) supplies, these countries may in the future be lost to Russia and China.
3. The Nabucco pipeline could serve as a major incentive for Turkmenistan and Azerbaijan to resolve their differences. Its construction would also reignite the urgency of a trans-Caspian pipeline. In the end, these two projects stand or fall together, so showing commitment to Nabucco would increase incentives for Azerbaijan and Turkmenistan to mend fences; and steps toward construction would speed up this process.
4. Even Russia and Iran would benefit from the construction of Nabucco and a trans-Caspian pipeline. Greater competition would compel Russia to invest further in its energy industry. Iran, for its part, could focus its efforts on developing its LNG industry, which has far greater significance for both Europe and Iran in the longer term. Furthermore, Europe may well reward moderation with trade in energy once more moderate forces come to power. Committing to Iranian gas now would, however, reward an incumbent government which little deserves these rewards.

Trans-Caspian Pipelines and Europe's Energy Security

Svante E. Cornell*

Key Argument: Azerbaijan, Kazakhstan, and Turkmenistan have an energy export potential equal to or larger than that of Gazprom. These resources could reach Europe directly if infrastructure is developed to form an East-West energy corridor. If Europe proves unsuccessful in supporting such projects, the export of these resources will likely take place through Russia's pipeline network, thus further increasing European energy dependence on Russia. Meanwhile, both Kazakhstan and Turkmenistan pursue strategies based on multiple export routes, and ongoing construction of new pipelines will allow especially Kazakh oil to reach the Chinese market. This further underlines the urgency in diversifying import routes to Europe if it is to secure independent access to Caspian resources.

Policy Implications

- The EU and its member states should strongly support the Nabucco project, understanding that this commercial project is dependent on political support.
- Europe should support the Turkmen-Azerbaijani dialogue, as this is a precondition for a Trans-Caspian linkage. A component of this could be supporting joint development of the Kyapaz/Serdar field and ensuring the westward export of its resources.
- Europe should engage directly with the new Turkmen leadership to a higher degree, in a manner that would encourage its transformation from totalitarian statehood.
- When dealing with the region, Europe must realize that it is in no position to put conditions on energy- or other relationships. Central Asian states are not devoid of options; as both Russia and China are in more advantageous positions both politically and geographically.

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Introduction

Europe's growing dependence on imported fossil fuels has emerged as an increasingly important political issue. The ever-tightening global oil markets have caused the price of oil to rise above levels unimaginable only several years ago, with gas prices following suit. Meanwhile, Europe's growing consumption of natural gas is being met principally by Russian exports. Growing concerns have nevertheless developed in Europe regarding Russia's reliability as an energy supplier, following increasingly reckless Russian behavior towards its neighbors and toward European investors. Following the adage that energy security lies mainly in diversity, a new quest for alternative energy resources that could alleviate some of Europe's dependence on Russian energy has developed.

Even aside from the dependence issue, Russia is presently not in a position to single-handedly provide a substantial portion of Europe's growing gas consumption. As former Russian Deputy Minister of Energy Vladimir Milov has observed, Russia "faces an investment crisis, especially in gas," and had "done nothing" to invest in infrastructure that would enable it to increase production substantially.¹ Indeed, Gazprom has consistently failed to invest in new field infrastructure, relying on large Soviet-era fields for the bulk of its production. With the exception of the large Zapolarnoye field in Western Siberia, Gazprom's fields are either stable or declining in production.² Hence Russia's own natural gas production has reached a level whereby it cannot grow considerably—let alone generate substantial new export capacities—without substantial investments amounting to billions of dollars. Indeed, Russia needs to invest heavily in new fields only to maintain its current output level.

If things are stagnant in Russia, areas to its south have shown considerably more dynamism. Among major developments in the past decade is the emergence of the Caspian Sea basin as a major source of energy, with large fields now gradually coming online. The two shores of the Caspian

¹ "How Sustainable is Russia's Future as an Energy Superpower?", Summary of presentation by Vladimir Milov at *Carnegie Endowment for International Peace*, 16 March 2006. [<http://list.carnegieendowment.org/t/80287/192304/42757/o/>].

² "Natural Gas Supply for the EU in the Short to Medium Term", *Clingdael International Energy Program*, March 2004; "Turkmenistan: Putting Gazprom - and Russia - in a Bind", *Stratfor.com*, 15 April 2005.

nevertheless exhibit different situations. On the one hand, the eastern shoreline, in Kazakhstan and Turkmenistan and home to the most significant resources of both oil and gas, remains closely tied to Russia's transportation monopoly dating to the Soviet period. On the other hand, the western shoreline, in Azerbaijan, is increasingly linked up to European markets. The Baku-Tbilisi-Ceyhan oil Pipeline and the South Caucasus Gas pipeline, completed in 2005-2006, constituted a crucial step binding the western shore of the Caspian with European energy infrastructure. And while Azerbaijan's resources are substantial, the Caspian will only play a key role in European diversification of supply if the East Caspian is also connected to Europe. For this to happen, two major projects will need to be completed. As far as natural gas is concerned, a major task is to beef up the connection between Turkey and the European gas grid which the Nabucco pipeline, scheduled to run from Turkey to Austria, proposes to do. For oil, the BTC pipeline already delivers oil to the Turkish port of Ceyhan, with convenient transport by tanker to Italian refineries. For both gas and oil, however, energy connections over the Caspian Sea are necessary, linking Kazakhstan and Turkmenistan with the BTC and SCP pipelines and onward to Europe. The Nabucco project and its importance are discussed elsewhere in this volume (Norling), while this paper discusses the rationale and politics of Trans-Caspian energy connections.

Caspian Energy Producers

The energy producing states of the Caspian basin—Azerbaijan, Kazakhstan, and Turkmenistan—have large untapped potential production of both oil and natural gas. As far as oil is concerned, Azerbaijan has a production capacity of ca. one million barrels of oil per day (bpd). In spite of doubts over the longevity of Azerbaijan's reserves, field growth, new extractive technologies, and possible new discoveries make a continued production at the aforementioned level likely in a 20 year-perspective. Kazakhstan's much larger reserves of oil are likely to enable a production of over two million barrels per day over the next decades, especially as production from the supergiant Kashagan field come online in the middle of the next decade.

As far as gas is concerned, Turkmenistan alone produced 90 bcm per year in the late Soviet era—a substantial amount compared to Gazprom's exports to

Europe, which at present are in the order of 150 bcm. Turkmenistan's present output stands at ca 70 bcm, but major investments in the country appeared much more likely in 2007 than even a year earlier, given the reforms undertaken by the new leadership under Gurbanguly Berdymuhamedov. To this should be added smaller capacities in Azerbaijan, which may reach 30 bcm by 2012, as well as Kazakhstan, where associated gas to the Kashagan field could form substantial volumes. Moreover, disputed fields in the Caspian Sea—such as the Serdar/Kyapaz field claimed by Azerbaijan and Turkmenistan, or the Araz/Sharq/Alov field claimed by Azerbaijan and Iran—are estimated to have reserves of 5-10 billion barrels of oil equivalent, and would hence greatly contribute to the region's potential output if political disputes are resolved.

The energy producers of the Caspian region hence have an export potential equal to or greater than that of Gazprom. Meanwhile, their domestic markets are considerably smaller, whereas Russia's export capacity stands to be affected considerably by domestic consumption as the Russian economy expands and energy remains cheap, subsidized, and inefficiently used.

It is hence a near-certainty that gas from Azerbaijan, Turkmenistan, and Kazakhstan will be reaching Europe in increasing quantities in the following decades, a process that has already begun for oil. The question is through which export routes these resources will be transported to Europe. That new pipeline capacity is needed is obvious, and this gas can reach Europe in various ways. It can be transported independently and directly from producer states through a varied set of routes to European markets, increasing Europe's energy security by diversifying its supply routes. This, of course, requires the building of new transportation networks, which will be discussed below. Yet unless such alternative delivery options are constructed to bring natural gas from fields in Azerbaijan, Turkmenistan, and Kazakhstan to Europe, Russia is likely to fill the vacuum by controlling the transportation of this region's gas—buying it cheaply through its monopoly position in Central Asia and selling it at several times the price to Europe using its monopoly of supply. Indeed, Gazprom's pledges to increase exports to Europe to 180 bcm by 2010 are not likely to come from domestic production;³ instead, it would re-export

³ "Gazprom expects to increase gas exports to Europe to 180 bcm by 2010." *Gateway to Russia*, 17 December 2004. [http://www.gateway2russia.com/st/art_260393.php].

Caspian gas at a profit. In the process, Moscow would make a large profit while increasing its political leverage over both Europe and the states of Central Eurasia. This is consistent with Russian energy policy, but as seen below, it also represents a prospect that lies neither in Europe's interest nor in that of the producer states.

Europe's Alternative: The East-West Corridor⁴

Europe's future growth in gas supplies is thus likely to be mainly met *not* by growing Russian gas production but by gas supplies from the energy-rich states of the Caspian region: primarily Azerbaijan, Kazakhstan, and Turkmenistan. These are nevertheless bifurcated both in regional terms and in terms of output. The first main division is geographic: Azerbaijan on the West Caspian is considerably closer to Europe, while the major producers are the states of Central Asia on the eastern shore of the Caspian. Secondly, the producers vary in terms of reserves. Azerbaijan and Kazakhstan are mainly oil producers, with much less significant gas production. Turkmenistan, on the other hand, is the exact opposite: gas constitutes the bulk of Turkmenistan's reserves, which are probably among the world's top ten reserves, depending on estimates, and a production capacity that could easily reach over 100 bcm, almost all of which is available for export. Uzbekistan has considerable deposits of both oil and gas, but its larger domestic market makes its export capacity more limited.

Only several years ago, the export of Caspian oil and gas to the EU would have seemed utopian. Yet the completions of the Baku-Tbilisi-Ceyhan and South Caucasus pipelines have altered this. These pipelines effectively connect the western Caspian shore with European markets, providing top-of-the line infrastructure for oil as well as gas, once the Nabucco pipeline is realized. This also makes the prospect of East Caspian resources reaching Europe more realistic than ever, as the infrastructure is now in use just across the Caspian.

⁴ This section builds and develops on the chapter "Geostrategic Implications of the Baku-Tbilisi-Ceyhan Pipeline", by Svante E. Cornell, Mamuka Tsereteli and Vladimir Socor, published in *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West*, Washington and Uppsala: CACI & SRSP, 2005.

It is obvious that the potential entry of Caspian natural gas to Europe through the South Caucasus and Turkey would help Europe diversify its energy supplies, and to reduce dependence on the state-owned Russian monopoly Gazprom. Indeed, there appears to be little reason for Europe to access the same resources via Russia, allowing Gazprom as a monopolist to control prices, while making Europe vulnerable to voluntary as well as involuntary supply interruptions. Developing pipelines directly to the Caspian region will perfectly complement major reforms planned in the European gas sector, aiming at the creation of a competitive market of multiple operators with the interest of having different options of delivery routes.

Such a competitive market is in the long-term interest of Europe; but it is objectively speaking in Russia's interest, too. Diversification of supply routes and gas sector reform in Europe will eventually drive the Russian monopolistic supplier, Gazprom, as well as the Russian gas sector in general, toward much-needed reforms and transparency that will give it sustainability and stability. Indeed, a driver behind the development of the South Caucasus Energy Corridor has been the inflexibility of the Russian state monopolies, Gazprom and Transneft. By dominating access to markets and by creating barriers to access for others, they have forced producers to look for alternative means to the market. By choosing to exploit its control of energy export as a geopolitical weapon, Russia has forced its southern neighbors to respond with initiatives that will preserve their sovereignty in the face of such threats. The result has been the development of alternative routes, which in turn makes Russia nervous and suspicious. Furthermore, without market liberalization, it will be impossible to attract investments to the Russian gas sector, and without investments, Gazprom will not succeed in meeting its ambitious production goals.

Looking to the Future: Kazakh Oil and Turkmen Gas

For the United States and Europe, BTC provides further impetus for Western involvement in the energy and security sectors of the wider Caspian basin; and indeed, it proves that the lofty but near forgotten ambitions of building an east-west corridor linking Europe to Central Asia and beyond via the Caucasus are not only possible but are being realized.

Kazakh Oil: Which Way?

The first major post-Soviet pipeline to come online was the Caspian Pipeline Consortium pipeline linking Kazakhstan's Tengiz oil field on the Caspian shore to Russia's Black Sea coast. Though being mainly on Russian territory, CPC is the first oil transportation system operating independently from the Russian state monopoly, Transneft. But the quantities of oil coming out of the Kashagan project—forecast at 450,000 barrels per day in 2010 and eventually up to 1.2 million bpd—will require at least one major new export pipeline. For this oil, Kazakhstan could look at variations of three options: a parallel CPC line; feeding Kashagan oil into the BTC pipeline; and exporting to China. Each of these options presents both economic and political challenges. Although CPC can be expanded significantly, the entire flow from Kashagan is unlikely to be fed into CPC for the obvious reason that the Turkish government is highly unlikely to allow an additional million bpd of oil to pass through the heart of Istanbul. That said, the Russian-led project to build a Bosphorus bypass pipeline from Burgas in Bulgaria to Alexandroupolis in Greece may change that situation. The prospect of constructing special lines to bypass Istanbul to the north or south adds to the cost of delivery and further dilutes Russian control. In any case, Kazakhstan has recently shown a desire to reduce its reliance on Russia for the export of its energy resources. It is significant to note that Kazakhstan officially joined the BTC pipeline at its inauguration in Baku in May 2005, and that operators of the Kashagan field own a substantial portion of the pipeline. Initially, Kazakh oil is set to cross the Caspian by tanker, but Kassymzhomart Tokayev, Kazakhstan's former foreign minister, has repeatedly declared that it will construct an underwater pipeline linking its port of Atyrau and Baku. For it to be commercially viable, the construction of this 500-mile extension of BTC would require BTC's capacity to be upgraded to 1.7 million bpd.

Meanwhile, Kazakhstan has deepened its relations with China in the energy sector. For some years after the collapse of the USSR, Russia kept alive the hope that it could persuade Kazakhstan to feed oil for the Orient through Russia's emerging Siberian pipeline system. Since this would have simply rebuilt on its eastern exposure what it was seeking to escape to the west, Kazakhstan declined, turning instead to China. Over the course of a decade,

the two countries repeatedly discussed the possibility of building a pipeline connecting western Kazakhstan's oil fields with China's Xinjiang province, but the project was not found to be economically viable. However, as regards both the pipeline and Chinese acquisitions of energy assets abroad, China's mainly state-owned companies have proved willing to pay above-market rates far beyond what a rival might offer. China's 2005 acquisition of the Canadian-based Petrokazakhstan company, Kazakhstan's third largest oil producer, for a sum hundreds of millions of dollars above what competitors were ready to pay, is only one example of this practice. In 2004, construction began on the Kazakhstani section of a three-billion dollar pipeline, capable of carrying up to 400,000 bpd, linking western Kazakhstan to western China. Initially, oil for this pipeline will be provided mainly from the Kumkol deposits operated by Petrokazakhstan. Indeed, China's acquisition of Petrokazakhstan gives valuable indications of China's interest in controlling both production and transportation of energy resources, enabling it to ensure a safe flow of oil to China. But to reach full capacity and hence become commercially viable, the Kazakh-China pipeline will need more oil than is now allocated to it. To address this problem it is expected that at least a part of the oil flowing from the vast Kashagan fields will be fed into this pipeline.

Thus, it is evident that Kazakhstan is effectively implementing an export strategy of its most valuable product based on multiple routes. As was the case with BTC, a decision regarding the balance among them will eventually be guided as much by political as by economic concerns. In all likelihood, Kazakhstan will continually readjust the balance between the amount of oil being sent into each of the three eventual channels: Russia, China, and the South Caucasus energy corridor. This emerging strategy, if accomplished, will help serve Kazakhstan's ambition of becoming a major actor in global energy markets in the coming decades. More important, it accords with Kazakhstan's geopolitical strategy, which is to seek a balance between the three major powers with which it has close relations, using each to keep in check the others, even as it benefits from links with all three. By successfully diversifying the channels for exporting its most valuable product, Kazakhstan has thus fortified its sovereignty and independence of action.

Turkmenistan's Gas

Even though the government of Turkmenistan may wishfully confuse estimated reserves with proven reserves and hence overstate its potential wealth, no one disputes that the country possesses formidable deposits of oil and especially gas that are bound to make their mark on its national life, the region, and world energy markets. Like Azerbaijan and Kazakhstan, the challenge has been to break Russia's imperial monopoly over its exports and to create efficient export channels that will reduce what might be called the "distance tariff." In the late 1990s, talks were well underway for the creation of a trans-Caspian pipeline bringing Turkmen gas westward, via the South Caucasus, to Europe. Despite the length of the planned pipeline, it would have delivered gas to European markets at relatively moderate cost. But when gas rather than the expected oil was discovered in Azerbaijan's Shah-Deniz field, Azerbaijan ceased being merely a transit country for gas to Europe but a significant producer. As this happened, Azerbaijan temporarily lost interest in the trans-Caspian gas pipeline to Turkmenistan. The fact that the two countries fell into a bitter dispute over competing claims to mid-Caspian deposits only prolonged the stand-off and added to the ill-will. Russia, taking advantage of this situation, managed to extract a long-term agreement from Turkmenistan to export gas through Russia. With these developments, a significant component of the so-called East-West energy corridor disappeared.

The vision of a trans-Caspian energy corridor linked with Turkmenistan remains unfulfilled. Whether or not it is revived will depend on future political developments in Turkmenistan, which are unknowable. For the time being, Turkmenistan remains legally bound to export gas through Russian pipeline systems at a price that is still below world market levels, at ca. \$100 per thousand cubic meters, compared to the \$250-300 that European countries pay Russia.

However, the Turkmen leadership has shown great frustration with this situation. Ashgabat has begun to look around for potential buyers elsewhere, both to the East and West and South. Decade-old projects to build gas and oil pipelines across Afghanistan to Pakistan and India have been revived, but will depend on the political situation in Afghanistan. The Asian

Development Bank has taken a keen interest in this project, among other things seeing in it an income stream for the new Afghan government that could help offset the influence of drugs. A feasibility study completed in 2005 offered an encouraging picture for the future, and both Chinese firms and the Russia gas monopoly Gazprom have informally expressed interest in it, as have Indian firms, which have also begun eyeing oil and gas investments in Kazakhstan and Uzbekistan. The TAP project continues to suffer from several problems, most importantly the fact that its ultimate success is dependent on Pakistan and India resolving their differences to the extent that they could allow hydrocarbons to cross the Pakistan-India border. To the extent that India is reluctant to rely on Pakistan's word for its own energy security, the prospects of building TAP are stalled. This problem, along with what will doubtless be an expensive construction process in Afghanistan itself, will likely delay the construction of a TAP pipeline for several more years.

More important than a revived TAP pipeline is the Chinese factor. Indeed, President Niyazov in April 2006 took his entire government to Beijing, signing many agreements, among them a deal to build a gas pipeline from Turkmenistan to China across Uzbek and Kazakh territory. While considered utopian because of its exorbitant cost, the Chinese politically driven interest in diversification has made the pipeline a viable proposition. Indeed, Niyazov used this deal to increase his leverage with Moscow, enabling him to force Gazprom to raise the price for Russian imports of Turkmen gas.

The death of Niyazov in late 2006 created some uncertainty regarding the Turkmen leadership's future orientation. Moreover, a trilateral meeting was held in May 2007 between the Kazakh, Russian, and Turkmen presidents, in which a new pipeline project was decided upon, and which would channel additional Turkmen and Kazakh gas resources northward. This agreement led to some panic in Western capitals, as it would, if realized, negate the possibility of western export routes across the Caspian, simply because sufficient resources would not be there. Yet several factors indicate that panic is not warranted. Given the present geopolitical realities in Central Asia, it would be extremely difficult for Kazakh and Turkmen leaders to simply refuse Russian projects. This is the case especially because President

Putin was willing to present the matter personally, travel to Central Asia, and use his well-known power of persuasion on his smaller neighbors. Aware of Russia's ability to create difficulties for them in myriad ways, these leaders would rather acquiesce to Russian demands. This is particularly the case for Berdymuhamedov, who only recently came to power and was still in the process of consolidating his position. The fact that Berdymuhamedov fired and jailed a major rival (Akmurat Rejepov, who was influential in helping Berdymuhamedov assume the presidency) only days after the deal with Russia was concluded is indication enough of the linkage between Russian foreign policy and domestic security issues in Central Asia: assurances from Russia were likely key in the new president's resolve to remove a potentially dangerous rival. However, as Central Asian leaders have done for centuries, they work harder to undermine an unwanted agreement with a stronger power that they have reluctantly agreed to rather than refusing to sign one. Indeed, Ashgabat's actions following the May summit speak to this effect. On the one hand, the Turkmen leadership has worked hard on the Chinese pipeline, indeed commencing construction of it in the Fall of 2007. While this act was mainly symbolic and should not be taken to mean that the pipeline will be completed soon, it does indicate Ashgabat's interest in escaping Russian dependence. Likewise, a steady flow of American and European representatives have been welcomed in Turkmenistan in the past year, and Berdymuhamedov's September 2007 trip to New York entailed high-level meetings with American officials, in which Turkmenistan's interest in diversifying its foreign policy options remains apparent.

The Iran Factor

Iran figures prominently both in discussions on European gas supply diversification as well as in terms of the transit of Central Asian supplies to Europe. This is the case because of the legal and political complications that could surround the building of a trans-Caspian pipeline. Kazakhstan can resort to shipping oil by barge to Baku and feeding it into the BTC pipeline, implying a "virtual" Trans-Caspian pipeline. This option is not there at present for gas, given the high cost of the liquefaction process needed to ship this commodity by sea. If Russia is successful in stopping the Trans-Caspian

option, strongly supported by the United States (which recently gave its approval to fund a feasibility study for such a pipeline), the option to ship gas from Turkmenistan via Iran to Turkey and Europe would theoretically be present. While this may not be desirable to European buyers, not least since it would increase Iranian leverage vis-à-vis Europe at a time when Iranian international behavior is highly problematic, Europe would be faced with choosing between engaging Iran and remaining dependent on an increasingly aggressive Russia. It is not unlikely that many European leaders would see pipelines through Iran as a lesser evil, especially as Europe is already buying Iranian oil. This would nevertheless compromise European and American unity on Caspian issues, and be an important divergent element in Transatlantic policy toward the region.

Implications for Europe and the South Caucasus

The EU and its member states can do several things for energy development in the region, and by extension for itself. The first would be to strongly support the Nabucco project, understanding that this commercial project is dependent on political support and cannot be left to market forces alone; since all its competitors are politically supported and not market-oriented, and energy issues are by nature political.

Second, Europe could invest in supporting the Turkmen-Azerbaijani dialogue, which would be a requirement for a Trans-Caspian linkage. Promising signs of a rapprochement have been observed, but the two states may need some additional incentive to put their differences aside. Supporting joint development of the Kyapaz/Serdar field and ensuring the westward export of its resources would be one such element, which would have the added benefit of *de facto* building half the Trans-Caspian pipeline.

Third, Europe could engage directly with the new Turkmen leadership to a higher degree. While far from a democracy, Turkmenistan is exhibiting rapid progress by regional standards, though it has a long road to travel. Engaging the country, if the process is conceived of correctly by the EU, would encourage this process.

Finally, it is clear that when dealing with the region, Europe would be well advised to realize that it is in no position to put conditions on energy- or other relationships. Central Asian states are not devoid of options; quite to

the contrary, both Russia and China are in a more advantageous position both politically and geographically in the region. Indeed, should Europe not move rapidly to devise a coherent policy and to increase its engagement with the region, the energy resources of Central Asia are likely to reach Chinese and not European consumers.

Developing a Cohesive EU Approach to Energy Security

Zeyno Baran*

Key Argument: European dependence on Russian natural gas is troubling as it is increasingly obvious that Moscow is able to use its energy leverage on European states for political and economical gain. The EU's vulnerability in this regard is in large part an effect of the practice of dealing bilaterally with Russia on energy issues, granting Russia the capacity to "divide and conquer" among EU states. Thus, in order to overcome its energy dependence on Russia, the EU needs to establish a European-level external energy strategy, become more cohesive regarding its external energy policy, and streamline both its energy relationship with Russia and its efforts to diversify energy supply.

Policy Implications

- A more formal framework should be established to streamline EU policies on energy. European states must realize that working together on issues of energy security, especially when dealing with Russia, will be mutually beneficial in the long term.
- This should include more proactive steps toward demanding reciprocity in interactions with Russia, including greater transparency, allowing third-party investment in the energy sector, and respecting the rule of law. The EU should also consider prosecuting companies like Gazprom or Transneft for their monopoly positions.
- It is absolutely vital that the EU diversify its energy supply by establishing a Southern Corridor. The completion of the Turkey-Greece pipeline is an important first step, but must be supplemented by the Greece-Italy connection, Nabucco, the White Stream, and a trans-Caspian gas pipeline.

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Introduction

On November 18, 2007, at a ceremony along the border between Turkey and Greece, a newly-constructed natural gas pipeline linking the one-time rivals was officially inaugurated. Soon afterwards, gas originally extracted from the Shah-Deniz field in Azerbaijan arrived in the northern Greek town of Komotini. With that, the long-awaited dream of a “Southern Corridor” for gas between the Caspian Sea and Europe is one step closer to realization.

This corridor stretches for over 1,500 kilometers across four countries, incorporating several different existing pipelines while traversing mountain ranges, rivers, and the Sea of Marmara. Although a tremendous feat of engineering in and of itself, the establishment of a southern energy corridor is also very important politically. For the first time, Caspian natural gas is able to travel to Europe free from Russian control.

The Turkey-Greece pipeline is the first of several linkages envisioned for the transport of Caspian and Central Asian gas into Europe. Plans are in the works to extend the Turkey-Greece pipeline to Italy, and construction on the significant Nabucco pipeline that will stretch from Turkey, Bulgaria, Romania, and Hungary, and into Austria is slated to begin in early 2009. Furthermore, a third pipeline project, entitled White Stream, has been proposed. The White Stream pipeline would link Georgia and the European Union via the Black Sea to Romania.

Europe's Puzzling Dependency on Russia

A key objective of these pipeline projects is to overcome Europe's increasing dependence on Russian and Russian-supplied natural gas. Collectively, the twenty-seven countries of the European Union rely on Russia for nearly 50 percent of their gas imports—representing around 25 percent of the bloc's total gas consumption. This dependence is not distributed evenly. The further one travels east, the larger one finds Russia's share of local energy supply needs. Of the ten EU states that rely on Russia for at least 75 percent of their gas imports, seven once lay behind the Iron Curtain.¹

¹ The exceptions are Finland, Greece, and Austria—all of which lie in the east of Europe geographically.

This dependence is troubling because, under the leadership of President Vladimir Putin, the Kremlin has pursued a strategy whereby European reliance on Russian energy is leveraged into economic and political gains for Moscow. That Russia is able to “out-leverage” the EU at all is puzzling and merits further examination. After all, by nearly every measure of soft and hard power, Europe would seem to have the upper hand. The EU has three and half times as many people, spends seven times as much on its military, and has a GDP fifteen times larger than Russia. Even in EU-Russia energy trade, the balance of power appears to favor the European Union. While the gas the EU gets from Russia comprises 25 percent of European consumption, it also represents a full 70 percent of Russia’s exports.² Moreover, because of a lack of export infrastructure to any other region, Moscow currently has no real alternative to the EU market. In that sense, Russia is more dependent on the European market than Europe is on Russian supplies.

However, this power differential can have impact only if the EU acts as a unified body on energy policy—which, in today's reality, is simply not the case. When each of the twenty-seven EU states deals with Moscow on a bilateral basis, this tilts the balance of power in favor of Russia. And the Kremlin has proven adept at exploiting this advantage, consistently and thoroughly outmaneuvering the EU. For example, the energy deals that Putin or his successor-designate Dimitri Medvedev (now chairman of state monopoly Gazprom) has or soon will sign with Austria, Hungary, Bulgaria, and Italy have already undermined investor confidence in the Nabucco gas pipeline, a project that is at least in theory a “high priority” for the EU. Furthermore, the planned Nord Stream pipeline between Russia and Germany runs directly counter to the European priorities of integration and diversification.

Russia’s energy policy toward Europe could best be described as “divide and conquer.” And although the “division” achieved by these tactics is generally one of EU policy, the effect can also be quite literal. Nord Stream is a perfect example that reveals clearly the political motives behind Moscow’s energy policy as well as its fondness for bilateralism. Nord Stream is at least three

² Mark Leonard and Nicu Popescu, “A Power Audit of EU-Russia Relations,” *European Council on Foreign Relations*, 7 November 2007. [<http://ecfr.eu/page/-/documents/ECFR-EU-Russia-power-audit.pdf>].

times more expensive—and poses a much greater environmental risk—than any of several overland options proposed.³ Yet an overland route from Russia to Western Europe would also, by necessity, transit at least one other country (most likely Poland), thereby linking the energy supply of those states to those of states further west. A sub-sea route enhances Russia's ability to disaggregate Europe's energy market; a separate pipeline supplies each region—and a separate lever shuts off each pipeline. Thus, Putin vigorously, and successfully, promoted the sub-sea route to German Chancellor Gerhard Schröder, who, after leaving office, began working for Nord Stream.

Ironically enough, despite its best efforts, Moscow will not be able to completely eschew the interests of third parties in constructing Nord Stream. Before the pipeline can be completed, Moscow must secure the blessings of at least one littoral state of the Baltic Sea, as Nord Stream's subsea route will inevitably cross one of their exclusive economic zones (EEZ). Thus far, no country has indicated a willingness to allow such an environmentally risky pipeline to cross its EEZ.

It is often argued that Nord Stream actually does align with the EU goal of diversification because it provides an alternative supply route to Russia's existing gas transportation infrastructure, much of which is over a quarter-century old. Some point out that if one of the three primary pipelines currently supplying Europe with Russian gas is disrupted due to technical malfunction, terrorism, or extortion by transit countries, then the existence of Nord Stream is justified because it will ensure European supply. While this may be true, diversification of supply *routes* is not the same thing as diversification of supply *sources*. Nord Stream actually increases Europe's overall dependence on Russian-supplied gas.

Russian Energy Strategy

Maintaining a high level of dependency is, of course, a cornerstone of Russia's strategy in Europe. The somewhat unique nature of natural gas as a tradable commodity—there is no global market and the construction of costly pipelines effectively locks consumers into a prolonged contract with

³ Robert L. Larsson, "Nord Stream, Sweden, and Baltic Sea Security," *Swedish Defense Research Institute*, March 2007. [<http://www.foi.se/upload/english/reports/foir2251.pdf>].

producers—means that Moscow can more easily translate this dependency into political and economic leverage. Natural gas is vital to the economies of many European nations, and its primacy is only growing. The prospect of being forced to pay a higher price, or of experiencing a curtailment of supplies, can exert a powerful influence on a country's policies.

Moreover, the Kremlin has demonstrated that it has few qualms in manipulating energy supply volumes in an effort to change a state's policies. In July 2006, Russian oil pipeline operator Transneft shut down its pipeline to Lithuania shortly after the Lithuanian government sold its highly-profitable Mazeikiu Nafta oil refinery to a Polish firm instead of Russia's Lukoil. Transneft claimed that the shut-down was solely due to technical problems along the route but steadfastly refused all outside offers of assistance in repairing or assessing the damage—and even hinted that the pipeline might remain closed regardless.⁴ Indeed, the pipeline's closure is now official; Transneft claims that continued operation of this branch is no longer "profitable." It seems as if losing the Mazeikiu Nafta auction was a blessing in disguise for Lukoil; moreover, the refinery is clearly much less desirable and profitable now that it must import crude oil via tanker. It may not be too much of a stretch to assume that had Lukoil won the auction, there would not have been a "technical malfunction" and that the pipeline would still be operational today.

The July 2006 incident is hardly the first time that Moscow has shut down pipelines in attempt to influence countries it considers to be in its backyard. Several times in 1990 and 1991, Russia cut supplies to the Baltic states in a blatant attempt to quash—and later exact revenge for—their independence movements. Later, in 2003, Transneft shut down its pipeline into Latvia after the Latvian government did not sell its Ventspils Nafta export terminal to the Russian company. While at first denying its intention to force a sale, Transneft eventually dropped all pretenses and admitted that the cutoffs were an attempt to pressure the government into selling the port. Transneft Vice President Sergei Grigorev spelled this out very clearly, saying "Oil can

⁴ Zeyno Baran, "Lithuanian Energy Security: Challenges and Choices," Hudson Institute, December 2006. [<http://www.hudson.org/files/publications/LithuanianEnergySecurityDecembero6.pdf>].

only flow from Russia. [Latvia] can of course sell [the port] to Westerners. But what are they going to do with it? Turn it into a beach?"⁵

Many Western countries chose to interpret the Ventspils Nafta debacle as a normal takeover attempt between two economic entities, ignoring the clear political implications. The energy sector, particularly in the former Soviet Union, lies at the intersection of business and politics. Political motivations clearly lie behind Russian gas cut-offs to non-EU countries like Georgia in 2001 and 2006, as well as recent price hikes to Ukraine, Georgia, and Azerbaijan. The dependence of these and other countries on Russia for such a vital and irreplaceable commodity gives the Kremlin tremendous leverage.

Moscow further increases its leverage in Europe by acquiring ownership (partial or otherwise) of downstream energy assets. In the past two years, Gazprom has signed deals with Eni (Italy), Gasunie (the Netherlands), BASF (Germany), E.ON Ruhrgas (Germany), and Gaz de France, supplementing the company's already significant holdings in Eastern European countries. Although Gazprom, flush with cash thanks to skyrocketing energy prices, can often buy a stake in downstream assets outright, its preferred method of acquisition is through a trade for access to Russian oil and gas fields—with the Russian energy company naturally always retaining a controlling stake. This type of assets-for-access swap is highly beneficial for Russia, since it gains a presence in downstream European markets without giving up majority control over its own resources. The increasing scarcity of energy reserves globally, as well as the prospect that a competitor could win access to those reserves, is deftly exploited by Moscow to secure the best deal for itself.

Europe's dependency on Russian gas also undermines many of its foreign policy goals. Specifically, EU members are forced to limit their criticisms of Moscow, lest they be given a raw deal at the bargaining table—or become the next victim of a Kremlin-orchestrated supply disruption. Although mere sermonizing is not likely to be productive, Europe would have a freer hand to criticize Russia's increasingly tainted record on transparency, responsible governance, and human rights if it were not so dependent on Russian energy.

⁵ Michael Lelyveld, "Moscow Seeks Takeover of Latvian Oil Port," *RFE/RL*, 12 February 2003.

The Central Asian Dimension

By the same token, Europe is also obliged to weaken its support for countries that Moscow considers to be within the Russian sphere of influence (roughly, all former Soviet republics and ex-members of the Cold War-era Warsaw Pact defense alliance). If the EU wants to encourage true and lasting reform in states like Georgia, Azerbaijan, Ukraine, Kazakhstan, and Turkmenistan—all of which are key energy producers or transit countries—it must offer them a non-Russian perspective. As it is, these states' dependence on Russia is even greater than that of the EU. Not only do the Russian government and Russian government proxies have substantial holdings within these states, Russian-controlled infrastructure dominates energy imports and exports, particularly in Central Asia. This gives Moscow tremendous leverage, especially since the primacy of energy exports to Central Asian economies means they are far more susceptible to pressure. Turkmenistan, for example, has frequently quarreled with Russia over the price that the latter country pays for Turkmen gas. In 1997, this escalated to a point at which gas exports to Russia ceased, depriving Turkmenistan of its primary source of revenue. Over a year later, Turkmenistan's economy was in free-fall and President Saparmurat Niyazov was obliged to accept Moscow's offer—a price below the actual value of the gas.

Turkmenistan and other such states cannot achieve real independence from Moscow without the construction of non-Russian-controlled export routes. Conversely, the establishment of such routes would also benefit Europe by loosening its own dependence on Russian gas pipelines.

Unsurprisingly, maintaining and increasing control over pipeline routes in Eurasia is an overriding policy concern for Moscow. This is the case not only because of the political and economic influence this control buys it, but also because Russia relies upon an inexpensive supply of Central Asian gas. This allows Russia to continue heavily subsidizing natural gas for its own population while still meeting its supply commitments to Europe. Additional, non-Russian-controlled pipelines would ruin this dynamic, resulting in deleterious economic and political effects for the Russian government.

Interestingly, Central Asian countries have recently begun to take advantage of Moscow's need for their gas. In late November 2007, Gazprom acceded to Turkmen demands and offered Ashgabat a price of \$150 per tcm through 2009—an increase of 50 percent from 2007 rates. The fact that Moscow is now willing to pay this price, despite its previous fierce resistance to the notion of an increase, is a sign that the Russian leadership is worried about the Central Asian countries “defecting” and signing onto a trans-Caspian pipeline project.⁶ On the one hand, this is a positive development because it reveals that American and European efforts to convince Central Asia to look westward have had an impact. Moscow would not agree to the price increase if it did not judge a Central Asian defection to be a realistic possibility. On the other hand, Gazprom's willingness to pay the higher rate could decrease Central Asia's dissatisfaction with Moscow, thereby reducing the region's desire to take the political risk of moving forward with a trans-Caspian gas project.

This Central Asia “gas premium” is just one example of how Moscow has been sparing no effort to thwart the construction of a Southern Corridor. In fact, the gas cut-offs to Georgia and Azerbaijan mentioned above were a not-so-subtle message sent by Moscow expressing its displeasure at those countries' support for the Baku-Tbilisi-Ceyhan (BTC) oil pipeline. Fortunately, Western—mainly U.S.—support was unwavering, and BTC was eventually built. Russia was more successful in preventing the construction of a natural gas pipeline across the Caspian Sea to Turkey that was also pushed by the United States in the late 1990s. Moscow lobbied hard and fast in Turkey for the country to agree to a Russian natural gas pipeline, knowing full well that such a project would kill demand for the trans-Caspian alternative. In 1997, Russia and Turkey agreed to build a pipeline, now known as Blue Stream, across the Black Sea, and a few years later, the trans-Caspian project was shelved.

Now, with the EU showing greater commitment to constructing the long-planned Nabucco pipeline, Moscow has stepped up its efforts to prevent the pipeline's construction. Gazprom has tried, so far unsuccessfully, to gain a stake in the project or to become the key supplier for the pipeline. Putin has

⁶ The 2007 rate of \$100 per tcm was itself an increase from \$65 per tcm in 2006.

personally traveled to each of the five countries that Nabucco will pass through in an attempt to dissuade them from the project, or at the very least to sow dissent among the partners. He has leaned particularly hard on the leadership in Hungary, offering to make that country the terminus of a Russian-built pipeline and site of Gazprom's distribution hub in central Europe. In applying this pressure, Putin employed the familiar tactic of playing Hungary against neighboring Austria. Hungarian Prime Minister Ferenc Gyurcsany appeared very tempted by Moscow's offer but refrained from prematurely abandoning Nabucco.⁷ Obviously, had Gyurcsany agreed to Putin's offer, there would have been little market demand for additional gas via Nabucco, severely undermining the pipeline's prospects and perpetuating European dependence on Russia.

At the same time, Gazprom has pursued other tracks to kill demand for Nabucco. In June 2007, Gazprom signed a memorandum of understanding with Italian energy company ENI on the construction of a massive gas pipeline, labeled South Stream. This \$14.8 billion project would stretch from the Russian Black Sea coast across Southeastern Europe and into Italy.⁸ Moscow has also worked hard to lock up Central Asian gas exports in an attempt to preemptively block the construction of any trans-Caspian pipeline that could supply Nabucco. Azerbaijani gas will probably be sufficient for the first phase of Nabucco. In fact, BP recently announced the discovery of significant additional resources in Azerbaijan's Shah-Deniz field, which will allow energy companies operating there to double production.⁹ Later phases of Nabucco will nevertheless require additional sources of natural gas—sources that will most likely come from Central Asia (and eventually also from Iran and Iraq). If it appears unlikely that those sources will be available, investors will be unlikely to fund the costly project.

⁷ Vladimir Socor, "Nabucco Gas Pipeline Project is Back on Track," *Eurasia Daily Monitor*, 19 September 2007. [http://www.jamestown.org/edm/article.php?article_id=2372432.]

⁸ "South Stream Threatens Nabucco," *Platts*, 29 November 2007. [http://www.platts.com/Natural%20Gas/highlights/2007/ngp_eiee_112907.xml].

⁹ "BP Makes Major Gas Discovery in Azerbaijan," *Reuters*, 14 November 2007. [<http://www.cnn.com/id/21785263/>]

European Policy Options

For Europe, the key to overcoming its dependency on Russia and doing away with the leverage Moscow currently enjoys is greater cohesion regarding external energy policy. Moscow can only extract favorable conditions when it deals with states bilaterally and plays them against each other. Obviously, the EU, a collection of twenty-seven independent states, can never hope to be as strongly coordinated as Russia, a self-described “sovereign democracy” whose government increasingly resembles that of the Soviet state from which it descended. Nevertheless, a more formal framework should be established to streamline EU policies on energy. Several European leaders, particularly EU Energy Commissioner Andris Piebalgs, have supported such a position. Unfortunately, formalizing a common European energy policy is quite difficult. Member states are far more reluctant to cede sovereignty to Brussels on energy policy than they are on trade tariffs or visa regulations. At the very least, however, European states must realize that working together on issues of energy security, especially when dealing with Russia, will be mutually beneficial in the long term. For one thing, greater competition in the market will help reduce gas prices; the higher prices that Gazprom recently agreed to pay Turkmenistan and Kazakhstan will inevitably be passed on to European consumers.

While many states in the European Union may be wary of “getting tough” with Russia, it should hardly be contentious for them to demand reciprocity in their interactions with Russia. This would mean increasing transparency, allowing third-party investment in the energy sector, and respecting the rule of law. For a long time, the only efforts undertaken by the EU to move Russia toward greater reciprocity was to passively insist that the country ratify the Energy Charter Treaty and associated Transit Protocol. These entreaties were repeatedly brushed aside by Moscow. Now, however, Brussels appears to be taking more robust steps to ensure reciprocity. Specifically, the European Commission has proposed that a “reciprocity clause” be added to EU laws, which would limit ownership of European

energy assets to countries that comply with the same requirements that the EU does.¹⁰

The EU also has the legislative tools at its disposal to prosecute companies like Gazprom or Transneft for their monopoly power. In fact, the European Commission's Directorate-General for Competition has already used its anti-trust laws to prosecute Microsoft and block a proposed merger between General Electric and Honeywell. It is well within its authority to do the same to Gazprom, which is not a simple business monopoly, but a state-owned strategic one.

It is absolutely vital that the EU diversify its energy supply by establishing a Southern Corridor. Thanks to the completion of the Turkey-Greece pipeline, gas can now travel all the way from Azerbaijan to the European Union without traversing Russia. This is an important first step, one that must be supplemented by the Greece-Italy connection, Nabucco, and a trans-Caspian gas pipeline, as well as possibly the White Stream project. Building a robust non-Russian-controlled transit route from Central Asia and the Caucasus will break Russia's leverage, both in Europe and in the Central Asia-Caucasus region. But for this to happen, the EU must demonstrate its firm support for states in that region. After all, these states are much more vulnerable to Russian pressure than are most European states. Before leaders like Turkmenistan's Gurbanguly Berdymuhamedov will commit to a project such as a trans-Caspian gas pipeline—a project which would certainly provoke the ire of Russia—they must have a firm and steady political commitment from the entire EU.

In the long term, the establishment of a Southern Corridor is good for Russia as well. As long as Russia maintains its dominance over the pipelines linking Caspian and Central Asian energy producers to Europe, neither Gazprom nor the Russian state will reform. The ties between the Kremlin and energy companies have enriched those in power, enabling them to sap away at democracy, rule of law, and human rights in Russia. And billions of dollars in energy revenue have allowed the state to buy up previously independent

¹⁰ "EU, Russia to Explore 'Reciprocity' in Energy Trade," *EurActiv*, 17 October, 2007. [<http://www.euractiv.com/en/energy/eu-russia-explore-reciprocity-energy-trade/article-167662>].

media outlets through Gazprom's media division. Reform of the Russian energy sector is therefore crucial to any broader reforms in the country.

The time has come to establish a European-level external energy strategy.¹¹ If every member state of the EU pursues its own energy policy, that only decreases the overall security of the Union, limits the EU's foreign policy options, and damages its own energy security. Although specific supplier choices can be made at the state level, these decisions must complement the broader strategy goals set by the European Union.

¹¹ Zeyno Baran, "The Common Foreign and Security Policy and the Security of Energy Supplies," *European Parliament*, February 2007. [http://www.europarl.europa.eu/meetdocs/2004_2009/documents/dv/studybar/studybaran.pdf].