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**ENERGY DIPLOMACY IN THE CASPIAN BASIN:
SINCE THE END OF THE COLD-WAR**

A Dissertation

Presented to

The Faculty of the Department

of Political Science

University of Houston

In Partial Fulfillment

of the Requirements for the Degree of

Doctor of Philosophy

By

Tuncay Babali

August, 2003

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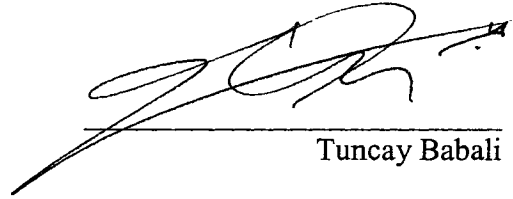
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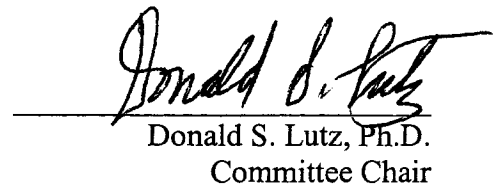
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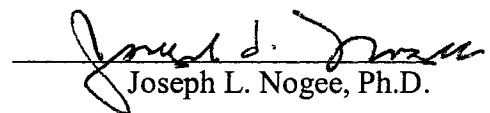


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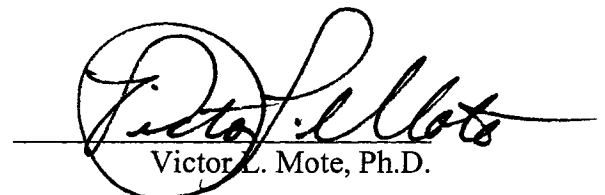
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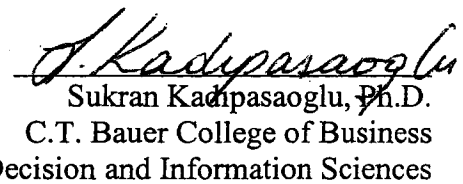
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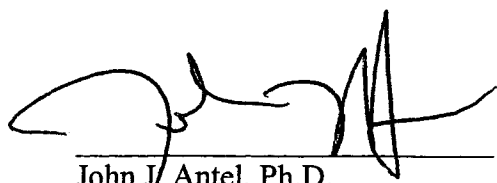
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Abstract

The Caspian region is considered to be one of the next oil and gas frontiers. Along with the re-distribution of political power and the emergence of new balances after the collapse of the Soviet Union, the continuous waves of change also have had significant effects on the prospects for development of energy resources in the region.

The objective of this study is to develop a model in order to understand and predict the outcome of the policies of the major actors (governments and companies) in the development and marketing of Caspian Sea energy resources. More specifically, the purpose is to identify the principal factors and their interactions in selecting export routes for the energy resources of the Caspian Basin. My hypothesis in this study is that political factors are dominant in the region. In the final analysis, the political process is more important than economics in determining which pipeline is to be built. The principal inputs to the development of the model will be detailed analyses of (1) the development of the Baku-Tbilisi-Ceyhan (BTC) pipeline project, and (2) the determination of the export route for Kazakhstan's giant Kashagan offshore oil field. Such a predictive model can then be applied to other countries in the region, or other similar resource-rich regions of the world.

After studying the developments leading to BTC's success, the promising oil and gas developments in Kazakhstan shall be examined. How will the Kashagan oil field be developed? What alternatives are available to the Kazakh government other than the Russian oil pipeline network? With regard to this question, I put forward the most likely outcome.

My methodology will modify Bruce Bueno de Mesquita's (BDM) model of predicting political events in an attempt to find an answer to the above-mentioned central question. Applicability of the BDM model will be tested in the context of energy development, which is different from the original and traditional fields of application for this model.

Acknowledgements

I would like to humbly extend my deepest thanks to my dissertation committee chair, Professor Donald S. Lutz of the Department of Political Sciences, for all of his tireless assistance in reviewing my dissertation and for his always encouraging approach, which got me through the pessimistic moments during this study. I would also like to thank Professors Joseph L. Noguee and Victor L. Mote of the same department for their constructive and to the point corrections on the draft texts. I am thankful to Dr. Richard E. Matland for his initial guidance at the early stages of this dissertation and for introducing me to the Bueno De Mesquita's predictive model, which would ultimately become the foundation of my research. Dr. Sukran Kadipasaoglu of the Bauer College of Business for her research design suggestions and help in interview data conversion into a statistical data file. Ambassador Ali Arsin, former Consul General Vakur Gokdenizler and Deputy Consul General Murat Ozcelik for their unwavering support and providing me an opportunity to pursue this degree. Special thanks go to Bobbie Jo Howard and Refik Sahin for their assistance in my doctoral academic writing. I also extend my gratitude to the members of the American Turkish Energy Professionals Group (ATEP) in Houston. Finally, to my wife Emine for her support for my studies at the department and to my son Emre, for his unconscious de-facto approval of my studies at the expense of sacrificing from his right and need to spend more time as a family.

Preface

The objective of this study is to develop a model in order to understand and predict the outcome of the policies of the major actors (governments and companies that will be discussed later) in the development and marketing of Caspian Sea energy resources. More specifically, the purpose is to identify the principal factors and their interactions in selecting export routes for the energy resources of the Caspian Basin. The central question of this study is: *Can we develop a model based on certain factors to predict which export route will be chosen for the energy resources of the Caspian Basin?*

The principal inputs to the development of the model will be detailed analyses of (1) the development of the Baku-Tbilisi-Ceyhan (BTC) pipeline project and, (2) the determination of the export route for oil boom Kazakhstan. Such a predictive model can then be applied to other countries of the region, or other similar resource-rich regions of the world.

As will be discussed in a separate chapter, the BTC project has very significant geopolitical implications for the entire Caspian region. A detailed study of the making of this project should provide us with enough to understand future Caspian energy developments. Therefore, in my opinion, it is crucial to understand and find answers to the following questions: Despite all the negative economic aspects of the project and fierce opposition from both the companies and Russia, why was the BTC project successful? What might be the geopolitical consequences of this project for the Caspian Basin?

In this study, I will try to define and explain the course of events that led to the realization of the BTC pipeline. In exposing the BTC experience in the region and adopting Bueno De Mesquita's predictive model for international relations, I shall:

- Analyze what policy choices were most likely to be made and implemented in the 1990s.
- Examine the processes by which policy choices were made.
- Identify what political realignments may result from this policy decision, and what the implications of these new alignments might be with regard to realization of energy development projects in the Caspian region.

After studying the BTC's success, I shall examine the promising oil and gas developments in Kazakhstan. How will the Kashagan oil field be developed? What alternatives are available to the Kazakh government other than the Russian oil pipeline network? In this respect, I shall put forward the most likely outcome.

My methodology will modify Bruce Bueno de Mesquita's (BDM) model of predicting political events (BDM 1985, 1996, 2002) in an attempt to find an answer to the above-mentioned central question. Applicability of the BDM model will be tested in the context of energy development, which is different from the original and traditional fields of application for this model.

Main Hypothesis

My hypothesis in this study is that political factors are dominant in the region. In the final analysis the political process is more important than economics in determining which pipeline is to be built.

In a broader setting, it becomes necessary to take into account the various structural constraints or contextual issues shaping outcomes associated with the predicted positions of each of the actors on any given issue. In this study I argue that the following nine issues are major factors critical in energy resource development policies. Each actor's ability to shape energy resource development in the region depends on the relative ability to control these factors, and the same factors determine the major actors in this field. These include:

1. Political power
2. Economic power
3. Geo-strategic location
4. Military power
5. Know-how and technology
6. Control of the export routes
7. Ability to create spheres of influence and/ or launch coalitions and alliances around shared goals and interests
8. History and socio-cultural influence
9. Consideration of environmental issues

Different combinations of these factors lead the actors to formulate different policies as dictated by their interests. By studying the BTC pipeline project and possible export route for Kazakhstan's Kashagan oil, and the information gathered through interviews with 116 area experts, I will attempt to show that the extent to which each actor possesses these factors determines the actor's policy towards the Caspian pipeline issues in particular and energy resources in general. Through interviews and detailed analysis, this study will also attempt to identify which factors are most important and which are less critical.

Contributions to the Existing Body of Knowledge

This study provides a comprehensive analysis and produces valuable insights into the energy resource development process in the Caspian Basin context. To my knowledge, there are no academic studies on this region that address the issue of energy resource development

by including all the relevant actors and defining the critical factors. Thus, this is a novel contribution to the literature on the resource-based economic development.

Second, in this model, transnational companies are treated as actors equal to nation states. Because, they are very much at the center of decision-making process together with nation-states, they are conducting the negotiations with the countries, which will be producing these resources and with those which will lie along the transit routes to western markets. Clearly transnational oil companies have their own interests and they have the resources (i.e. economic, financial and technological) to realize their goals in the region. Furthermore, this study will confirm some of the earlier literature (Cowhey 1985) by showing that oil companies tend to underestimate the relevance of politics in the decisions they must make. This study will review this issue at a greater depth than that found in the current literature and will conclude that political factors are dominant in the region and at least as important as economics in determining which pipeline is to be built.

Third, no published study has explored a comprehensive set of factors, discussed above, with regard to their relevance to issues of energy development. This study will provide an improved research tool, by which we can understand energy development and especially pipeline politics at the regional level.

Finally, the study will be important in terms of its likely contribution to two additional, broader, areas:

- 1) Studying the pipeline politics around the BTC project and Kashagan oil field with the support of the empirical data collected through interviews that have been conducted, yielded some evidence to prove that in today's volatile energy geopolitics, transportation and delivery of the resources to

the markets are much more important for the development of these resources than the actual production problems and proven resource assessments.

- 2) The globalization process, in its manifold aspects and seemingly inevitable sweep, has engulfed the geo-space of the former Soviet Union as well, thus the entire region of our study. The advocates of globalization believe that states will be increasingly bound by the impersonal power of the marketplace and will find their freedom of action constrained to a far greater extent (Gilpin 2001; Strange 1996). Whether it is, as some argue, the third wave of globalization,¹ or the first, the relationship between the energy resources (of the region) and their periphery will be studied thoroughly for the first time.

I urge the readers to read the observations and conclusions chapter (Chapter Nine) of this dissertation prior to delving into the entire text. Further, as they peruse the complete study, I would ask that they be always cognizant of the interaction among various issues such as politics, economics, ethnicity, history, prospects for interdependency and transition to democracy etc. This exercise might also be helpful to those researchers who are interested in the region and/or energy resource development issues in terms of giving them some hints to do further studies on related subjects.

¹ First wave as generally accepted, is the Agricultural Revolution (Neolithic age) Second wave started right after the geographic explorations and with the industrial revolution and ended with the Nuclear Age in late 1940s, the third wave is the information revolution of the 1990s. Also see: Toffler & Toffler. 1979. The Third Wave.

Table of Contents

Preface	vi
CHAPTER ONE: Introduction	1
The Petroleum Heartland	2
Supply Routes	4
Kazakhstan – The Biggest New Oil Producer in the Caspian Basin.....	7
Major actors in the Caspian Basin	8
CHAPTER TWO: The Literature Review	13
Literature Review	14
Literature on the Region	15
Resource Based Economic Development Literature.....	21
Summary.....	24
CHAPTER THREE: Research Design and Model to be used	25
Research Strategy	25
Assumptions on Actors in the Caspian Basin	28
Game Theory Analysis	30
Data.....	32
Broad Applicability of the model	35
Application of the BDM Model to the Caspian Energy Context	36
Stated Policy Preferences	36
Potential Influence	38
Salience.....	41
Data Collection	42
Interviews and questionnaires.....	42
Other Sources	43
CHAPTER FOUR	44
I. International Context of the New Era and the Caspian Region.....	44
A. The end of the Cold War and the “Sea-Change” in the Respective International Position of the Caspian	46
B. An Assessment of the Relative Global Significance of the Energy Resources of the Region	47
C. Are we witnessing a contemporary version of the old “great game” with new players and new rules?	54
II. Intra-Regional Context of the New Era - Roots Of Instability	60
A. Economic Sources Of Instability.....	60
Corruption	63
B. Ethnic Make-up of the Region and Related Problems	64
Geography and population	64
History; An ever-present problem in the region.....	66
The Communist legacy and the problems around ethnicity & national identity	70
C.Ethnic Conflicts With Specific Effects on the Caspian Energy Resource Development.....	77
Russian-Chechen Conflict.....	78
Nagorno-Karabakh dispute	79
Georgia and beyond	84
D. Lack of Organized Civil Society and Democracy	85
Problem of Succession	87
E. Political Islam & Terrorism Problems	90
F. Environmental Issues	94
Issues at Stake: Fisheries, Sturgeons, Caviar, Agriculture and Wildlife	95
The issue of the Turkish Straits.....	99
G. Issue of the Legal Status of the Caspian Sea	106

CHAPTER FIVE	118
I. Three Major Actors in Terms Of Providing Alternative Routes to Export Caspian Oil and Natural Gas	119
1. Russia	119
Russian energy policy toward the Caspian Basin.....	119
Weaknesses and some limitations of the Russian energy policy.....	122
Political and military sources of Russian influence in the region.....	127
a) Old establishment's perception of the region.....	127
b) Russia's role in solving and prolonging the ethnic conflicts in the region.....	128
c) Russian military power and its implications for the region.....	129
Some Unknowns for the Future.....	134
a) Russia's Capitalism Experience and Relations With the West	134
b) The United States-Russia Commercial Energy Dialogue	136
2. Iran	142
3. Turkey	148
What are Turkey's broader policy objectives regarding Caspian energy resources?	152
1) Meeting Turkey's energy requirements, medium-to-long-term.....	152
2) Opportunity to become Europe's gateway to an additional energy-resource-area.....	154
A. Political Assets of Turkey in the Caspian Region	159
A Regional Power?	159
B. Economic Assets.....	159
C. Social and Cultural Aspects of Relations.....	165
II. Other Actors Effective in Energy Resource Development of the Region.....	168
4. The United States	168
5. Oil and Gas Companies	173
Which companies are involved?	173
6. Other Countries of the Caspian Basin; Azerbaijan, Kazakhstan & Turkmenistan.....	179
Risk factors in Azerbaijan, Kazakhstan and Turkmenistan.....	184
Legal and Regulatory Environment	187
Kazakhstan.....	189
Turkmenistan	190
Trans-Caspian plans	192
Azerbaijan.....	194
7. European Union and China; Are They Major or Secondary Actors?	196
European Union	196
China	203
CHAPTER SIX	210
BAKU-TBILISI-CEYHAN (BTC) MAIN OIL PIPELINE PROJECT.....	210
What brought this project to fruition?	211
Conflicting perceptions and interests on the way of the realization process	212
The 'early oil' controversy	214
Breakthrough.....	220
The final stage	226
Implications of the Project.....	228
Increased interest from the companies	228
The Kazakh commitment	229
A boost for the Baku-Tbilisi-Erzurum Gas pipeline	231
One step closer in realization of TCGP project.....	233
Environmental concerns are better addressed with BTC	234
Impact on oil prices and OPEC production policies	235
Conclusion.....	235

CHAPTER SEVEN	237
RESULTS OF THE INTERVIEWS	237
Demographic and some other characteristics of the respondents	238
Interest toward the Caspian	241
Do you agree or disagree?	241
“Great Game”, Major and Secondary Actors, New Rules of the Game	244
Saliency of the actors	247
Conflict or cooperation, zero-sum game or win-win solutions	249
Is there a particular solution or a project for the energy development of the region?	250
Approach to History	250
Major problems of the region	251
Viable options to export energy resources of the region to the market	253
CHAPTER EIGHT.....	256
KASHAGAN and BEYOND.....	256
Significance of Kashagan.....	256
Implications of the Discovery	259
Possible Routes to transport Kashagan Oil and Gas.....	262
Application of the Bueno De Mesquita Predictive Model.....	269
Some concerns about the likely scenario.....	273
Some other problems that can hinder development efforts	277
Conclusion.....	279
CHAPTER NINE.....	280
CONCLUSIONS.....	281
I. On the Model and Analysis Used	281
II. On the Issues	282
A. Geopolitical implications of the oil and gas development in the region.....	282
B. Importance of political factors in oil and gas development	284
1) Energy projects are catalysts for regional cooperation and political stability.....	284
2) Which one is more challenging, production or transportation of hydrocarbon resources of the Caspian basin?	286
3) Security and stability in the region	287
4) Regime change and succession issues	288
5) Political Islam	289
C. United States-Russia Commercial energy dialogue and possible effects on the Caspian region....	289
III. Observations and Conclusions on Some of the Key Actors and Several Critical Issues Surrounding Them.....	291
1. Russia	291
2. Iran	293
3. Turkey and the future of BTC project	294
4. Multinational Companies	296
5. Kazakhstan, Azerbaijan and Turkmenistan	297
Oil and Gas Development	297
Transition to what?.....	298
The extent of Western influence	300
Leadership problems	300
APPENDICES	
APPENDIX One: Questionnaire	302
APPENDIX Two: Results Based on Whole Data Set & Excluding Turks.....	306
REFERENCES	319

List of Tables and Figures

Table 3.1. Application areas of the BDM's model and accuracy rates -----	33
Table 4.1. World Energy Demand, barrels per day (million) -----	49
Table 4.2. The Caspian oil resources and prospects for the future	52
Figure 4.1. Caspian gas prospects (bcm) -----	52
Table 4.3. Declining Output of the New States of the Caspian after 1991 (1991=100)	61
Table 4.4. Basic economic indicators for Azerbaijan, Kazakhstan and Turkmenistan, 1998-2001 (Rates of change and shares, per cent)	61
Table 4.5. International trade and external balances of Azerbaijan, Kazakhstan and Turkmenistan, 1998-2000 (Rates of change and shares, per cent)	61
Figure 4.2. Map of Nagorno Karabakh and invaded Azeri territories	81
Table 4.6. "Nations in Transit 2002" Rating and Score Summary for the Transcaspian countries of the CIS.	89
Table 4.7. Foreign Merchant Vessels Operating or Transiting Through the Straits & Accidents.....	102
Table 4.8. Total crude oil transit through the Turkish Straits (in both directions) in view of the scheduled completion of the BTC pipeline	103
Figure 4.3. Map of the Proposed Caspian Oil Export Routes as of December 2002.....	105
Figure 4.4. Map of the alternative models for sharing oil and gas (Model 1: Condominium)	115
Figure 4.5. Map of the alternative models for sharing oil and gas (Model 2: Sectoral division based on median line principle)	115
Table 5.1. Turkey's energy, natural gas and electricity demand.....	152
Figure 5.1. 2001 Caspian Region liquid production by company	175
Figure 5.2. Caspian Region's remaining reserves ranked by company	176
Table 5.2. Caspian Oil and Gas - Proved Reserves at the end of 2001	180
Table 5.3. Caspian Region remaining reserves summary	180
Figure 5.3. Oil and gas reserves estimates as of 2002	180
Table 5.4. Caspian Region liquids production potential	181
Figure 5.4. Oil production and consumption (mb/d)	182

Table 5.5. Caspian Region gas production potential.....	183
Table 5.6. Availability of the energy related legal and environmental legislation	189
Figure 6.1. Map of the Baku-Tbilisi-Ceyhan (BTC) Oil-Export Pipeline.....	211
Figure 7.1. Education level of the respondents.....	238
Figure 7.2. Job groups of the respondents	239
Figure 7.3. Specialty area of the respondents	240
Figure 7.4. Summary of the results for the “do you agree or disagree” section	244
Figure 7.5. Who are the major actors?.....	245
Figure 7.6. Rules of the Game- The most important factors.....	246
Table 7.1. Saliency Scores for the Actors	247
Figure 7.7. Saliency Scores for the Actors.....	248
Table 7.2. Resource Scores Based on Whole Data Set	249
Figure 7.8. Resource Scores for the Actors	249
Figure 7.9. Ranking of the major problems of the region (by mean values)	252
Figure 7.10. Major problems of the region	252
Figure 7.11. What are the viable export routes?	253
Figure 7.12. Viable export routes.....	254
Figure 8.1. Caspian Region remaining liquids reserves.....	260
Figure 8.2. Caspian Region Remaining Gas Reserves	261
Figure 8.3. Map of the alternative routes for Kashagan (and Kazakh) hydrocarbon resources	262
Table 8.1. Actor’s official route preferences – officially considered routes.....	269
Table 8.2. Actor’s votes	270
Figure 8.4. Who are the major actors?	271
Figure 8.5. Votes of the actors = Resources x Saliency based on Mean Values	271
Table 8.3. Possible Coalitions among the actors.....	272

Acronyms

ACG	Azeri-Chirag & Gunashli oil fields of Azerbaijan
AIOC	Azerbaijan International Operating Company
BTC	Baku-Tbilisi-Ceyhan Main Oil Export Pipeline
BG	British Gas
BP	British Petroleum
bpd, b/d	barrels per day
bcm	billion cubic meters
bcf	billion cubic feet
boe	barrels of oil equivalent
CERA	Cambridge Energy Research Associates
CFE	Conventional Forces in Europe
CIS	Commonwealth of Independent States
CITES	(UN) Convention on International Trade in Endangered Species
CNPC	China National Petroleum Company
CPC	Caspian Pipeline Consortium
CSCE	Conference on Security and Cooperation in Europe
ECO	Economic Cooperation Organization
EEZ	Exclusive Economic Zone
ENI	Ente Nazionale Idrocarburi
EU	European Union
FDI	Foreign Direct Investment
FSU	Former Soviet Union
GDP	Gross Domestic Product
GG	Governmental Guarantee Agreement
GUAM	Georgia-Ukraine-Azerbaijan-Moldova
GUUAM	Georgia-Ukraine-Uzbekistan-Azerbaijan-Moldova
HGA	Host Government Agreement
IEA	International Energy Agency
IGA	Inter-Governmental Agreement
IISS	International Institute for Strategic Studies
ILF	Ingenieurgemeinschaft Lässer-Feizlmayr
ILSA	Iran-Libya Sanctions Act

IMO	International Maritime Organization
INOGATE	Interstate Oil and Gas Transports to Europe
km	kilometer
MEP	Main Export Pipeline
mb/d	million barrels per day
mta	millions of tons per annum
mtoe	million tons of oil equivalent
NATO	North Atlantic Treaty Organization
NGO	Non-Governmental Organization
NIS	Newly Independent States
NM	Nautical Mile
OECD	Organization for Economic Cooperation and Development
OKIOC	Offshore Kazakhstan International Company
OPEC	Organization of Petroleum Exporting Countries
OSCE	Organization for Security and Cooperation in Europe
OTC	Offshore Technology Conference
PfP	Partnership for Peace
PKK	Kurdistan Worker's Party
PLE	Pipeline Engineering GmbH
PSAs	Production Sharing Agreements
RCD	Regional Cooperation for Development
SOCAR	State Oil Company of the Azerbaijan Republic
TA	Turnkey Agreement
TACIS	Technical Assistance to the Commonwealth of Independent States
tcf	trillion cubic feet
tcf/d	trillion cubic feet per day
TCGP	Trans-Caspian Gas Pipeline
TCO	TengizChevroil
tny	tons per year
TPAO	Türkiye Petrolleri Anonim Ortaklığı
TRACECA	Transport Corridor Europe-Caucasus-Asia
UN	United Nations
USSR	Union of Soviet Socialist Republics

To the people of the Caspian Region and
to each who believe he can make a difference
for the betterment of his country

CHAPTER ONE

This chapter is a prologue to arguments that will be made later in this dissertation and will serve as kind of a summary of the motivations and policy objectives of the actors (countries and companies) involved in the region. It will also attempt to place the Caspian region into a broader international strategic context, especially as a critical new non-OPEC (Organization of Petroleum Exporting Countries) hydrocarbon (oil & gas) source, by discussing briefly the exploration and production capacity of this region and possible export routes, to which I shall return to discuss in greater detail in later chapters (Chapters 4, 5 & 6).

INTRODUCTION

More than a decade after the collapse of the Soviet Union, the process of disintegration and re-alignment in world politics still continues. The regions most affected by this downfall are the constituent parts of the defunct communist empire. The political, social and economic disintegration, which have followed the demise of this “heartland” of power, initiated spillover effects that yet unfold. Such turmoil has not been witnessed among the varied regions of the former Soviet Union including the Caspian Basin¹ since World War I. Along with the re-distribution of political power and the emergence of new balances, the

¹ In this study, I will refer to Caspian Basin (or region) as the territory covering the present five countries: Russia, Kazakhstan, Turkmenistan, Iran and Azerbaijan. The term “Transcaspian” includes the Transcaucasian republics of Georgia and Armenia (although these two countries are not littoral states of the Caspian they are often included in the analysis of the region since they are at the intersection of the Caspian and other surrounding regions). It also comprises the Northern Caucasus section of the Russian Caspian region.

recent waves of change also have had significant effects on the prospects for development of energy resources in the region. This issue is worth examination simply because the importance of these resources is far greater today than it was 80 years ago.

Since the early 1990s, fundamental changes in oil and gas development of the Caspian Basin have affected the geopolitical atlas of world energy in a number of ways. On the supply side, the Eurasian hinterlands (Central Asia and Siberia) have been added to the Middle East and North Africa. The integration of regions of supply provides a central link for regions of demand on the areas of the European continent, the Indian subcontinent and the Asia/Pacific Rim. Thus, a new “Petroleum Heartland” has arisen – consisting of Middle Eastern, Caspian, North African and Russian oil and gas suppliers – with economic and geopolitical links to an Inner Demand Crescent – continental Europe, the Indian subcontinent and the Asia/Pacific Rim – and, to a lesser extent, an Outer Demand Crescent (U.K., Japan, the Americas, sub-Saharan Africa and Australasia). These mega trends already have impacted Eurasian geopolitical games and will greatly refashion oil and gas stakeholders' strategies regarding business opportunities in this region.

The Petroleum Heartland

The Middle East, and the Persian Gulf in particular, remains the epicenter for the petroleum resources of the world. However, since the collapse of the Soviet Union, the Caspian Basin has become an exciting new and important source of supply for Western markets. The newly independent states of the Caspian Basin, namely Azerbaijan, Kazakhstan and Turkmenistan are estimated to possess reserves of more than 25 billion barrels of oil. This volume is comparable to that of Kuwait and greater than that of Alaska's North Slope and the North Sea combined. More recently, studies using sophisticated three-

dimensional imaging methods, which had not been used in the region before, have led to the upward revision of the size of (proven) oil reserves in the Caspian Sea from about 80 billion barrels to about 180 billion barrels, and there is hope for yet more discoveries.² This is equivalent to approximately two-thirds of Saudi reserves, which account for roughly 25 percent of world reserves. The US Energy Information Administration (EIA) reports that Caspian Sea exports were about 800,000 b/d (of the two million b/d produced mainly by Kazakhstan and Azerbaijan) in 2002. The EIA estimates that the region's exports could increase to more than three million b/d in 2010 and possibly to an additional two million b/d by 2020, with several oil projects in the region due on stream in the coming years (Oil & Gas Journal-OGJ Oct. 16, 2002). In addition, proven reserves of Caspian natural gas Basin compose approximately 7-9 percent of total world reserves. Undisputedly large resources are located in Turkmenistan³ as well as in Azerbaijan.

Certainly, oil and gas exploration and production (E&P) in the Caspian Basin will be maximized to the full potential of the market. E&P capacity of this region and potential exporting routes will lead to integration of the Caspian Basin, together with Central Asia, with the Middle East to form the "New Greater Middle East." (Robins 2002). However, the New Greater Middle East has to compete with other regions, especially its close neighbor Russia, for a considerable share of the world energy market. Russia has proven oil reserves

² International Energy Agency-IEA figures of 2002 and CERA estimates, www.cera.com. Note that the proven reserves figures do not reflect potential and/or probable reserves that ongoing exploration in the Caspian region is expected to prove.

³ Turkmenistan was the fourth largest producer of natural gas following the Russian Federation, USA and Canada in the 80's and the early 90's. After the collapse of the Soviet Union, production declined about 75 percent. The main reasons for such drastic decline are limited access to Russian pipelines, the inability of former large consumers to pay their bills (e.g., Ukraine) and, most importantly, the absence of direct export pipelines to prospective major consumers (Turkey, Europe, India and China).

of about 50 billion barrels and possesses the world's largest natural gas reserves, with 1,717 tcf of proven reserves and 7,500 tcf of potential resources.

In short, hydrocarbon resources of the Caspian region are sizable enough to justify the intense interest of the international energy industry, regional countries like Iran and Turkey as well as great powers like the U.S. and Russia, especially in terms of their potential to be a reliable supply for western markets.

Supply Routes

Caspian geography dictates a high degree of dependence of producer countries on transit countries for oil and gas export. Geopolitical forces and environmental concerns about oil shipping routes, which create pressure for the construction of pipelines that are not always the shortest route to market, intensify this dependence. Some of the proposed pipelines involve an exceptionally high, even unprecedented, number of transit countries.⁴ While transit has always been risky, Caspian transit countries are riskier than most. Three of the five Caspian littoral states are landlocked (Azerbaijan, Kazakhstan, Turkmenistan). Russia and Iran have terminals (existing or potential) with direct access to open seas, but much of the oil shipment from those terminals requires eventual passage through environmentally, or politically-sensitive places like Georgia, the Turkish straits of Bosphorus and Dardanelles, the Danish Straits and the Strait of Hormuz.

As often indicated by leading energy industry magazines, such as the *Oil and Gas Journal*, the single most important factor that dictates future oil production in the Caspian, is

⁴ Perhaps the most extreme example is the proposed Trans-Caspian Gas Pipeline, which involves four countries (Turkmenistan, Azerbaijan, Georgia, and Turkey) and transit across a territory with controversial property or use rights (the Caspian Sea itself). There are few examples of such transit complexity elsewhere in the world (such as gas pipelines from Russia to Europe).

the availability of export capacity. Progress in the development of the important oil and gas fields (Tengiz, ACG, Shah Daniz, and Kashagan) remains dependent on the timely construction and commissioning of their respective proposed pipelines (OGJ Dec.17, 24, 2001).

The Baku-Tbilisi-Ceyhan (BTC) main oil pipeline, scheduled for completion in 2005, will be the first oil pipeline coming out of the Caspian Basin that will not cross Russian territory to reach international markets. The pipeline will cross Azerbaijan and Georgia before reaching the eastern Mediterranean coast of Turkey. The BTC project is estimated to cost about \$2.9 billion for a 1,090-mile pipeline. The principal stakeholder is British Petroleum (BP) with a 38 percent share, followed by Azerbaijan's state oil company, SOCAR, with a 25 percent share. Other members of the consortium include Italy's Eni SpA; Norway's Statoil; Turkish Petroleum; Japan's Itochu and Intex Corp; the US-Saudi venture, Delta Hess; France's TotalFinaElf; and US-based ConocoPhillips and Unocal. Once complete, the pipeline will have the capacity to ship a million barrels of oil a day.⁵

The BTC pipeline was often portrayed as being a politically, not economically, feasible project. From the earliest stages of the project until the beginning of its construction, detractors of this pipeline have questioned whether the Caspian Basin contains sufficient energy reserves to justify the massive construction and projected transportation costs. BTC opponents suggested that political factors were possibly blinding the US and Turkish governments to the financial risks of the pipeline, which, they claimed, have been more politically motivated than any other oil project in the world. Proponents, on the other hand, insisted that both economic and political factors must be considered when evaluating the

⁵ www.eurasia.net

project. The pipeline would also prevent additional tanker traffic through the already crowded Turkish Straits (OGJ, Jan. 14, 2002, 60). It became clear in 2001 and 2002 that, despite the availability of more economic and shorter alternative routes through Iran in the south and Russia to the north, the BTC pipeline would be the main export pipeline for Azerbaijani oil. Several global oil conglomerates (such as BP, TotalFinaElf, ConocoPhillips) attached even greater importance to the BTC pipeline, predicting that it would emerge eventually as the primary conduit for the flow of not only Azerbaijani oil and gas, but for the entire Caspian Basin energy resources to Western markets. It is yet too early to conclude that this indeed might be the case.

Both the Clinton and Bush administrations have been among the project's staunchest supporters. Clearly, the BTC pipeline could deny Iran a significant role as a Caspian energy exporter, reduce the dependence of the Caspian, Caucasus and Central Asian states on Russian pipelines, and bolster fledgling regional economies, especially those of Azerbaijan, Georgia and Turkey. As Ambassador Stephen Mann, senior US adviser on Caspian Basin Energy Diplomacy, stated, "We have never said it's just about business. It's about these producing countries gaining a greater measure of autonomy. " (OGJ Dec. 24, 2001)

Companies with extensive holdings in the region, such as ExxonMobil Corp. and BP PLC, tried unsuccessfully for years to persuade the US government to consider supporting a shorter and less expensive pipeline from Iran. These companies had hoped that President George W. Bush, a former oil executive, would reconsider the US position. But currently the US remains steadfastly against any project that could give Iran more leverage in Western oil markets. Instead, US officials such as Vice-President Dick Cheney "reaffirmed" the Bush

administration's commitment to the BTC pipeline declaring the project sound, both politically and financially (OGJ, Jan. 14, 2002, 60).

The BTC project has significant geopolitical consequences for the entire Caspian region. Detailed analyses of the development and implementation of this project are necessary to achieve a better understanding of the future of energy development in the Caspian Basin.

Kazakhstan – The Biggest New Oil Producer in the Caspian Basin

One of the most significant oil discoveries of the last 30 years was the Kashagan shallow-water oil field, off Kazakhstan, in the fall of 2000. A two-year appraisal program undertaken by contracting companies in the North Caspian Sea production-sharing agreement, in conjunction with the Kazakh government resulted in a preliminary estimate of producible reserves in the range of 7-9 billion barrels for that field.⁶ Some experts indicate that, on the basis of further studies, these estimates prospectively may be revised up to 50 billion barrels.⁷ The prospects for the development of this field and the Kazakh government's decision on exporting their oil on a route that does not include Russian soil are very important topics of discussion in the region. This is another area that warrants further investigation to gain insights into energy resource development policies in the Caspian Basin.

⁶ The Kashagan field is operated by AGIP KCO (formerly known as Offshore Kazakhstan International Operating Company-OKIOC) on behalf of the partners Agip, Exxon Mobil, Shell, British Gas, TotalFinaElf, Phillips and Inpex.

⁷ The field, known as Kashagan, lies in the north-west Caspian off the coast of Kazakhstan and is reported to cover an area 75 kilometres long by 35 kilometres wide. Drilling began in 2001 under the auspices of its concessionaire, the Offshore Kazakhstan International Operating Company (OKIOC).

William Zempolich, the company's head of exploration said in October 2000 that preliminary results suggested it was "one of the largest discoveries made in the past 30 years". General manager Keith Dallard added it was "much, much bigger than anything we've seen in the North Sea". Senior Kazakh officials have suggested that Kashagan could be the second largest offshore site in the world, ranking just behind Saudi Arabia's massive Ghawar field. Ann Smith, Pamela. "Race for Caspian Treasure intensifies" *Middle East*, Jan2001 Issue 308, p31; OGJ June 28, 2002; www.rigzonenews.com/news on 05/07/2002

Major actors in the Caspian Basin

The primary actors in the Caspian Basin are:

- Russia,
- Iran
- Turkey
- The United States
- Azerbaijan,
- Kazakhstan,
- Turkmenistan,
- Oil companies, and
- EU & China

Russia, Iran and Turkey are the three foremost competitors in the region in terms of providing alternative routes to export oil and gas from the region. In addition to these countries, the roles of the United States and other Caspian littoral countries like Azerbaijan, Kazakhstan and Turkmenistan and transnational oil companies are of fundamental importance and they all constitute primary actors. These actors have their own interests in the region in terms of energy resource development, and they all try to maximize their interests.

Russia has had a long and important role in Central Asia and the Caspian region. It remains an important influence in the area as the largest trading partner for Kazakhstan, Turkmenistan and Azerbaijan and Russian territory and the existing energy industry infrastructure constitutes the principal transportation channel for oil and gas out of the region. Russia holds the largest natural gas resources and one of the largest oil reserves in the world. With its extensive pipeline network, Russia exerts substantial influence on both world energy markets and the Caspian energy sector, for which it has served historically as a transit route. A fundamental objective underlying Russia's policy in the Caspian is to keep "outsiders" like Turkey and the United States from interfering in its "sphere of influence."

On the other hand, Turkish governments' primary objectives in Eurasia are consolidating the independence of former Soviet states and promoting "strategic pluralism" across the region.

Since the end of the Cold War, Russia and Turkey have been in a competition for the transportation of Caspian oil to Western markets. Turkish and Russian policy makers competed for a main export oil pipeline across their territory to carry Azerbaijani and possibly Kazakh crude to the European market. Ankara (together with Washington) has pushed for the BTC main export pipeline project that would bypass both Russia and Iran, while Moscow backed the "northern route" to Novorossiysk. By mid-2001, however, the Russian government —after realizing then that it was impossible to prevent the BTC— dropped its opposition to the project. Instead, Russia has taken steps toward finishing the construction of the high-capacity Tengiz-Novorossiysk pipeline (built by the Caspian Pipeline Consortium), cautiously but shrewdly playing Kazakh oil against Azerbaijani oil on the world markets.

The actors, in this competition certainly include Iran as an important actor. Undeniably, Iranians have many assets, such as their energy technology, experience and geographical location. The Iranians try these advantages fully in pursuit of their regional ambitions. They strive to weave a web of energy cooperation with all the Caucasian and Central Asian countries proximal to Iran. Iranians plan to modernize all their major ports and to make their road and railway system a gateway. They have already signed contracts to transport Kazakh oil and Turkmen across their territory.⁸

⁸ Kazakhstan signed an agreement in 1996 to begin oil swaps with Iran under which Kazakhstan sends oil to Iran's sea ports on the Caspian while Iran will simultaneously export an equivalent amount of its oil from its

In implementing the strategy to establish Iran as an oil and gas transportation corridor, the Iranian government has several objectives to:

- Realize the earnings potential that its strategic location offers;
- Secure leverage over neighboring states that become reliant upon the use of Iran's transportation facilities;
- Continue to reduce isolation from the international oil and gas industry that US policy has sought to impose.

The Turks' interests in the region's oil and gas resources are obvious. First, Turkey has a general and strategic stake in the independence and well being of the new Turkic republics of the region. Former President Demirel once said "We see this rich region of oil and gas reserves, not just as a source of energy, but as an element of stability. Just as the founders of the European Community saw coal and steel as a source of peace and stability for Europe, so we see oil and gas in our region serving the same role." Stability and prosperity in the region will also mean increased trading and investment opportunities for Turkey. (Iskit 1996)

As for Turkey's more specific interests, they include, in addition to transit revenues from export pipelines crossing the territory, securing relatively low cost crude for refineries and gas for consumers, as well as substantial work contracts for Turkish companies. We should also add to this picture Turkey's safety and environmental concerns regarding increased tanker traffic through the Turkish straits connecting the Black Sea and the

Persian Gulf ports on behalf of Kazakhstan resulting in greater efficiencies and reduced transport costs for both countries. Large-scale swaps of this type by American companies with Iran have been opposed by the United States. U.S. Energy Information Agency, (December 1998) <http://www.eia.doe.gov/emeu/cabs/caspian.html>.

Mediterranean (the Bosphorus and the Dardanelles), and the government's insistence on the necessity of avoiding this route for Caspian oil exports.

The United States is clearly another major actor in this competition, although not in the region. Caspian energy development has some significant implications for broader US foreign policy goals. These goals fall into four general categories:

- To strengthen the independence and prosperity of the new states of the Caspian region;
- To bolster energy security by ensuring the free flow of new sources of hydrocarbons to world markets, unfettered by regional competitors and geographic choke-points, such as the Bosphorus and the Strait of Hormuz;
- To re-establish economic linkages among the new states of the Caspian region to mitigate regional conflicts; and
- To enhance business opportunities for companies from the United States and other countries.⁹

The other Caspian littoral countries, Azerbaijan, Kazakhstan and Turkmenistan - as owners of abundant energy resources, are natural actors. However, after the collapse of the Soviet Union, the energy industry in these countries and especially the oil and gas sector shrank along with the rest of the economy. This contraction was due to inefficiencies inflicted upon these economies during the administrative-command system of the Soviet Union, the integrated and dependent nature of Caspian economies to that of Russia and the

⁹ Speech delivered by John S. Wolf, Special Adviser to the President and Secretary of State for Caspian Basin Energy Diplomacy, at the 19th Annual Conference of the American-Turkish Council on March 30, 2000 in Washington DC. The same goals were confirmed by Ambassador Mann, State Department's senior adviser on Caspian Basin Energy Diplomacy, during the Cerawee conferences held on February 10-14, 2003.

reluctance of post-Soviet governments to implement policies that would remedy these inefficiencies in an era of otherwise open market conditions. These new countries have begun to learn the energy business from scratch. Lack of modern institutions and companies to deal with the challenges of the energy industry and the lack of know-how, technology and capital to develop these resources have hindered the potential role to be played by these countries. However, with the accumulation of wealth from the export of oil and gas, they should learn to be real actors soon enough.

As of 2003, due to reasons that will be touched upon later, Turkmenistan, in the words of Ambassador Mann, senior U.S. adviser for Caspian Energy Diplomacy, “made herself a non-player in this game.” Ultimately, by refusing to participate in any proposed pipeline coming out of their territory, the Turkmen made themselves solely dependent on the Russian transport system. The remaining newly independent countries of the Caspian, Azerbaijan and Kazakhstan, are the geographic focus of this study.

Transnational oil companies clearly prefer to present energy development issues in geo-economic rather than geopolitical terms, putting cost efficiency ahead of balance of power and emphasizing competition between economic actors rather than the struggle for spheres of influence between Russia, Iran, Turkey and the United States.

With some exceptions, the strategic interests of these companies and those of their governments have been demonstrated to be concerted, and it is not rare that a government uses a company to further its political interests. The opposite case has also been observed in many instances. That is to say that the companies are far from being negligible actors in the Caspian oil and gas scene. Either on their own account or in the name of governments, they add to the complexities of this grand puzzle.

CHAPTER TWO

This chapter discusses some of the extensive literature written directly or indirectly on the Caspian region and energy resource development issues. I will also present some examples of the recent trends in these two separate literatures, which I think relevant to my dissertation. Previously, studies specifically on this important region were very rare and considered to be relatively out of the mainstream agenda of Soviet studies. This chapter attempts to show the way in which the topical literature is struggling to deal with this newly emerged energy rich region. The issue of how to study this region, either within the umbrella of the Commonwealth of Independent States (CIS), or Central Asia, or under a totally new classification of regional study, is not yet a resolved issue among scholars. Examples of these different approaches toward studying the region are widely observable in the literature. Then, there is a new tendency that is studying the countries of the region in greater depth and for specific issues. I will delve into a couple of examples of this new trend, as well. The basic underlying criteria employed to choose among many examples of the above mentioned sections of the literature is their relevance and supportive aspects to my central questions laid down in the preface and introductory chapter. I found it useful to identify some of the books that I believe support my hypothesis and central arguments, such as Cowhey's book on the importance of political factors in energy development, Goltz's Azerbaijan Diary on the importance of ethnic conflicts and history as elements of political risks in the region, and Olcott's book on corruption, authoritarianism and lack of pluralism in the region and their

effect on economic and political development of the newly independent countries of the region.

THE LITERATURE REVIEW

To determine the questions most significant to my topic, and to gain precision in achieving deeper analysis concerning issues important to oil and gas development in the Caspian region, a review of the pertinent literature is indispensable.

Can the discipline of political science enhance a study of recent developments in Caspian energy diplomacy? Scholarly theories are like lenses that one puts on when viewing the question of interest. They allow us to see the picture more clearly in terms of the crucial factors on which an investigator concentrates. They permit us to discern the forces that drive a given issue. Except for game theory, the relevance of which will be discussed in greater detail in the next chapter, theories of international relations have limited relevance to the issues of Caspian Sea energy resource development. At first glance, it seems that economic theory is more useful. For example, economists have identified the ramifications of changes both in the nature of energy markets and in international politics based on supply/demand and cost/benefit analysis and have elaborated the consequences of market structure in order to understand the outcomes of the international energy markets (Gelb 1988, Auty 1990, Sachs 1995, Gregory 1997). Engineers and technicians have grasped the ramifications of changing technologies on these same markets (Wheeler JIE 1992, Foss 1999). As Peter Cowhey argues in his book The Problems of Plenty, however, both economists and technologists have missed many key implications of the political dimensions of these changes. Economists and technologists have miscalculated the way in which coalitions of nation states and corporations act together to steer international energy market developments (Cowhey 1985;1).

Along with economic views, some of the major schools of international relations have relevance to this study. For example, neo-realists have analyzed the effect of international interdependence (Krasner 1983; Baldwin 1993; Keohane 1984, 1986; Keohane and Nye 1977, 1987, 2000). This school has examined the creation of international regimes that indeed have been led by both nation-states and other important international actors, including corporations. The possibilities of an international energy regime have been considered.

Literature on two major areas shed valuable light on our proposed research. One is literature that deals directly with the Caspian region and its energy resources; the other is energy-based resource development literature. I will begin with the literature on the region.

Literature on the Region

I am convinced that, unless political scientists embark upon detailed studies exploring the multifaceted relationships among the individual actors in the Caspian basin, it will be almost impossible to reach tangible conclusions and understandings of any of the issues and problems that are present in the region, including the exciting energy developments.

In the past, Soviet academicians and researchers composed the bulk of the most serious studies of the region. The few Western universities with Central Asian programs concentrated on the languages, history, religion and culture of the circumscribed area. Turkish specialists, following the lead of the great French Central Asian and Caspian expert, Alexandre Bennigsen, were among the most important scholars, and arguably came closest to an understanding of an integrated culture, in which Turkey plays a significant role.

In contemporary analyses, the Caspian basin is less a region than a concept. In the context of Eurasian studies, the concept of the Caspian together with Central Asia is kept flexible as note is taken of the emerging issues that drive the interaction of regional states with the

outside world - not least the presence of the West. In short, issues surrounding the Caspian are multi-layered and overlap. The task of the contemporary Eurasian analyst is to unravel and elucidate them.

A great deal of research on Eurasia (both in the Western geographical sense and that of the Russian 'Near Abroad') has essentially offered a series of isolated insights about the Caspian as well - building blocks for a structure that has yet to be designed in its entirety (Hartshorn, 1993; Cohen 1996; Malashenko 1998; Herzig 1999). These insights however, have not shown a capacity for continuing growth in their own totality to cover the whole region. The international politics of the Caspian cannot be measured by a single standard. Particular past and present circumstances shape the states of the region and their relations. The diversity and change in these relations can never be captured fully by a single theoretical model, but belief in the need to ascertain the essence of issues of the region is essential to an understanding of the international politics of the region.

None of the Caspian states, except Russia and Iran, have direct access to an open sea. Azerbaijan, Turkmenistan and Kazakhstan have a maritime frontage on an inland sea. Being landlocked creates physical dependence on the neighboring countries that can offer routes of passage.

The internal political and economic makeup of each republic differs. In spite of this, the majority of commentators still analyze the Caspian as a single economic and socio-cultural community. These commentators focus either on the population of Turkic peoples, or on a post-Soviet region, or on a region that has been part of the Russian empire (Bennigsen 1980; Croissant 1996; Malashenko 1998). Perceptions, however, are gradually changing. The Caspian is now generally described as the 'Caspian region or basin.'

Today a considerable number of scholars (Croissant 1999; Amirahmadi 2000; Ruseckas 2000; Aras 2001) increasingly view the basin as one of the political and economic powerhouses of the twenty-first century. The various co-operative-competitive issues engulfing the sensitive region include the exploitation of the Caspian seabed resources, likelihood or not of ethno-political conflicts, problems involved in oil and gas transit routes, links with world markets, and the region's critical security and environmental issues. Studies have focused particularly upon changes in the political and economic structures, and can be included under the twin-heading of regional economic challenges (Yergin & Stanislaw 1993; Clague et.al. 1997; Gregory & Stuart 1997; Shenoy & Gulen 2002) and the creative role of regional co-operation (Ruseckas 1999; Garnett, Rahr & Watanabe 2000; Kalicki 2001; Allison & Jonson 2001).

In most of the studies, the region is considered as part of Central Asia and/or the Caucasus (Allison and Jonson, 2001; Garnett, Rahr & Watanabe, 2000; Makowsky and Sayari, 2000; Winrow 1995 & 2000). Literature involving the Caspian alone is rare (Aras 2001; Hale, 2000; Kramer, 2000; Winrow 1999; Karpat 1996).

Since the internal political and economic makeup of each republic and their international relations differ, there is this recent trend in literature to look at the countries of the region individually. In this respect, Thomas Goltz's book Azerbaijan Diary (1999) stands out in its objectivity. Mr. Goltz's account of six years as a freelance journalist in a volatile region, where oil men, spies, Islamic militants, mercenaries and corrupt politicians struggle for power, reads like a combination of all factors that are part of geopolitics of the Caspian region, i.e. ethnic conflicts, authoritarianism, corruption, terrorism and economic poverty. The book, in addition to being an interesting story, is also a fascinating look into the aftermath of the fall of the Soviet Union and the new role of Russia in the region. Another interesting point in the book is the

historical aspect that is very much part of the existing conflicts and perceptions of neighboring countries in the region. Thomas Goltz reveals the classical example of "rewriting" history (which is the common practice in all Commonwealth of Independent States-CIS countries of the Caspian region and Central Asia.) Goltz argues that this method was utilized by Armenian "historians" in creating the myth of "Great Armenia" and using it to "inspire" Armenian youth into the war against Azerbaijan during the Nagorno-Karabakh conflict.

Another product of similar detailed approach to the newly independent countries of the Caspian Basin is Martha Brill Olcott's book Kazakhstan: Unfulfilled Promise (2002). Olcott explains that, at the outset of independence 10 years ago, Kazakhstan's leaders promised that the country's rich natural resources, with huge oil and gas reserves, would soon bring economic prosperity, and it appeared that democracy was beginning to take hold in this newly independent state. However, she claims that more than a decade later, economic reform is mired in widespread corruption. A regime that flirted with democratic pluralism is now laying the foundation for family-based, authoritarian rule. Olcott describes how President Nursultan Nazarbayev has stuffed relatives into key positions of the state and business, a by-product of which is rampant corruption. Beside the establishment of elite-run government, Olcott discusses in great detail: ethnic, linguistic, financial, and secular differences in attitudes between the northern part of the country and traditional ones in the south. While the book examines the development of this diverse and strategically vital nation, it greatly enriches the literature on post-Soviet transitions. In addition, Kazakhstan: Unfulfilled Promise examines shortcomings of the U.S. policy in the region and at the future challenges Kazakhstan may pose to the international institutions and companies. Similar works, however, are still missing for Turkmenistan.

Another characteristic of the literature on the region is that, so far, the majority of research has been conducted generally from a particular nation's perspective. They are either pro-Russian, pro-Iranian or pro-Turkish. One of the latest examples to this kind of study is Dr. Amirahmadi's (ed.) book "The Caspian Region At a Crossroad: Challenges of A New Frontier of Energy and Development." (2000) Amirahmadi asserts that there is a "very lopsided understanding of the region" and that his book "attempts to correct this deficiency." He clearly fails to fill this deficiency but focuses on propaganda for pipelines through Iran, a settlement on the legal status of the Caspian Sea that would benefit Iran, or its Islamic regime. Nevertheless, this Iranian focus may be the most important asset of the book. The authors in this volume provide a fairly detailed look at the Iranian perspective on a wide variety of issues. On the other hand, the book also fails to demonstrate a clear connection between the politics and the economics of energy projects in the Caspian region, as well as on the impact of oil and gas resources on the region's economic development. Therefore, an examination of the new energy geopolitics of the Caspian and the respective roles of the major players will provide a unique contribution to the few studies that attempt to bring all the important actors into a single analysis.

One of the few exceptions in the literature about the region is Michael P. Croissant and Bulent Aras's study; Oil and Geopolitics in the Caspian Sea Region (1999). The editors of this book have come closest to laying a foundation to study the Caspian basin and its energy resources as a whole, while not favoring the interests of any country in or out of the region. The twelve chapters contributed by fourteen authors and co-authors are divided into three parts dedicated to examining and analyzing the general history and mutual background of the Caspian Sea region; the five littoral states of Azerbaijan, Russia, Iran, Kazakhstan, and Turkmenistan; and three "external" interested states: the United States, Turkey, and Georgia (with the omission

of EU perhaps). Nonetheless, the reviews by the authors go well beyond the boundaries assigned to them and overlap the topics, territories and their relations assigned to other authors. This is proper, in view of the mutually complex real-life interrelations in the Caspian Sea Basin. No topic or state there could be adequately understood without considering the others. Besides, the issues covered by the authors are not limited to the oil and energy resource development strategies and factors affecting these strategies per se.

In a broader perspective, what is missing in the literature about the region is the discussion about the possible effects of political risks associated with the future of the region. Whoever studies the region, and any actor involved in the region, must discuss the issues involved in developing the oil and gas resources of the Caspian and in bringing that oil and gas to market. These issues can be analyzed from at least three angles:

- (1) the transportation problems,
- (2) the great power involvement and
- (3) the potential instability of the regimes in place.

These three dimensions interlock. The transportation problems invite involvement of neighboring states like Turkey for both economic and political reasons. The solutions also affect the great powers (the United States and Russia). The potential instability of the regimes in place makes them seek allies outside the region. In turn, the internal politics of the new states of the Caspian Region and Central Asia also affect the great powers. These interlocking dimensions of

political risk perhaps make the region the world's most complex geopolitical environment for the oil industry, and the stakes are enormous.¹⁰

Resource Based Economic Development Literature

The second major arena relevant to the scope of this dissertation is the resource-based economic development literature. A prominent study in this area is by Peter Cowhey, The Problems of Plenty; Energy policy and international politics (1985). Cowhey's basic premise is that in order to understand the evolution of the world energy situation it is necessary to consider 'the way in which coalitions of nation-states and corporations act collectively to steer international energy markets' (1985:1). There is undoubtedly some basis for his claim that neither economists nor technologists have paid sufficient attention to the political dimensions of energy problems. This clearly overlaps with the underlying assumption of my thesis; "despite what the rules of economics may dictate as a certain energy development strategy for the region, politics matters and affects these choices." Cowhey's principal analytical concept on the other hand is 'international management strategy', which is the way a coalition of actors (governments and/or corporations) intends to manipulate their environment in order to achieve some goal. Part of his book is primarily concerned with developing the taxonomy of such strategies. This is done by arguing that they have two dimensions, the jointly prescribed action and the coordinating style. The former concerns the methods of manipulation to be adopted and the latter the degree of flexibility that coalition members are allowed in adhering to such methods. Cowhey treats each dimension as independent variables, and distinguishes three levels for each, so that nine types of strategy are set out. Basically he attempts to 'identify the general patterns underlying the

¹⁰ Frédéric Grare, "La nouvelle donne énergétique autour de la mer Caspienne: une perspective géopolitique", in *La Caspienne: une nouvelle frontière*, Cahiers d'études sur la Méditerranée orientale et le monde turco-iranien, no. 23, Paris 1997, pp. 15-38.

selection of international management strategies and their political economic consequences' (Cowhey 1985: 279). He argues that each strategy is a product of predictable combinations of economic, technical, and political factors pertaining to how actors understand their interests and perceive the distribution of risks and rewards in the world market" (Cowhey 1985: xii) This is clearly an overlapping area that corresponds to Mesquita's research method (Mesquita 2000, 2002) which I will rely on heavily. (This will be explained in the next chapter.) What is more important than Cowhey's suggested management strategies is his underlying message that 'preoccupation with prices and elasticities of supply and demand could prevent us from spotting a restructuring of the institutional framework (OPEC-OECD framework) of the world market in hydrocarbons' (Cowhey 1985: 372). I found his reading of history, essentially from a political science perspective, interesting and useful.

Springing from this underlying message, the literature has steadily focused on geopolitical factors that matter in energy-based development. For instance, The New Geopolitics of Energy by John Mitchell, Peter Beck and Michael Grubb (1996) is about how changes in the scale and structure of energy demand, supply and international trade have become interwoven with broader, non-energy political changes. They argue that for the next fifteen or more years the arithmetic of the energy outlook and current international political trends create a new 'geopolitics of energy' which differs greatly from the OECD-OPEC focus of earlier decades. The book is mostly about energy supply because that is most subject to geopolitics.

The authors attempt to describe what is new in geopolitics. Among others, some of these "new" trends are listed as follows:

- The oil market has become a more open, competitive and transparent commodity market with the trading instruments common in such markets for futures and hedging operations.
- The end of the Cold War has removed a major constraint on the freedom of US action in the Middle East and in other parts of the world. The United States has demonstrated its military power on the ground in the Middle East to protect, among other things, an important part of that region's oil supplies to the world market.
- Immense and comprehensive changes are integrating Russia and other former members and regions of the Soviet Union into the world economy, their energy sectors included. Relations between Russia and the other successor states (and former USSR allies) have changed and are still developing, with consequences for the flow of energy trade across new and old borders.

The geopolitical agenda affecting these energy calculations and observations is broad.

Some of them according to this book are:

- managing responses to future disruptions to international energy trade,
- oil supply to the world market and gas supply to Europe in particular; resolving tensions inhibiting the development of oil and gas exports from the former Soviet Union;
- improving the environment for investment in projects and pipelines to export gas from eastern Russia to Northeast Asia.

In short, the main thesis of the book is that, the geopolitical issues of energy must be reconciled with broader policy agendas of competitiveness, foreign policy and environmental policy.

Summary

Exciting energy developments are taking place in Eurasia, from Russia and the Caspian Sea to the Indian Subcontinent and the Far East. The Caspian region occupies a prominent place in this context. While the existing literature provides valuable insights into economic and technical developments in the Caspian region, there are no academic studies, to my knowledge, addressing the energy resource development and export, including all the relevant actors and defining the critical factors in the Caspian basin. This dissertation attempts to close this gap by providing a comprehensive analysis of the new energy geopolitics of the Caspian, and the roles of prominent actors. The research methodology and the novel approach used to assess the major actors and the factors acting on the geopolitics of the Caspian region and on the development of export routes are provided in the next Chapter.

CHAPTER THREE

This chapter will discuss the methodology and data sources used in my dissertation and explain how the original Bueno De Mesquita (BDM 1985, 1996, 2002) model of predicting international relations can be modified in an attempt to find an answer to the central question of this dissertation: Can we develop a model based on certain factors to predict which export route will be chosen for the energy resources of the Caspian Basin? Following a brief explanation of the original BDM model and basic assumptions on actors in the Caspian Basin, applicability of the BDM model to my case will be discussed (later will be tested in Chapter 8) in the context of energy development of the Caspian Basin in general and possible export routes for the giant Kashagan field of Kazakhstan, which will constitute a novel field of application for this model.

RESEARCH DESIGN AND MODEL TO BE USED

Research Strategy:

This research is in part modeled after the approach introduced by Bruce Bueno De Mesquita (BDM) to provide practical guidance on how to explain and predict the evolving policy choices and events related to energy development in the Caspian region. More specifically, I have adopted Mesquita's interpretation of a practical model of political decision-making, alternately known as the *expected utility*¹¹ model or *rational-actor*¹² model

¹¹ Expected utility is the value attached to a particular action or decision discounted by the chance that the prospective outcome of that action or decision will arise.

¹² Rationality is a basic characteristic in this model that enables individuals to connect choices transitively, take constraints into account, and choose the course of action that they believe will give them the best result.

(Bueno de Mesquita 1984; Buena de Mesquita, Newman and Rabushka 1985, 1996; Bueno de Mesquita and Stokman 1994).

Mesquita's interpretation of *applied modeling* makes some sacrifices in theoretical or analytic purity in order to gain empirical leverage. At the same time, his model remains faithful to the strategic perspective, which suggests that actors do what they believe is in their best interest. Moreover, strategic behavior can affect the outcome, which may be determined equally by the context and structure of relations. The representation of decision makers in this model, however, assumes that individuals and/or actors are *bounded in their rationality*¹³.

The expected utility model proposed by Mesquita is sufficiently general to forecast the results of almost any policy question at any level of politics. Examples include such areas of economic concern as minimum wage laws or price stability, as well as more direct political concerns; for example, intergovernmental agreements to share technology or to extend military basing rights to other governments. The scope of issues may affect a single nation, a small group (cabinet, union, or boardroom), or international relations (Mesquita 2000).

To understand or predict the policy choices affecting energy export routes in the Caspian region, according to the BDM model, we first have to identify and learn a little more about each actor- also referred to as players and/or stakeholders. The expected utility approach requires following basic information on identification of the relevant actors who

¹³ Bounded rationality is the inability of leaders to evaluate all of the information that is available to them in making choices (Simon 1947, 1982). They may do what they believe is best given what they have taken into account, but their rationality is limited by the fact that they do not take into account everything that is available to them.

may wish to influence such policies in the region. In this analysis, each actor is endowed with three, and only three, characteristics. Each actor:

1. Has a stated or inferred position on the issue at any time; *stated policy preferences*. A specified range of policy alternatives encompasses all possible outcomes (i.e., that encompasses the most extreme positions taken by any of the actors or group of actors).
2. Is endowed with resources with which to exert some influence over decisions; *potential influence (resources/capabilities)*. These resources include, but are not limited to, estimates of the relative political, economic, or military capabilities that each actor may employ to influence the policy decision.
3. Has its own agenda of priorities or estimates of the importance (*salience*) attached to the issues at hand, signifying its interest in influencing policy outcomes (Mesquita 2002: 505).

The theoretical framework for the model, based on the tenets of microeconomic theory, assumes that actors strive to obtain the largest net gain based upon an evaluation of the costs and benefits associated with choices, taking into account what is for them an acceptable level of risk. This framework assesses each actor's perception of the likely actions of all the other actors. It defines the environment in which policy choices are made.

By studying the BTC pipeline project and applying the conclusions drawn from this case study to predict the outcome for the main export route for the Kazakh oil, that will be produced mainly from the Kashagan oilfield, a modified BDM model can bring all the

relevant factors (the nine factors mentioned in the first chapter)¹⁴ under consideration and help to predict the most likely scenario with regard to this issue.

Assumptions on Actors in the Caspian Basin

The following are three basic assumptions about the actors in this model:

1. The actors know how much value their rivals place on alternative policy preferences or what perceptions those rivals maintain about their risks and opportunities. Each decision maker chooses based on his or her perceptions and expectations, with these perceptions and expectations sometimes being in error.
2. An actor's resource endowment represents the pool of potential power upon which the player can draw during negotiations or conflict over the issue resolution. Thus, the resource variable reflects potential power.
3. The third critical assumption is that this model builds on the discussions by recognizing that stakeholders have preferences over outcomes within issues as well as over the issues themselves. This is also called salience and concerns a player's preferences in distributing resources across issues. (Mesquita 2000, 2002: 506-507)

When alternative courses of action and various viable options are pitted against each other, the array of forces of the competing interests, influences which interest (if any) will win. Of course, this array depends on more than just the relative power of the actors involved. As mentioned above, it also depends on each actor's willingness to spend influence

¹⁴ 1. Political power; 2. Economic power; 3. Geo-strategic location; 4. Military power; 5. Know-how and technology; 6. Control of the export routes; 7. Ability to create spheres of influence and/ or launch coalitions and alliances around shared goals and interests; 8. History and socio-cultural influence; 9. Consideration of environmental issues

on the issue in question (salience) and the intensity with which it prefers one proposed settlement to another. Each actor has a total number of potential “votes” that is equal to its salience scores multiplied by resource/capability scores. (Mesquita 2000, 2002: 480-507) Calculation and explanation of these judgmental scores are discussed below in detail.

$$\text{Votes} = \text{saliency scores} \times \text{resource scores}$$

Potential “votes” that are being calculated according to above formula, may be influenced by external considerations and/or by the institutional arrangements that impose structural constraints on the decision-making process. Therefore, it should also be recognized that any decision about foreign policy is made within a political, economic, and social context. That context, in accordance with the path dependency theory, may well be the result of earlier strategic decisions by the actors involved and is an element that must be taken into account by decision makers in looking to the future. In short, issues related to culture, history and institutions are also important. These factors structure the particular orientations of the actors/stakeholders that ultimately determine political behavior. Each of these elements should be “captured” in the general structure of any policy analysis and forecasting attempt.

The actors anticipate how the formal decision-making setting will influence all actions and pick policy proposals in the negotiating process that they believe will survive within that structure. The actors, however, as assumed earlier, are bounded in their rationality. That is, they are able to look ahead only as far as the next stage of decision-making.

The events that will be discussed with regard to the BTC project clearly reflect this kind of step-by-step bounded rationality pattern. Until the decision was given that BTC would be the main oil export pipeline for Azerbaijan, there were different milestone

decisions, such as the announcement of Baku-Supsa (Georgia) pipeline which was to be early on oil export pipeline in 1995, elimination of Russian Baku-Novorossiysk and Iranian southern routes in 1997 and BP's announcement of the commerciality of the project, even without the Kazakh oil commitment, in June 2001. At every step of the decision making process, none of the actors could foresee the next stages until the final decision was made.

Returning to the model in question, the prospect that a proposal will succeed depends on how much support it can muster compared to that garnered by each of the feasible alternatives. In any policy negotiation, there are likely to be many proposed settlements. By pitting all alternatives against one another, the median or most likely preference (weighted by declared official position, power, salience, and intensity), is found. The median position is the predicted outcome. This model will be instrumental in predicting the outcome in the discussion of alternative routes for exporting Kazakh oil, in general, and the development of Kashagan oil field, in particular.

Game Theory Analysis

Mesquita's "game theory analysis" (Mesquita 2002: 480-500) is used as the basic method of analysis in this research. The "game theory analysis" provides the closest analogy to the situation in the Caspian basin, and the proper tools to predict some policy outcomes. The analogy used in Mesquita's model is a game in which players simultaneously make proposals to each other about how to resolve a policy issue and exert whatever pressure they can to get their rivals to accept their proposals. Proposals consist of suggested new positions on a continuous policy of each actor's preferred option. The game is essentially a multiplayer version (with "n number of players") of the international interaction game theory (Mesquita 2002: 480-500). Players evaluate options and build coalitions by shifting positions

on the issue in question. In the original model, the above steps are repeated sequentially until the issue is resolved or until logic concludes that the costs of continuing negotiations exceed the benefits. In this research however, application will be limited to a single round and will not be repeated sequentially, simply because there is not enough data to identify various decision rounds that are applicable to all actors and accepted by all area experts with regard to Caspian energy development. Evaluation will be based on experts' overall assessment regarding the resource and salience scores for each actor and prediction will be made based on the results of applying these assessments to the original BDM model.

The "game theory analysis", can further help explain, to some extent, the governments' policies and reaction towards the region. Particularly, in terms of whether the nature of relations between players in the region reflects the elements of zero-sum game¹⁵ or win-win situation, the game theory analysis certainly has specific applicability value. This issue is discussed in detail in Chapter 4.

In this model every actor is assumed to know the array of potential power, positions and salience of each other actor. This information is common knowledge. The private information possessed by each decision maker involves the shape of its own utility function¹⁶ and the beliefs it holds about the expected utilities of every other actor. Thus, everyone is assumed to know the basic information that goes into the expected utility model. Everyone knows the shape of their own utility function, but can only form a belief about the shape of the utility functions of the other decision makers. The model offers an empirical advantage

¹⁵ A game in which the value of the gains to one or more players is exactly equal to the value of the losses for the other players. Zero sum games do not require that any player loses everything, but just that the sum of gains and losses is zero.

¹⁶ Utility here means a cardinal measure of the degree to which one choice is preferred to another as measured by risks.

over the methods of real decision makers. If it is a reliable description of how decisions are made, then it mirrors how real decision makers think about problems. Real decision makers, however, almost certainly take intellectual shortcuts. With fifteen, twenty, thirty, or more actors involved in a particular decision it is too difficult for them to keep track of all of their expected actions and interactions. As a result, each player as a decision maker in the real world tends to focus on the five or six most important actors (besides themselves). Here again, the model fits into the Caspian Basin context as we consider Russia, the United States, Iran, Turkey, Kazakhstan, Azerbaijan, Turkmenistan, European Union, China, and oil companies (in total ten actors). Since Turkmenistan is considered a non-player in this game and China and the E.U. have indirect effect –for reasons detailed in Chapter 4 – there are a total of seven important actors, i.e., players consider six actors in addition to themselves.

Data

In this study, area and energy experts constitute the basic source of data. As Mesquita states in his books, predictions made based on the opinions of experts are quite accurate. This model is also used by various companies, which do consultancy work simply by applying this very model to predict various issues at hand. One of these companies is New York-based Decision Insights Inc. (DII). Since 1981, DII has a 22-year track record of independently assessed, consistent accuracy (Table 3.1.).

Table 3.1. Application areas of the BDM model and accuracy levels

Subject Area ¹⁷	Accuracy
US Government Experience	Over 90%
European Community	97%
China and Hong Kong	92%
Middle East	Over 90%
Other Business Applications	Over 90%
<i>Overall Record</i>	<i>Over 90%</i>

Source: <http://www.diiusa.com/details.html>

It is reasonable to assume, therefore, that the best data sources are individuals who are working either as bureaucrats in various governments, businessman working within the region, or academic researchers interested in the region, with area or issue expertise. With their input, it is possible to identify which players are likely to be involved in any given issue. Furthermore, while these experts themselves often doubt that they possess the essential information to quantify capabilities or salience, careful interactive analysis generally makes it possible to elicit this crucial information. In addition, asking for numerical estimations is usually helpful because it distills the process down to very specific, structured considerations and gives empirical precision for more accurate predictions. This will be further explained below. Controlled experiments show that predictions extracted from the model using information from area experts are substantially more reliable than predictions made by the experts alone (Mesquita 1985, 2000, 2002). After all, most area specialists have invested heavily in learning critical facts about their area of expertise.

¹⁷ There are several types of more detailed evidence that demonstrate the accuracy of the DII approach. Please refer to: <http://www.diiusa.com/details.html>

Respondents were chosen by two methods. First, certain key positions were identified, such as staff members of the major institutions, career civil servants close to top-level political appointees in the relevant ministries and departments, and representatives of important companies and interest groups. Second, the “snowballing” technique came into play, in which respondents were asked to identify others with whom to speak (Peabody PS 1990). Through these channels, it was possible to reach important and influential people in the policy communities of the energy sector, or people in close contact with top decision makers.

In this research, for each actor’s predicted position on any given issue, data are collected on the three variables: *resources/capabilities*¹⁸, *stated policy position*¹⁹, and *salience*.²⁰ In a broader setting, it is also necessary to consider any structural constraints or contextual issues shaping outcomes. For the Caspian these contextual issues, among others, include: the economic difficulties facing the countries of the basin; the ethnic make up of the region and related identity crisis, history, lack of democracy and an organized civil society, political Islam and related terrorism problems, environmental issues, and the issue of legal status of the Caspian Sea. These contextual issues will be discussed in more detail in the following Chapter.

¹⁸ Potential power, often referred to as “resources or capabilities,” is simply the bargaining clout of each actor, relative to each other. It is a measure of the amount of influence an actor would have on determining the outcome relative to other stakeholders *if* all stakeholders were fully motivated.

¹⁹ The information on each actor’s position concerns the best available estimate of their current bargaining stance. It is neither what they absolutely want nor what you think they will accept.

²⁰ Salience is used here as the commitment the actor has in pursuing a specific issue over other issues.

Broad Applicability of the Model

Based on above arguments, there are four key elements in terms of general applicability of this model:

- The number of actors involved in the negotiation is not a limiting factor. The benefit of using the model increases with the number of actors.
- The methodology has an equal success rate across different cultures.
- The specific topic of negotiation is not a limiting factor for the model. It is equally applicable to government policy, a corporate merger, or a policy decision by a specific interest group.
- The model does not apply to pricing issues determined by a “market” rather than by interactions between identified actors.²¹

It is a valid concern that the data provided by the area experts may be considered biased due to their particular perspectives. However, the outcomes predicted by the model are quite uniform across different experts. Upon reflection, this is not surprising. The area experts are not asked about their “opinions”, but rather, are asked to provide facts: Who are the actors/players? What do they say they want? How influential could they be and how much do they care about the issues in question? It turns out that the vast majority of specialists view this basic factual information in the same way. Even the suspected ethnic bias among the experts does not change the basic facts and results (See Chapter VII, Results). Naturally, different specialists may use different labels for actors (especially when the actor is a group and not an individual), however, the underlying structure of the data is remarkably similar from specialist to specialist (Mesquita 2000, 2002)

²¹ <http://www.diiusa.com>

Application of the BDM Model to the Caspian Energy Context

To collect data from the area experts and to develop estimates based on this collected data, precise operational definitions of the three variables – *stated policy preferences*, *potential influence*, and *salience* - are essential. These are described below:

Stated Policy Preferences

The stated position is each actor's current negotiating position on the issue. This position is not the outcome the actor expects, or is prepared to accept, but is the actor's current negotiating stance. When the position has not been stated, it can be derived as follows: If actors were asked to write down their current position on the issue continuum without the knowledge of the positions of any of the other stakeholders concerned with that issue, what would they write? To place a numeric value on the stated position, in the original BDM model, the investigator must first define *the issue continuum*. The continuum will either have a natural numeric interpretation, such as the percentage or speed of reform on democratization or privatization policy, or the analyst will need to develop numeric values that reflect the relative degree of difference across policy stances that are not inherently quantitative. It is important that the numerical values assigned to different positions (and they can range between any values) reflect the relative distance or proximity of the different solutions to one another.

There is, however, a need to modify this variable with regard to its application to the Caspian Basin because alternative routes to export Caspian energy resources constitute *discrete options* rather than an *issue continuum*. As was the case for the alternative routes to export Azeri oil, there are three basic alternative routes (seven in total) for Kazakhstan's massive Kashagan oil field as well: Russian, Iranian and Turkish routes (the other options,

Pakistan& India, Bulgaria&Ukraine and China are discussed in Chapter Eight). Therefore, the model needs to be applied, not over an issue continuum, but to different options. This is also going to be the new area to test the original BDM model.

Basically there are three different stated policy preferences. I will refer to the Russian route as “Option 1”, Turkish route as “Option 2” and Iranian option as “Option 3”. Area experts will be asked to choose one of these and three other options (“Option 4”-Pakistan&India, “Option 5”-by-pass options via Bulgaria & Ukraine and “Option 6”-China). Furthermore, I will try to define each of the ten actor’s position between these options based on the answers to the following questions:

- What is the outcome that the actor would truly prefer above all others?
- What is the outcome that the actor anticipates at the end of the negotiation?
- What is the outcome that the actor is prepared to accept?

As it will be discussed in later chapters, in the Caspian context, it is not uncommon for a stakeholder to have a “public” position on an issue that is different than the position that he advocates to other actors. One example of this situation is, in the past, when asked, Kazakh officials consistently refused to make public statements with regard to a solid commitment of any Kazakh oil to the BTC pipeline; however, in private and during negotiations with other actors, such as Turkey and the U.S., on an off-the-record basis, they indicated that the proposed connection between the BTC pipeline and the Kazakh port city of Aktau to export the oil to be extracted from the new fields, is a step ahead option for them when compared with the other available options.

When a group – such as a consortium of companies – is negotiating, there is often one unified stated position for the group. This position is the product of internal discussions

among stakeholders within the group and voiced by the biggest shareholder in that specific consortium. Therefore, it will be more informative to list the individual stakeholders rather than to treat them as a single group. When it can be estimated, the stated position for an individual stakeholder within the group should be the position advocated by the stakeholder as the appropriate group position during their internal negotiations.

Potential Influence

Potential influence or power, often referred to as “resources or capabilities,” is simply the bargaining clout of each actor, relative to each other. It is a measure of the amount of influence an actor would have in determining the outcome relative to other actors if all actors were fully motivated (i.e. actors have a salience score of 100, which is explained in detail in the next section).

Resources can be derived from multiple sources. In the Caspian context, based on historical background and responses that I acquired from area and energy experts, these sources can be identified as follows:

1. Political power
2. Economic power
3. Geo-strategic location
4. Military power
5. Know-how and technology
6. Control of the export routes
7. Ability to create spheres of influence and/ or launch coalitions and alliances around shared goals and interests
8. History and socio-cultural influence
9. Consideration of environmental issues

Each actor’s ability to shape energy resource development in the region depends on the actor’s ability to control these factors. The examination of the developments with regard

to the BTC project and separate assessments for each actor's capabilities will also help to identify which factors are most important and which are less crucial.

It is also important to distinguish potential power from salience. Just because an actor is not involved actively in an issue does not mean that the actor could not exert great influence. The United States, for instance, has the power to significantly influence many issues in the Caspian Basin. The United States, however, is also pre-occupied with many other issues in the world, and not all issues can have similarly high salience. Therefore, it is possible in this case that the U.S. resource scores could be higher while her salience scores could be lower.

When comparing one actor's resources with another's, one measures only those resources controlled directly by the actor and not resources controlled by associates or allies of the actor who are also listed as players. This is important to avoid double counting.

When it comes to attributing numerical value, the numerical value of 100 is given to the most powerful stakeholder on this issue. [There can be more than one actor at this score or at any other score.]

All other values (positive only) are evaluated relative to 100 and to other stakeholders. Thus, two stakeholders with 40 and 60 would equal a single stakeholder at 100 in a head-to-head contest where no one else is involved and all three stakeholders try as hard as they can. Two other actors at 15 and 30 would, if they shared a common position, be very close in potential influence to a group at 40 and would probably just barely persuade the group at 40 to accept their point of view where no other players are involved. The resource scores should not be thought of as percentages. An actor or decision maker with a score of

100 does not have 100 percent of the resources; in fact, it may have only a small percentage of the total. The total is the sum of all of the resources across all of the actors or stakeholders.

In this study, experts are asked to assign a resource scores for each actor. In addition, experts are also asked to attach numerical values for each actor's capability to draw support for their own stated policy option.

Researchers have amassed data on a variety of variables used to estimate national capabilities.²² Power is most frequently estimated by counting both tangible and intangible assets, as mentioned above as sources of capabilities. In addition, there are several important studies that I intend to use as statistical and detailed data sources in order to assess the capabilities of each actor in terms of their strength in the energy sector. Some of these studies are: World Energy Outlook 2002: Energy and Poverty, International Energy Agency (2002), BP Statistical Review of World Energy, BP (2002) and World Energy Assessment, United Nations Development Programme (2002).²³ World Bank and IMF statistics were also

²² Power is most often evaluated as some estimation of national capabilities. This is also the approach taken throughout this research. Sometimes national capability estimates are adjusted by taking additional factors into account, such as GNP levels. National capability estimates are also adjusted to take geographic distance/ geo-strategic location into account. Power is sometimes estimated on an issue-by-issue basis. This reflects limitations to the assumption that national capabilities are perfectly fungible. If we assume that resources are not fungible, then we must look within the state at bureaucratic, interest group, and other factors that make countries more powerful in some spheres while less powerful in others. This view of the non-fungibility of power is consistent with interest group perspectives and the strategic perspective of international politics.

²³ World Energy Outlook 2002: Energy and Poverty, International Energy Agency (2002). Released prior to the World Summit on Sustainable Development (WSSD), the report includes new, country-by-country data on energy industry worldwide and provides regional projections to 2030 and provides a quantitative framework for poverty alleviation strategies.

BP Statistical Review of World Energy, BP (2002). The report provides data on world energy, including production, consumption, and trade.

World Energy Assessment, United Nations Development Programme (2002). A comprehensive overview of energy resources and technology options from the point of view of sustainability and makes policy options for producing and using energy in ways that are compatible with sustainable development.

helpful, with data on gross national product (GNP), industrial output, trade volumes, and the like.

Salience

Salience is the commitment an actor has in pursuing an issue over all other issues competing for attention. Salience is not a measure of how hard someone will try to accomplish their goal, nor is it the percentage of time or effort they are prepared to put into an issue. Rather, salience is a measure of their preparedness to focus on the issue when it comes up, even if it means putting aside some other issue.

Unlike the position and resource scores, the salience scores are judgmental. There is no fact-based source for this information. The scoring procedure described below represents the collective “wisdom” of Bueno de Mesquita and his colleagues in international relations.

1. This variable is restricted in its possible value. It cannot be larger than 100 or less than 1.0.
2. If the actor has zero salience on an issue, then that actor is not a player and should not be included in the analysis.
3. As salience compares the commitment to this issue in relation to all other issues competing for attention, including other business and personal matters, few actors should be expected to have a salience as high as 100.

Range of salience scores are as follows:

90—100: This issue is of the utmost importance. An actor would drop whatever she is doing and turn immediately to this issue whenever asked.

70—89: This issue is very important to an actor. She would try very hard to reschedule to handle this issue when it arises.

50—69: This is one of several important issues. Others are more important. An actor would have to drop this if one of those more important issues arose. Otherwise, she will focus on this issue.

30—49: This is an issue that an actor cares about but that is not very important to her. She has many more important issues to deal with and so generally would not drop what she is doing to deal with this one.

10—29: This is a minor issue. An actor rarely makes much effort to deal with it, or for that matter, rarely even pays attention to it.

Less than 10: An actor really doesn't care about this issue.

Caspian area experts and international relations professors/professionals were asked to estimate the salience scores for each actor's attribution of importance to their respective stated policy position. It might be difficult to apply this variable to the multinational oil companies; however, they definitely have their own salience scores with regard to the Caspian region. The companies' salience values, together with their capabilities might be considered to be limited or lower in comparison with the other actors; however, their stated policy positions are crucial to set the stage for negotiation.

Data Collection

Besides some sources already mentioned in the above section, basic methods of collecting data would involve systematic interviewing and direct observation through various data sources.

Interviews and questionnaires

Verbal and written interviews were conducted, and questionnaires were administered to people in respective intra-regional and neighboring countries, as well as the United States and representatives of the oil and gas companies. The total number of interviews and questionnaires completed to date is 116. The subjects were mainly upper level civil servants and executives, diplomats of these countries based in the United States, political appointees in departments, congressional staff and members of various national energy regulatory

agencies or boards and people outside of governments, including journalists who write on the region and/or energy issues, consultants, academicians, lobbyists and researchers. I used a semi-structured interview method, which allows more opportunity for probing and gives the respondent considerable freedom to expand on a given question (Peabody PS 1990).

Face-to-face interviews were usually completed in approximately one hour, while questionnaires typically took fifteen to twenty minutes to complete. I did two pretests with my interview and three with my questionnaire. The pretests with the interview took about 40 and 50 minutes while pretests with the questionnaire took 18, 22 and 20 minutes, respectively.²⁴

Other Sources:

In addition to the foregoing, my main sources were the works of major think-tank institutions and studies of scholars working in the region (like the Eurasia Foundation, the Brookings Institute, the Royal Institute of Strategic Studies-RISS, the Carnegie Endowment, the Rand Corporation and various institutes in the countries of the region). The Baker Institute at Rice University, among other numerous seminars, meetings and publications, organized a conference in 1998, which focused on Caspian energy resource development from which data and papers were obtained. This effort, however, is not restricted to the determination of the answers to a topic, but rather, to the development of sharper, more in-depth questions about the topic.

Other types of data collection were also used in the research, *inter-alia* energy conferences that I have attended on the relevant subjects. Major conferences that have been

²⁴ Overall the respondents had no major difficulties in understanding the questions; however, following the pretests, the questions considered to be too difficult to understand were changed. Several typographical and grammatical errors were also amended.

followed over the last three years include, Cambridge Energy Resource Associates (CERA) and Offshore Technology Conference (OTC).²⁵

The *Oil and Gas Journal*, which is the most prestigious journal in the energy field, along with its Databook 2002 edition, and the Society of Petroleum Engineers' online library has also been among the reference sources. Cartographic data were checked from the Society of Petroleum Engineers' World Atlas CD.

Fortunately access to some of the major oil pipeline companies regarding the Caspian has been secured. They include BP, Shell, Conoco, TPAO, SOCAR and BOTAŞ.

Other sources include political leaders' messages, entries and coverage in national media regarding the energy projects of the countries in perspective, congressional and parliamentary hearings and committee reports, possible reflections of domestic policies, examinations of documentary material, and local statistics compilations.

²⁵ CERA week is held each year during the second week of February in Houston. OTC is held in May of each year and is the largest in its category. These two conferences are high-fee early registration type conferences and are very prestigious events in the energy sector.

CHAPTER FOUR

This chapter will be two parts. In the first part, I will discuss the international context of the new era in the Caspian region by looking at the relative global significance of the energy resources of the region and trying to find an answer to a widely discussed polemical question in the literature: Are we witnessing a contemporary version of the old “great game” with new players and new rules in the region?

In the second part, which is more instrumental for the analysis presented in this dissertation, roots of instability in the region will be discussed. In other words, issues emerging both in the present time and those that have roots in history that have already affected and continue to affect the outcome of the energy development projects in the region will be discussed. Development of Caspian Sea oil and natural gas along with the necessary export pipelines has been slowed by issues like ethnic conflicts, political instability, and lack of civil society and cooperation in the region. The chapter will set the stage for the results of the interviews with area experts in terms of giving some clues by rehearsing some of the important issues and explaining how and why these issues are likely to serve as a further deterrent to Caspian energy development projects. It is important to discuss these issues, because they cause energy companies and potential investors to think twice before investing in the development of the oil and gas fields of the region and construction of proposed pipelines.

PART I.

INTERNATIONAL CONTEXT OF THE NEW ERA AND THE CASPIAN REGION:

A. THE END OF THE COLD WAR AND THE “SEA-CHANGE” IN THE RESPECTIVE INTERNATIONAL POSITION OF THE CASPIAN.

The Caspian region, together with Central Asia was the heartland of the ancient Asian world. Its pivotal geographical position allowed it to play a central role in the relations among peoples of Eurasia. In the Middle Ages, it was the land bridge between China and Europe. In the modern world, the Caspian's importance grew as the Great Powers of the time engaged in a power and influence game along its borders. Then, the 70-odd year Soviet rule closed both regions to international influence and observation. Finally, with the collapse of the Soviet Union in 1991, both the Caucasus and Central Asia, bound together by the Caspian Sea and its reaches, rose again to claim their prominence in geopolitical calculations.

Many changes have come to Central Asia since independence was achieved with the Soviet Union's disintegration in 1991. The full implications of political independence sunk in slowly. The republics of the Commonwealth of Independent States (CIS) have gained formal independence, but are finding that substantive political and economic independence is much more difficult to achieve. Russia remains crucial to all these CIS republics, in the economic, political and military spheres.

Since the Soviet breakup, Western firms seeking to exploit the vast reserves of oil and natural gas in Transcaucasia and Central Asia have swarmed to the region. The West's strong attraction signals a major alteration of the region's geopolitics, transforming these once Soviet republics into the links of a pro-Western strategic belt across the former Soviet South.

This prospect has already caused concerns from Russian and Iranian sides to work vigorously against such a reorientation to protect their own interests and spheres of influence.

Energy resource development is the key for international position of the Caspian region in world politics. Currently four struggles are shaping the policies of many actors toward the region:

- 1) The first struggle is to ensure the sovereignty and the independence of the new states in the region.
- 2) The second struggle is to provide energy security to the national energy industries and more importantly to world energy consumers. The outcome of this struggle is also important in terms of providing the free flow of energy from the region to the marketplaces.
- 3) The third is which pipelines will ship oil and gas to the World's markets.
- 4) The final struggle concerns promoting commercial opportunities, not just for Russian companies, but also for western companies and companies in the region.

B. AN ASSESSMENT OF THE RELATIVE GLOBAL SIGNIFICANCE OF THE ENERGY RESOURCES OF THE REGION.

The Caspian region is considered to be one of the next oil and gas frontiers. Because of the poor investments and unqualified development activities in the past decades, there is a big difference between the potential and proven oil and gas reserves of the region.²⁶ The potential of the Caspian Basin is estimated to be 179-195 billion barrels of oil and 564-665

²⁶ "Region" refers to Kazakhstan, Azerbaijan and Turkmenistan only. Russia and Iran are evaluated separately; Iran as part of the Middle East, and as member of OPEC, Russia by its own.

trillion cubic feet of gas.²⁷ As of January 2003, the total proven oil reserves in the Caspian Basin are 40 billion barrels, comparable to those of the United States (22 billion barrels) and the North Sea (17 billion barrels).²⁸ Total proven gas reserves in the Caspian region are around 10 trillion cubic meters (almost twice the US reserves). Caspian oil reserves alone represent 3% of the world's proven oil reserves. It is also possible that 186 billion additional barrels, roughly equivalent to more than a quarter of the Middle East's reserves and 237-325 trillion cubic feet of gas remain to be discovered.²⁹ In the event of higher flows than expected from the newly discovered Kashagan field³⁰ in Kazakhstan, the region's output is likely to meet 5% of world oil demand by 2010.³¹ By comparison, proven oil reserves in the Middle East account for 55% of the world's proven reserves (over 600 billion barrels).

In 2002, world oil consumption averaged around 80m barrels a day. According to the International Energy Agency, global demand for oil is expected to rise by at least a third by 2010, to between 92m and 97m barrels per day. Most of the increase will be accounted for

²⁷ US Energy Information Administration, Dec. 98

²⁸ International Energy Agency (IEA) Jan. 2003 figures, Peter Pavilionis and Richard Giragosian Harvard International Review, Winter96/97, Vol. 19 Issue 1, p24, 8p,

²⁹ IEA, Caspian Oil and Gas, 98.

³⁰ The field, known as Kashagan, lies in the north-west Caspian off the coast of Kazakhstan and is reported to cover an area 75 kilometres long by 35 kilometres wide. Drilling began in 2001 under the auspices of its concessionaire, the Offshore Kazakhstan International Operating Company (OKIOC).

While , the Offshore Kazakhstan International Operating Company OKIOC, whose partners include such big oil multinationals as ExxonMobil, British Gas (BG), Royal Dutch/Shell, Total-FinaElf and Phillips Petroleum, is reluctant to estimate the size of its potential reserves, unofficial estimates have put the possible figure in the range of 25 to 60 billion barrels. Senior Kazakh officials have suggested that Kashagan could be the second largest offshore site in the world, ranking just behind Saudi Arabia's massive Ghawar field. After 2004, when OKIOC brings Kashagan on stream, Kazakhstan's oil exports are expected to rise dramatically, up from a daily average of about 680,000 barrels of crude in 2001. Pamela Ann Smith. "Race For Caspian Treasure Intensifies." *Middle East*, Jan2001 Issue 308, p31.

³¹ See Amy Myers Jaffe (Senior Energy Advisor, James A. Baker III Institute for Public Policy in Houston), "Truths and Untruths about Caspian Energy", *Private View* (The Quarterly International Review of the Turkish Industrialists' and Businessmen's Association-TUSIAD- In its kind, the most effective organization in Turkey), Autumn 2000, No.9 pp.46-52.

rising populations and rapid economic growth in South and East Asia. Total natural gas consumption is currently around 78 trillion cubic feet a year. As rich countries increasingly rely on gas, demand is also likely to soar (see Table 4.1.).

Table 4.1. World Energy Demand, barrels per day (million).

	Oil	Gas (oil equivalent)
1971	55	20
1993	65	38
2000	78	40
2010	95	57

In the next decade or so, most of the increased demand for oil will still be met by production from the Persian Gulf. With proven reserves of more than 600 billion barrels of oil and 1,600 trillion cubic feet of natural gas, the Gulf is the world's hydrocarbon heartland. Though far smaller than those of the Middle East, the Caspian basin reserves are big by any other standards; significantly bigger, for example, than Europe's proven reserves of about 50 billion barrels of oil equivalent. And it is not just proven reserves that fuel the oil interest. Seismic studies of the Caspian indicate geological structures that might conceivably hold a vast wealth of hydrocarbons (and many areas have barely been explored). As mentioned above, estimates for the region's potential range from a conservative 70 billion barrels of oil to an optimistic 200 billion barrels or more, touted by, among others, the Caspian governments themselves.³² The Kazakh government, for instance, likes to claim that its oil potential is second only to that of Saudi Arabia (Smith, 2001).

³² For the pessimistic estimates of the region please refer to the following articles: Amy Myers Jaffe and Robert A. Manning, "The Myth of the Caspian 'Great Game': The Real Geopolitics of Energy", *Survival* (Winter 1998-99); and Martha Brill Olcott, "The Caspian's False Promise", *Foreign Policy* (Summer 1998).

Siding with “cautious optimists,” the Caspian Basin contains at least 100 billion barrels of oil, and perhaps the equivalent in gas.³³ According to this estimate, at its peak, around 2015, the region could be producing 6 million barrels of oil per day, an almost sevenfold increase from its present output, which is similar to the current production in the North Sea. Indeed, the role of the Caspian oil development may be to replace North Sea production as the latter declines, thereby keeping the share of non-OPEC production in world supply more or less constant. Or, as it was argued during the Offshore Technology Conference (OTC), which took place in Houston between May 5-8, 2003, the Caspian Basin may become a major contributor of non-OPEC oil supply growth in coming decades. W. Calvin Kilgore, Director of EIA's Office of Energy Markets and End Use, said during the 2003 OTC Conference, his office predicts that the OPEC will produce nearly 56 million b/d by 2025, compared with 2003 production of 27 million b/d. Meanwhile, Russia's oil production is expected to start falling off after 2015, while the Caspian Sea region is expected to show major incremental increases during 2020-25 in both oil and natural gas.³⁴

How much the Caspian region actually produces and when it reaches peak production depends upon a number of factors. For illustrative purposes, it took 25 years for oil production in the North Sea to reach 6 million barrels per day under favorable circumstances. In the Caspian region, circumstances are less favorable. The region lacks supporting

³³ It is worth emphasizing that the Caspian Basin's potential is substantially unproven. Each dry hole causes exaggerated pessimism, just as each discovery gives rise to unjustified optimism. These swings make level-headed policy-formulation more difficult, particularly in the midst of a *maelstrom* of geopolitical attention. The balance between oil and gas is also far from determined, which has huge implications for the economic potential of the region's hydrocarbon reserves.

³⁴ Paula Dittrick “OTC: Caspian Sea region to become major non OPEC oil supplier by 2025” Oil & Gas Journal, May 6, 2003

industries and infrastructure, and there is a shortage of drilling rigs. However, one favorable condition is that the resource-rich Caspian states have relatively small populations, so most of their oil and gas is likely to be exported. If investments continue in the Caspian region at the current pace, and if sufficient export outlets are developed, the above mentioned daily production figures can be matched. Similarly, Energy Information Agency's (EIA) "high" non-OPEC supply case scenario projects annual oil production to reach 4.2 million barrels a day by 2010. In the "low" non-OPEC supply case scenario, which assumes some project delays, oil production would reach 2.5 million barrels a day by 2010. These figures mean that at best the Caspian region will account for about 4.5% of total world oil supply in 2010. Nevertheless, this represents almost one-half of new non-OPEC supply. By way of comparison, in recent years Middle East-OPEC has supplied over 30% of total world oil consumption, and could supply 40% by 2020. The Caspian region will never replace the Middle East as a primary source of supply, but it will limit the extent of the growth of world oil and gas dependence on the Middle East (Alexandre 2000; Goldwyn 2000). Thus, development of Caspian energy resources at the margin will play an important role. Forecasters tell us that the less it costs to get that oil to market, the sooner we'll see a 6-million-barrel regional oil industry with a strong trend to grow. This is quite a significant amount when compared to today's total world oil production of 76 million barrels per day.³⁵ (Please refer to Table 4.2. and Figure 4.1.)

³⁵ "OPEC- A Rising Share of World Demand", CERAweek, February 2000, [ww20.cera.com/ceraweb/details/1,1672, CID1596, 00.html](http://ww20.cera.com/ceraweb/details/1,1672,CID1596,00.html)

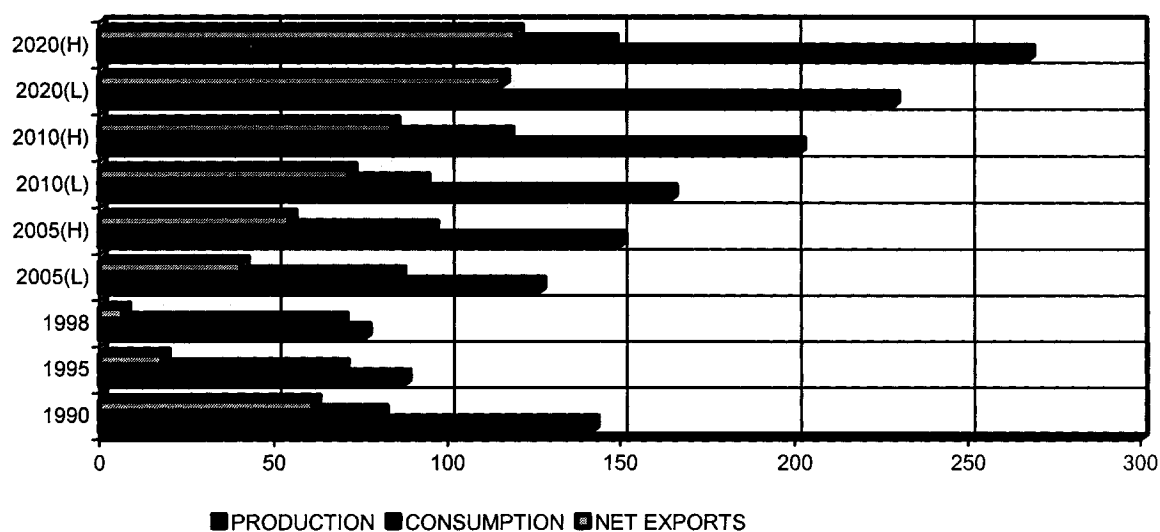
Table 4.2. The Caspian oil resources and prospects for the future.

	Proven & Projected Caspian Oil Resources (billion b/d)	Proven & Projected Caspian Gas Resources (trillion cubic feet)	Proven World Oil Reserves (billion b/d)	World Oil Production /Day (million)	Caspian Oil Production /Day (million)
1971				55	
1993	20	10		65	
2000	50		1.100	78	1
2010	70-115	237-325		95	4.2
2020	179-195	564-665		103*	6

Source: IEA, Caspian Oil and Gas, 98 & U.S. Energy Information Administration, Dec. 98; CERA

* Estimate for 2015 by IEA.

Figure 4.1. Caspian gas prospects (bcm)



Source: IPR Middle East News, February 23, 2000; *Caspian Oil and Gas, the Supply Potential of Central Asia and Transcaucasus*, IEA, 1998 & 2003.

The development of Caspian Sea reserves is only in the initial stage; the majority of gas and oil reserves in this region have yet to be developed. During the Soviet era, most of the Caspian remained unexplored, primarily because the Soviet Union lacked adequate technology to develop its offshore oil and gas reserves (most of the oil deposits of

Azerbaijan, and between 30 and 40 per cent of those of Kazakhstan and Turkmenistan are offshore) and it also wished to keep them as a "strategic reserve". Nevertheless, major discoveries made in Azerbaijan and Kazakhstan during the Soviet period indicated large reserves of oil, at least for those two countries, the production of which will increase with additional investment, new technology and the development of new export outlets.

The need for private investment to realize the full potential of the region's oil and gas reserves is beyond dispute. One estimate puts the total investment requirements at US\$ 140-200 billion (in more or less equal amounts for oil and for gas), of which only a few billion dollars have so far been committed.³⁶ These financial requirements are greater than the Caspian governments can finance. Attracting such volumes of private investment into a landlocked, conflict-ridden region of fledgling states, inexperienced in market economics, is a massive policy challenge that has only just begun. However, unless they meet this challenge, the economies of the region are likely to be trapped in a low-growth scenario.

Moreover, the technological complexity of extracting the oil deposits from sub-sea reservoirs further complicates the exploration in the Caspian Sea. In many cases, valuable oil deposits lie deep under the seabed and "many productive oil fields, such as the one in Tengiz, have highly sulphurous oil". Developments in international oil markets may also unfavorably affect the development of Caspian Basin oil and gas projects, especially if world oil prices decrease or world oil supply is boosted by increases in oil extraction in the newly developed fields of China, Indonesia, Vietnam and Saudi Arabia or from the traditional suppliers in

³⁶ "The Future of Caspian Oil: Can a "Great Game" be Averted?", Cambridge Energy Research Associates, December 1997.

Western Siberia, the Persian Gulf, North Africa and the Americas. Changes in international politics, such as the lifting of international sanctions against Iraq following the military operation in this country in May 2003 or a future softening of the U.S. position towards Iran, would certainly have an affect.

Whatever the proven and estimated reserves of the Caspian region, they will have an important role to play in terms of energy security of the world. From the energy security point of view, consuming countries benefit when global oil production comes from as diverse a base as possible. Such diversity reduces reliance on any particular geographic country or center, thereby lessening the potential for a large-scale disruption from any one area. Experience has shown that maintenance of moderate prices is more easily achieved when there is reasonable market competition within and outside of the OPEC (Cowhey 1985, Mitchell et.al. 1996, Shenoy et.al. 2002)

C. ARE WE WITNESSING A CONTEMPORARY VERSION OF THE OLD “GREAT GAME” WITH NEW PLAYERS AND NEW RULES?

“Great Game” analogy is widely used to characterize the involvement of many actors in the Caspian energy resource development policies. Boris Rumer and some other scholars argue that the collapse of the Soviet Union has revived the "Great Game" that Russia and England played in the nineteenth century for influence in Central Asia (Cohen 1996, Simpson 1992). This time the game has several new players, with the U.S. replacing Great Britain for influence in the region and with Iran and Turkey challenging the Russian role in the basin, each vying for influence over the abundant energy resources in the various former

Soviet republics lying at the Caspian basin and Central Asia.³⁷ In fact, there are two sides to this debate. The first side argues that, yes, there is a new “Great Game” in the Caspian and Central Asia. Others argue that there is no condition or context resembling the 19th century original “Great Game” (Croissant 2000, Bradshaw 1997, Federov 1996).

This new "great game" in the heart of Asia, according to the proponents of the first side of the debate, is unfolding not so much among the old colonial powers as among their former dominions, many of whom are themselves just emerging from hegemonic domination and seeking to define their roles in their regions and the world.

Holders of the first view argue that, the new version of Great Game is being played by multiple major powers for new economic and political stakes (that is, hydrocarbon resources and transportation routes). There are a dozen major and regional powers joining the game (the U.S., China, E.U., Iran and Turkey) in addition to the successor states to the Russian and British empires (namely Russia, U.K. through BP, India & Pakistan) which have renewed the struggle for hegemony in the center of the Asian continent. As the world shifts from a bipolar to a multipolar focus, the nations of Asia search for new trans-regional security arrangements. More specifically, the breakup of the Soviet Union and the creation of five Central Asian republics (Kazakhstan, Kyrgyzstan, Uzbekistan, Turkmenistan, and Tajikistan) have complicated the security relations of the Asian states.

However, this view is overly simplistic. Unlike the original nineteenth century 'Great Game', the twentieth century version is much too complicated to be called a “game”. This

³⁷ Boris Z. Rumer, "The Gathering Storm in Central Asia," *Orbis* 37, no. 1 (winter 1993): 89.

new struggle is not a repeat of the nineteenth-century great game in which the Central Asian states were merely the pawns of their superpower neighbors; instead, the Central Asian states are now the active players in this power struggle. In their unique geostrategic position, these states can influence neighboring Russia, China, and Iran, and even the Indian subcontinent. Today's situation includes more actors than the 19th century Great Game including governments and foreign and multinational corporations. Today, for the most part, the "Great Game", if we may still use the same phraseology, "consists of economic competition for jobs, pipelines, and new markets" as well as political influence and strategic advantages. As for the states of Central Asia and the Caucasus, in contrast to the situation in the nineteenth century, national leaders now have little objection to foreign involvement in the region. That is, they are actively seeking foreign investors as well as models and guidance on which to base their development.

The past importance of Central Asia came from only two sources, both now long vanished. The first was the fact that the region lay athwart the world's greatest trade route, between China, the Middle East and Europe. This state of affairs disappeared at the end of the fifteenth century, with the opening by Europeans of the sea route to Asia round Africa, and later via the Suez Canal. It will never return as a factor of global importance, given the capacity of modern shipping and the enormous distances, appalling roads and high insecurity of the land route. Economically, there has never been anything in Central Asia and the Caspian themselves to make them places deserving of the world's attention.

The second source of importance was Central Asia's capacity to produce repeated waves of warrior nomads, at a time when the mounted bowman was the most effective

soldier in the world. This too ceased to be relevant more than four hundred years ago, with the rise of the musket and the cannon. In fact, the last time those developments in Central Asia were of truly great importance for the wider world was during the early sixteenth century, when Babur's hordes swept into India to found the Turkic-Mogul Empire. In the twentieth century, Central Asia in general and the Caspian in particular had at no stage played an important role in deciding the fate of the world.

It is also vital to remember that Britain was interested in the region not for reasons of world hegemony but only because it was ruler of India. Britain's concern was purely defensive, motivated not by a desire to conquer Central Asia but by the fear that Russia would employ the region as a base from which to attack India or to march through Persia to the Gulf and threaten British lines of communication. The same fear lay behind Britain's support for the Ottoman Empire against Russia, which led to its participation in the Crimean War.³⁸ No Russian attack on the subcontinent is currently conceivable.

In today's context, contrary to the original 19th century geopolitics, external involvement can have a positive impact on regional conflict resolution by providing

³⁸ Even in the nineteenth century, the rivalry between Britain and Russia in the region was a great deal less important than propagandists on both sides cracked it up to be. In 1907 all the outstanding issues of respective influence and control in the region were solved relatively easily in the negotiations leading up to the Anglo-Russian Convention of that year. For this, two developments were responsible: the Russo-Japanese War of 1904-5 had revealed the Russian armed forces to be far less formidable than had been thought; and, much more important, the rise of Germany threatened the interests of both powers--not in some peripheral Asian desert, but where they really mattered: in Europe.

Seven years later, on October 28, 1914, Turkish and German warships dealt the death blow to more than eighty years of British anti-Russian strategy when they attacked the Russian Black Sea ports and heralded Ottoman Empire's entry into the First World War. Seven months after that, British, Indian and Australian troops were dying in their tens of thousands at Gallipoli as they struggled to smash their way through to Istanbul and serve Britain's vital interest of opening a supply route to the Russian armies fighting Germany on the Eastern Front. The consequences of their failure were too gigantic to contemplate here.

investment, creating employment and supplying much-needed foreign aid to regional markets. However, profit margins that many believe will accrue from the region's natural resources, combined with geopolitical and strategic factors, lure external players into a dangerous game-like interactions, played out within and throughout the region.

The prize in this new contest is the hydrocarbon resources of the Caspian Basin and control of the pipelines that are slated to bring the vast energy wealth of this largely landlocked region to Western markets. Russia seems to have more cards to win the first round in the competition to transport the early oil and gas production from Azerbaijan, Turkmenistan and Kazakhstan's offshore oil and gas fields in the Caspian Basin, but the real battle for influence will begin when these and newly discovered oil and gas fields reach peak production capacity. At that point, a decision must be made on which pipeline route will carry energy shipments in the long term. Russia, Iran and Turkey with the United States' support are locked in a high-stakes competition for approval of rival pipeline schemes, neither of which can claim a relative advantage in terms of risk since all must negotiate a precarious topography of sub-regional conflicts and wider problems affecting the region.

In the final analysis, as mentioned above, the “great game” metaphor may be too simplistic a notion to describe the dynamics of the Caspian region. Zero-sum, as opposed to win-win, strategies better characterize engagement by different actors in the region. In addition, this time the “rules of the game” are quite different; this will be discussed in more detail in coming chapters. Yet elements of “Great Game analogy” remain in the policies of the United States and Russia, which are viewed as the main players in the region. To a lesser extent perhaps, the involvement of multi-national oil, and non-oil,

companies also exhibit elements of a game. The difference is, while the former actors are largely interested in strategic positioning of their interests, the latter are focused on economic matters.

The United States, in an effort to contain Iranian interests in the Caspian region, clearly illustrates a hegemonic tendency. A similar tendency motivates Russia's "near abroad" policy toward the Caspian and Central Asia, which is an assertion of its past hegemonic control. In contrast, Iran and Turkey have followed a far more limited strategy toward the region, focusing on economic issues and national interests. Iran has underplayed ideological differences, while Turkey has brought ethnic kinship and cultural affinity into play in her policies toward the region. The role of Iran and Turkey has been more like a balancer in the region, in terms of providing alternatives to the above-mentioned hegemonic tendencies of the Great Powers.

Beijing may eventually become the regional hegemon. Or, a state within Central Asia itself, such as Uzbekistan, may exert control, with aggression toward peripheral areas. In a worst case, the region may explode, causing realignment of boundaries and annexations, with civil war spilling over into neighboring states. In a best case, an independent bloc of Central Asian market democracies, based perhaps around Uzbekistan and Kazakhstan, would succeed in playing off the United States, Russia, China and other neighbors to maintain a balance of power on their own terms.

The new rivalry for power and position in Central Asia and the Caspian Basin will continue. The outcome of the contest for regional influence will likely be unclear for the foreseeable future.

PART II

INTRA-REGIONAL CONTEXT OF THE NEW ERA - ROOTS OF INSTABILITY

A. ECONOMIC SOURCES OF INSTABILITY

All five states surrounding the Caspian Sea (Russia, Iran, Azerbaijan, Turkmenistan and Kazakhstan) have suffered sharp economic dislocation since the collapse of the Soviet Union. The four former communist countries were suddenly cut off from the centralized command economy that directed their resource allocation, long-range planning, investment funding, and management. (See Tables 4.3., 4.4. & 4.5.). Exploitation of rich natural energy and mineral resources was stalled. No longer a part of the Soviet Union, Kazakhstan, Turkmenistan and Azerbaijan are all land-locked and goods must transit through a second nation via transportation networks that are not yet fully developed (other than through Russia). Economic reform and movement toward a market economy have been uneven, as states fear that further economic dislocation will produce massive internal unrest and political instability. The lack of a modern financial system, a transportation network, banking institutions, and an enforceable legal system all hamper foreign investment. Migration of ethnic Slavs to Russia has cost the republics a large cadre of skilled technicians and managers; migration of ethnic Germans from Kazakhstan has cost the republic the group most responsible for cultivated agriculture. Many local nationalities are only a generation or two from being nomads or herdsmen. At the same time, population growth (Caspian areas often have five to six times the birthrate of urbanized Slavic states) has produced an underclass of poor, unemployed or underemployed, less-educated workers whose dissatisfaction in the 1980s often provoked the riots leading up to independence. Ethnic discrimination during the Soviet era produced few senior leaders from the Caspian region

nationalities in the military, industrial, legal, diplomatic, or managerial fields (Aydin 2000, Croissant & Aras 1999, Bradshaw 1997).

Table 4.3. Declining Output of the New States of the Caspian after 1991 (1991=100)

	1993	1995	1997
Kazakhstan	83	68	70
Turkmenistan	85	64	47
Azerbaijan	82	63	45

Source: IMF Working Paper # 98/132 & The U.S. Commercial Service

Table 4.4. Basic economic indicators for Azerbaijan, Kazakhstan and Turkmenistan, 1998-2001 (Rates of change and shares, per cent)

	GDP (growth rates)					Industrial output (growth rates)			Inflation (per cent change, Dec./Dec.)			Unemployment rate (end of period, per cent)		
			2000	2001										
	1998	1999	Ex-ante forecast	Actual outcome	official forecast	1998	1999	2000	1998	1999	2000	1998	1999	2000
Azerbaijan	10.0	7.4	8	11.4	8.5	2.2	3.6	6.9	-7.6	-0.5	2.1	1.4	1.2	1.2
Kazakhstan	-1.9	2.7	3	9.6	4	-2.4	2.7	14.6	1.9	18.1	10.0	3.7	3.9	3.7
Turkmenistan	5.0	16.0	12	17.6	16	0.2	15.0	25*	19.8

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE secretariat.

Table 4.5. International trade and external balances of Azerbaijan, Kazakhstan and Turkmenistan, 1998-2000 (Rates of change and shares, per cent)

	Merchandise exports in dollars (growth rates)			Merchandise imports in dollars (growth rates)			Trade balances (per cent of GDP)			Current account (per cent of GDP)		
	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000
Azerbaijan	-22.4	53.3	235.7	35.6	-3.9	10.3	-10.6	-2.4	19.3	-30.7	-13.3	1.9
Kazakhstan	-16.3	2.9	76.7	1.1	-15.3	30.5	4.9	11.3	21.3	-5.6	-1.4	4.8
Turkmenistan	-20.9	99.9	92.0	-14.9	46.7	36.9	-14.6	-8.9	12.4	-33.0	-26.0	1.5

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UN/ECE secretariat; UN/ECE secretariat calculations.³⁹

³⁹ Foreign trade growth is measured in current dollar values. Trade and current account balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. Current price GDP values for 2000 are in some cases estimated from reported real growth rates and consumer price indices.

The Caspian region offers tremendous economic opportunities in the post-Soviet world. Oil and natural gas are the most attractive areas for foreign investment. However, possible uneven development patterns are a significant potential source of instability in all of the Caspian littoral states. Differences in natural resource bases could provoke economically driven migration, polarize ethnic groups and cause increased tensions. This combined with widespread unemployment creates potential for conflict.

It is also worth considering what effect the anticipated wealth resulting from natural resources will have on regional problems and the potential for confrontation. There are concerns, for example, that countries gaining most from the exploitation of natural resources might use their newly gained wealth to increase their military spending, thus creating a destabilizing change in the regional balance of power (Blandy 1997, 1998). The most likely such change could occur between Armenia and Azerbaijan, with Azerbaijan presumably using its anticipated oil revenues to turn the existing stalemate in Nagorno-Karabakh conflict to its favor. As both western and Russian oil companies are eager to utilize Azeri oil for their own benefit, it is likely that Azerbaijan might attempt to escalate the conflict with Armenia using oil as a trump card, banking on winning an overall settlement that would deal with oil exploration rights and pipeline routes, as well as the Nagorno-Karabakh dispute.

The redistribution of wealth within societies is another potential source of conflict. There is no doubt that wealth from natural resources can offer a means for future regional development. If mismanaged, however, it could be tremendously destabilizing. For example, there is a real possibility of elites emerging along the lines of those commonly found in the oil-rich countries of the Middle East.

Corruption

Seizure of state assets disguised as "privatization" has feudalized the state in the ex-Soviet Caspian. Since they are not feeling dependent on the budget, officials can afford to ignore public policy and use their offices for private purposes. Rapid changes and economic pressures have already led to a marked increase in personal corruption with a negative impact on regional stability. Obviously, corruption is one of the biggest obstacles to reform and long-term stability and a major factor in distorting a fair and equitable distribution of wealth. Although corruption has been deeply embedded in these societies since the beginning of the Soviet era, after independence, bribery and other corrupt practices offered a way for people to supplement their incomes in these unstable economic environments.

Thus, mechanisms need to be established in Central Asia and the Caucasus to guard against and punish corruption. Until this problem is addressed, it will remain a potential flash point in the region in addition to crippling the effectiveness of foreign assistance and investment programs as well as resource development possibilities.

As Azerbaijan, Kazakhstan and Turkmenistan are just beginning to recover from the all-encompassing transition, the challenges they are facing are enormous. With ethnic strife, enforced migration, economic deprivation and widespread unemployment throughout the region, there is an inescapable need for foreign economic assistance and expertise from the West to reverse this trend and to realize the energy resource development strategies, particularly before political Islam can benefit from the ever-worsening situation.

Efforts to resolve economic ills through inter-republican or regional associations, and institutions also have not succeeded. In 1993, Kazakhstan, Kyrgyzstan, and Uzbekistan

formed a customs union, but a lack of resources and Russian opposition to any program of which it is not a part have hampered full implementation. Similarly, Russia (unsuccessfully) opposed Central Asian countries membership including Azerbaijan in the Economic Cooperation Organization (ECO), reactivated by Turkey, Iran, and Pakistan in 1991.⁴⁰ Turkmenistan's reluctance to enter into any multilateral regional agreement has also stifled attempts to find common solutions to common problems such as corruption, environmental degradation and lack of effective regional development programs.

B. ETHNIC MAKE-UP OF THE REGION AND RELATED PROBLEMS

Geography and population

The Caspian Sea is the world's largest inland body of water. The Caspian Basin constitutes a major sub-region within Eurasia and it serves both to link and to separate. It brings Russia and Iran in contact with one another, though their land is separated by hundreds of miles. It separates Transcaucasia⁴¹ from the other major former Soviet republics with predominantly Muslim Turkic populations. Yet its shores and the sea itself have - for millennia - constituted an important transportation corridor.

⁴⁰ The Economic Cooperation Organization (ECO) is the successor organization of Regional Cooperation for Development (RCD), which remained in existence from 1964 to 1979. Subsequently the Organization was restructured and reviewed under its present name ECO in 1985 by Iran, Pakistan and Turkey for the purpose of providing economic, technical and cultural cooperation among themselves. The objectives of the Organization also include expansion of mutual trade and promotion of conditions for sustained economic growth in the region.. In order to provide a proper legal basis to ECO, the basic document of the Organization, the Treaty of Izmir of 1977, was amended at a ministerial level meeting held at Islamabad in June 1990. The amended Treaty of Izmir was subsequently ratified by the founding members; with the Organization being fully operational in its revitalized form by early 1991. ECO's actual revitalization started in 1992 when Turkey actively promoted the admission of seven new members. Its present membership of ten includes Afghanistan, Republic of Azerbaijan, Islamic Republic of Iran, Republic of Kazakhstan, Republic of Kyrgyzstan, Islamic Republic of Pakistan, Republic of Tajikistan, Republic of Turkey, Turkmenistan and Republic of Uzbekistan.

⁴¹ The term *Transcaucasia* refers to southern Caucasus, which includes Azerbaijan, Armenia and Georgia. These states have emerged as the only independent states in the region after the collapse of the USSR.

The combined territory of the littoral entities bordering the Caspian Basin amount to more than 5 million square kilometers; approximately equal to two-thirds of the continental United States, or one-half of the territory of China. At the heart of the basin is the Caspian Sea itself. The Caspian Sea occupies a vast area of some c.144,000 sq mi (373,000 sq km) between Europe and Asia. It is bordered on the northeast by Kazakhstan, on the southeast by Turkmenistan, on the south by Iran, on the southwest by Azerbaijan, and on the northwest by Russia. The Caspian's surface lies 92 ft (28 m) below sea level. It reaches its maximum depth of c.3,200 ft (980 m) in the south; the shallow northern half averages only about 17 ft (5 m). It stretches for 750 miles (1,200 km) from south to north and is 200 miles (320 km) wide from east to west. The Caucasus Mountains rise from the southwestern shore, and the Elburz Mountains parallel the southern coast. The Caspian receives the Volga (which supplies more than 75% of its inflow), Ural, Emba, Kura, and Terek rivers, but has no outlet. The chief ports on the Caspian are Baku, a major oil center, and Astrakhan, at the mouth of the Volga.⁴²

The total population of the territories surrounding the Caspian is about ninety-five million—Azerbaijan with 7.5 million, Kazakhstan with 16.7 million, Turkmenistan with 488,000, Russia's Astrakhan Province with 991,500, Dagestan with 1.8 million, Kalmykia with 322,000, and Iran with 66 million. However, the greatest concentrations of population in such countries as Kazakhstan and Iran are far from the Caspian shoreline in the interior. On

⁴² The Columbia Encyclopedia, Sixth Edition.

the whole, the heart of the Caspian Basin is quite sparsely populated, except in such places as on the Volga Delta, Baku, and along the coastlines of Dagestan, Azerbaijan, and Iran.⁴³

The general balance of nationalities in the region may be understood to consist of a group called the “titular nationality,” for which the territory is designated. Only in Azerbaijan, Turkmenistan, and Astrakhan do the titular nationalities constitute substantial majorities. Elsewhere, diversity is the rule, in Azerbaijan, the titular nationality constitutes 90 percent of the population, with Russians being 2.5 percent and other nationalities making up the remaining 7.5 percent. In Kazakhstan, the titular nationality is a minority (44%); 34 percent of the population consists of Russians, while the other non-Kazakh nationalities make up 21.1 percent of the population. In Russia’s Astrakhan, 72 percent of the population is Russian, with the remainder being other nationalities. In Dagestan, 9.2 percent are Russian, while the remaining are of other nationalities. In Kalmykia, 45.5 percent of the people are Kalmyk, 37.7 percent are Russian, and 16.9 percent are of other nationalities, In Turkmenistan, 73.3 percent are Turkmen, 9.8 percent are Russian, and 18.5 percent are of other nationalities. In Iran, the national group—albeit difficult to define—consists of 49 percent of the population, while the remainder is made up of a variety of ethnic groups including Azerbaijani Turks, Turkmens, Kurds, and Baluch.⁴⁴

History; An ever-present problem in the region

The past is of tremendous importance to the collective identity of all Caspian nations, especially those of Armenian, Azerbaijani and Georgian. It reaches back more than two

⁴³ CIS Interstate Committee for Statistics, 1996 survey

⁴⁴ The World Fact Book, CIA.

millennia, and in this century Russian, Caucasian and Central Asian historians have eagerly attempted to interpret linguistic and archaeological evidence in order to justify the drawing of borders and the construction of nations. Memories of glorious dynasties and pride in church traditions, established in the beginning of the fourth century at approximately the same period as the introduction of Christianity in the Roman Empire, are crucial especially to the Armenian and Georgian patriotic consciousness.

In pre-modern, largely pre-Russian-times, rulers and priests were able to combine people's loyalty to a small community with a sense of belonging to a broader entity, as illustrated through the example of the Armenian kingdom in the tenth century or the wider Muslim community called "umma". For a very long period throughout the Middle Ages this was achieved by a dynastic-feudal order, functioning on mutual respect between princes and local elites - both Christian and Muslim. Honor and bravery in combat were essential values, since peace was the exception and war the rule. In the eleventh and twelfth centuries, Transcaucasia was in fact crushed in the struggle between Byzantium and the conquering Seljuk Turks from Central Asia. Anatolia and the Caucasus received massive Turkish immigration. The rivalry was later replaced by the Ottoman and Shiite Iranian conflict over the region, which lasted until the 18th century. During this period (from the 13th to the 18th century), however, the region enjoyed relative peace and commerce, as it was at the center of important trade routes. Later, during the 19th century, Tsarist rule improved peace and commercial activity considerably. Otherwise, the populations of multi-ethnic Transcaucasia and the Caspian experienced little change. The overwhelming majority lived in the countryside, and apart from tax collection and interference in criminal cases, the Tsarist authorities rarely meddled in the affairs of the local majority.

In the case of the Georgians, pride in language and poetry, a tradition of an independent Orthodox church founded a thousand years before the creation of Tsarist Russia, and the memory of brave queens and kings constituted a collective identity, and gradually the idea of a Georgian "people" emerged. When at the end of the century the Russian authorities launched a massive campaign of slander and repression against the Georgian language, this nationalist idea was suddenly expanded and made a political issue.

Armenian nationalism emerged from different conditions. For centuries the Armenians of the vast Ottoman Empire had lived as recognized "millet" - a religious community enjoying autonomy in its internal affairs. The Sunni Muslim rulers duly recognized the service and talents of the crafty Armenians (in particular its urban elite), and after the Greek war of liberation in the 1820's this non-Orthodox and non-Catholic Christian minority earned the honorific designation "the loyal community".

The decay of the Ottoman Empire, however, meant serious trouble for the Armenians, particularly those living in Eastern Anatolia. Since the disasters of the Middle Ages, this population of peasants, craftsmen and small shopkeepers had managed to survive incessant wars and nomadic raids. In the last quarter of the nineteenth century they still comprised approximately one-third of the population between the city of Erzurum and Syria (then an administrative unit within the Ottoman Empire). Since they had collaborated with the invading Russian army in Eastern Anatolia during the First World War, the Ottoman Government decided to relocate most of the Armenian population living on the frontlines of the war with Russia to Syria. During this relocation process, between 1915 and 1917, the migrating Armenian population came under revenge attacks from local Kurdish and Turkish

warlords, who were previously victimized by at least two decades (1890s and 1900s) of local Armenian revolts against the administration. Many of the survivors fled to Russian Caucasia, but they did not escape violence for long.

With the fall of the Romanov dynasty in February and the Bolshevik coup d'état in October 1917, Caucasia and the Caspian plunged into further chaos. Tragic events had already hit the Armenians of the Ottoman Empire, which have never been forgotten for the next decades. In 1918 the independent states of Georgia, Armenia and Azerbaijan were proclaimed. They began fighting each other immediately, and soon the region was invaded by Ottoman, German, British and finally by Russian forces. These clashes were particularly fierce and bloody because of the semi-military character of communities and the strong traditions of revenge.

In the meantime, during the second half of the 19th century, the Russian army had crushed the Muslim tribes (Chechens, Karachais and Circassians) in the Northern half of the Caspian, and when the Tsarist regime disintegrated, resentment among the surviving Chechens, Karachais and Circassians burst into armed action against the Cossacks of Kuban and Terek and other "White" Menshevik forces.

In the southern part, Armenians and Azerbaijanis were seized by intense fear and hatred, generated by the tragic events involving the Armenians in Anatolia and the Ottoman intervention of 1918. Generally, these tragic events implied plunder and massacres. Not only Armenians and Azerbaijanis were dragged into this abyss. In the autumn of 1918, Armenians and Georgians started a war. The two independent states fought over the small border area of Borchalo, and in Tbilisi a substantial number of the city's Armenian majority fled after

bloody mob violence. Again, nothing of this was forgotten during the official silence of the following seven decades.

The killing finally stopped when exterior forces intervened. In 1920, the Communists from the north and the Turkish army from the south took the initiative and finally took control and reached an agreement in Moscow in 1921. The Caucasus was reabsorbed into the Soviet Union, except for the Turkish districts in the southwest, which were ceded to Turkey (Ardahan, Kars and Agri). Both powers had allies in the region. The Azerbaijanis collaborated with the Turks, while the Chechens and the Circassians supported the "Reds" against the "Whites," as did the Ossetians and the Abkhazians, when the Communist Army invaded independent Georgia in 1921.

The Communist legacy and the problems around ethnicity & national identity

Stalin's solution to the "administrative" problem was to introduce a new criterion for political autonomy: A national identity could only be recognized if it was founded on a territory. Linguistic, historic and religious reasons were generally considered irrelevant. A number of nationalities – later dubbed "titular nationalities" by Western researchers – were given status as republics. In some cases smaller groups were entitled to administrative units of a lower level: Autonomous republics, territories and "oblasts" inside a Soviet republic. The Party decided that the "titular nationalities" in each republic should "sink roots" – i.e. create a cultural basis. This was called *korennisatziya*.⁴⁵ Its nationalist ideology and the corresponding national structures have had decisive importance in Caucasia and Central Asia to this day. So it would be a misleading oversimplification to characterize Armenians,

⁴⁵ It means "nativization" and refers to training of local population to hold administrative positions.

Azerbaijanis, Georgians, Kazakhs, Uzbeks and Turkmen simply as clansmen or tribal communities, although it would be also a serious error to neglect the strength of clientelism and clan mentality in the Caspian and Central Asian republics (Burley & Lang 1971; Saroyan 1988; Schwartz and Panosian 1992)

In addition to the challenges of economic and political transition faced by the other newly independent states of the former Soviet Union, Kazakhstan, Azerbaijan and Turkmenistan have had to contend with populations searching for and developing a sense of national identity, thus, from the first day of their independence, they faced the all-imposing necessity of replacing the now "discredited" socialist ideology and its social and economic model with a new thinking that could also help them to define their separate "identities".

Although Central Asia in general and the Caspian region in particular have a long and rich history, and various levels of identification are discernable among the people, the individual states as they arose from communist domination, especially in Central Asia, (except for Azerbaijan, Georgia and Armenia) ⁴⁶ had no sense of their separate identities in the modern sense. Before the Russian conquest, people mainly identified themselves with their clan, tribe, locality and sometimes religion. Further complicating the issue of national identities, Soviet rule created five union republics in Central Asia (Kazakhstan, Uzbekistan, Kyrgyzstan, Turkmenistan and Tajikistan) and three in the Caucasus (Armenia, Azerbaijan and Georgia). The borders of the union republics, especially in Central Asia, did not seek to create homogeneous republics or conform to historic quasi-identities. Rather, under the heavy Sovietization policies, they divided people and shattered whatever identity and "sense

⁴⁶ Azerbaijan, Georgia and Armenia had brief period of independence between 1918-1920.

of belonging" existed hitherto, and attempted to replace them with identities flowing from officially recognized republic borders.

The product of this "nationality engineering" was a poisonous mixture of various local, tribal and ethnic groups. Even a cursory examination of the ethnic overlap inherent in the modern states and their artificially created boundaries clearly indicates potential crises based on nationality questions for nearly all the Central Asian and Caucasian states. Such crises could easily destroy whatever political equilibrium exists both within and between them. During the Soviet era, strict authoritarian rule and suppression kept the destabilizing character of ethnic and religious diversity under control. However, the root causes of instability were never dealt with. Without providing adequate mechanisms to cope with them, this eventually contributed to regional turmoil as the forces of destruction were unleashed following the collapse of the Soviet Union.

The continuity of communist-background leadership in Central Asia after independence has, to a certain degree, provided a means to contain or suppress potential ethnic disputes, but this does not mean that Caspian and other Central Asian states have no problems with regard to future ethnic issues. "As was the case elsewhere in the USSR", the Moslem peoples of the Caspian "had a difficult time preserving their traditional cultures" under Soviet rule (Glantz 1997, Diuk 1993). In the post-Soviet era, with their newly earned independence, ethnic groups other than titular nationality have begun to demand certain improvements in their status and culture. In Kazakhstan, for example, this has already led to tensions over language policy with other ethnic groups demanding to have their language declared the "state language". Thus, titular groups are in such areas favored as education and

civil service to the disadvantage of Russians, who usually do not speak these languages. Consequently, disputes over language policies and the selection of state symbols have increased tensions in the multiethnic states of the Caspian basin, putting strains on regional stability (Federov 1996, Fuller 1994).

When, in the early 1920s, the central authorities in Moscow drew the political boundaries of the then union republics of the USSR in Central Asia and the Caspian, they paid no attention to local titular nationalities who were caught outside their home republics. The artificial "divide and conquer" boundaries established primarily under Stalin, purposely cut across nationalities.⁴⁷ Central authorities meant these boundaries to be internal, administrative lines of demarcation (no one dreamed that the Soviet Socialist Republics would ever become actual states). This ethnic mix was further complicated when the area became a dumping ground for exiled nationalities, such as Volga Germans and Crimean Tatars during World War II, followed by the relocation of war industries during the early 1940s, the Virgin Land program of the 1950s, and Moscow's systematic emigration of ethnic Slavs (to dilute the titular nationality) after Stalin's death. These policies naturally exacerbated differences among peoples and regions within these areas and have contributed to intra-state regional competition within, and inter-state tension between, the newly independent states of the Caspian and Central Asia.

⁴⁷ According to Martha Brill Olcott, the dispute between the Uzbeks and Tajiks is potentially the most contentious. Central Asia's two main Persian-speaking cities, Samarkand and Bukhara, were included in Uzbekistan, leaving the Tajiks with the backwater town of Dushanbe for their republic capital. For their part, the Uzbeks have periodically staked a claim to all of the Fergana valley, which includes Kyrgyzstan's Osh oblast, and part of the Khojent oblast in Tajikistan. The Uzbeks also argue that part of southern Kazakhstan and eastern Turkmenistan rightly belongs to them as well. The republics of Kyrgyzstan and Tajikistan disagree not only about where their border should be, but even where it is, and briefly came to blows over this question in the summer of 1989. "Central Asia's Post-empire Politics," *Orbis* 36, no. 2 (spring 1992): 256.

The core issue in terms of national stability and unity in the region is the ethnic composition of each state. Because none of the nationalities existed as independent states in the centuries before Russian conquest, substantial migration of ethnic groups has occurred. And because of Soviet policies, each of the Central Asian states has significant minority populations. As a result, major concentrations of ethnic minorities exist within countries. One million Uzbeks in the Khojent province of Tajikistan, half a million in the Osh area of the Fergana valley in Kyrgyzstan, and two hundred and eighty thousand in the Chimkent region of Kazakhstan; one to two million Tajiks in Samarkand and Bukhara, Uzbekistan; nearly a million Kazakhs in Uzbekistan; and roughly eight million (a number declining daily due to emigration) Russians, Ukrainians, and Germans in the northern part of Kazakhstan.⁴⁸ As of 2002 Ethnic Russians make up approximately 30 percent of Kazakhstan's population, and 18 per cent of Kyrgyzstan's.⁴⁹ Ethnic populations are also split by international boundaries.⁵⁰ Although all the post-Soviet states have agreed to honor the existing borders, with such overlapping populations, there is a considerable potential for future claims and for the spread of conflicts from one country to another.

Motivated not only "by ethnic ties, but also coupled with each country's self-image as the center of the Caspian region and Central Asia, cross-border ethnic issues have already caused considerable unease among neighboring countries. For example, extreme Russian nationalists, (not supported by the Russian government, though) in Kazakhstan argue that

⁴⁸ Anthony Hyman, "Power and Politics in Central Asia's New Republics," *Conflict Studies* 273 (London: Research Institute for the Study of Conflict and Terrorism, August 1994): 10.

⁴⁹ www.cia.gov/cia/publications/factbook; www.uskba.net/.

⁵⁰ Anthony Hyman, "Moving Out of Moscow's Orbit: The Outlook for Central Asia," *International Affairs* 69, no. 2 (1993): 302-03.

northern territories should be simply ceded to Russia. Although, most of the Russians in Kazakhstan seem to favor preservation of the status quo, this could change in the longer term if it become economically more convenient to join Russia or ethnic Kazakh nationalism becomes a burden to them. In the mid-1990s, Kazakhstan's President Nursultan Nazarbayev, as part of a comprehensive policy to ease these tensions, moved the capital city from Almaty to Aqmola (now Astana) in the heart of the Russian populated North.

Outside the borders of the CIS, there are well over 500,000 Turkmen each in Afghanistan, Iran, Iraq and Turkey. Moreover, there are about two million Kazakhs living in the Xinjiang region of China, which is populated overwhelmingly by approximately eight million Uighurs. Some additional 250,000 Uighurs are divided between Kazakhstan, Kyrgyzstan and Uzbekistan. They are known for their long-standing call for independence from China and the creation of "Eastern Turkistan", the west of which falls within the territories of contemporary Uzbekistan and Kyrgyzstan. There has been periodic ethnic unrest in Xinjiang, which the Chinese have put down with force. The Chinese are extremely agitated by the prospects of further instability spreading from, or being supported by, the newly independent states of Central Asia; particularly by Kazakhstan.

The same kind of ethnic mixture is present in the Caucasus. Although each of the independent Transcaucasian states has its own dominant titular nation, each also has a significant number of minorities. The situation in the region, in contrast to Central Asia where the overwhelming majority is Sunni Moslem, is further complicated by the diversification of religious sects that are closely related to the separate national-ethnic identities. The Azeris belong to the Turkish race and the majority of them are Shi'ite

Moslems like the Iranians, while a majority of the Armenians and Georgians are believers of two branches of the Eastern Orthodox Church. There are Armenians living in Azerbaijan and Georgia, as well as more than six million of them constitute Armenian Diaspora scattered all over the world, but principally in France, the United States and Russia.

Azerbaijan contains within its borders the Nagorno-Karabakh Autonomous Region, with a population of approximately 150,000 inhabitants who are overwhelmingly Armenian, while the country's Nakhichevan Autonomous Republic, which consists mostly of Azeris, is a detached exclave of Azerbaijan sandwiched between Armenia, Iran and Turkey (President Heidar Aliyev of Azerbaijan is from the Nakhichevan Autonomous Republic.) Moreover, because of historical circumstances, the Azeris have a large number of compatriots living in Iran's northwestern province of Azerbaijan, constituting a sizeable ethnic group in Iran (figures differ between 15 million and 25 million people, from 25 to 30 % of the entire population of Iran), so that the Azeris have a sense of being artificially divided into two states. This complicates Azerbaijan's relations with Iran, which is deeply concerned about the possibility of rising ethnic separatism among its own Azeris who may favor the establishment of "greater Azerbaijan". During the Elchibey Presidency (1992-1994) in Azerbaijan this issue was a major concern for the Iranians. Georgia, for its part, includes the Abkhaz Autonomous Republic, the Adzhar Autonomous Republic and the South Ossetian Autonomous Region, with sizeable minorities in each. Secessionist movements exist in Abkhazia and South Ossetia.

Multinational complications also exist in the North Caucasus, astride the southern boundary of the Russian Federation. With its nineteen native national groups (as the last

Soviet census recognized in 1989) and a significant Russian populations, as well as non-titular ethnic groups of Cossacks, Nogai and a number of others, the North Caucasus is one of the most ethnically and linguistically diverse regions of the world. The North Caucasus presents a complicated situation where a number of minorities and more than one titular nationality share the same territory. This already intricate condition is further aggravated by the fact that considerable number of the minorities and the titular nationalities are demanding separation from the states, autonomous republics or regions to which they are administratively attached. In fact, the Chechens and Ingushes of Checheno-Ingushetia, created in 1934 were separated in December 1994 because of the Ingushs' desire to remain within the Russian republican structure and Chechens' intentions to become independent. Chechens are currently fighting their second war for independence against Russian in a single decade. In contrast, Dagestan of the Russian Federation as a Caspian autonomous republic is distinguished by its lack of titular national groups and incorporates ten non-titular national groups that are recognized officially as "Peoples of Dagestan". Obviously, all of the North Caucasian "nationalities" are prone to future instability and conflict, which makes it very difficult for both Russia and external states to come to an understanding on regional realities.

C. ETHNIC CONFLICTS WITH SPECIFIC EFFECTS ON THE CASPIAN ENERGY RESOURCE DEVELOPMENT

This section discusses the ethnic tensions and conflicts in the region. Any of these hostilities could affect the resource development and oil export pipeline projects.

Russian-Chechen Conflict

Although Russian-Chechen conflict has a long historical background, the war between Russia and Chechnya began in December 1994 when Russia invaded Chechnya to suppress the movement toward secession in that republic. First Chechnyan campaign (1994-1996) was an embarrassing defeat for Russia despite tremendous human loss on the Chechen side. The lack of political leadership regarding Russia's stand on the North Caucasus and the lack of direction from the Russian military authorities in the day-to-day running of the campaign were instrumental in the agonizing defeat of the Russian Army during the first crisis. By correcting much of these deficiencies, Russia was able to restore control over much of Chechnya, with overwhelming force following the outbreak of the second Chechen war in October 1999. Though, the established is likely to be only temporary.

One of the more serious consequences of the Chechen conflict has been the gradual breakdown of law and order in Dagestan, political control of which is vital for Russian mastery of the North Caucasus and the Caspian. Although the situation in the region stabilized somewhat after the 1996 cease-fire, fighting again erupted in August 1999. Various contingencies may re-ignite fighting in Dagestan, as it was the case in the Spring 1999 uprising when some Chechen guerilla groups attempted to establish an Islamic republic in there. The situation in Dagestan is important because, on a wider scale, the preservation of Russian influence in the Transcaucasia and the Caspian depends on the complete control of the North Caucasus by the Russian authorities.

In addition, the failure to reach a final agreement on the status of Chechnya has created an ambiguous and uncertain situation throughout the region. Since the present

uncertainty and continuous fighting in Chechnya is unlikely to be finished any time soon, it becomes all the more difficult for the republics surrounding Chechnya to have promising expectations regarding their futures.

This conflict has had and will continue to have an affect on energy pipeline prospects passing through this region. The first Chechen war forced Russians to build a new pipeline in 1997, bypassing Chechnya section of the main oil pipeline from Baku to Novorossiysk. Further destabilization in the region, and especially in Dagestan (from where the new bypass pipeline passes through), will be a serious setback for the Russian energy interests in the Caspian Basin.

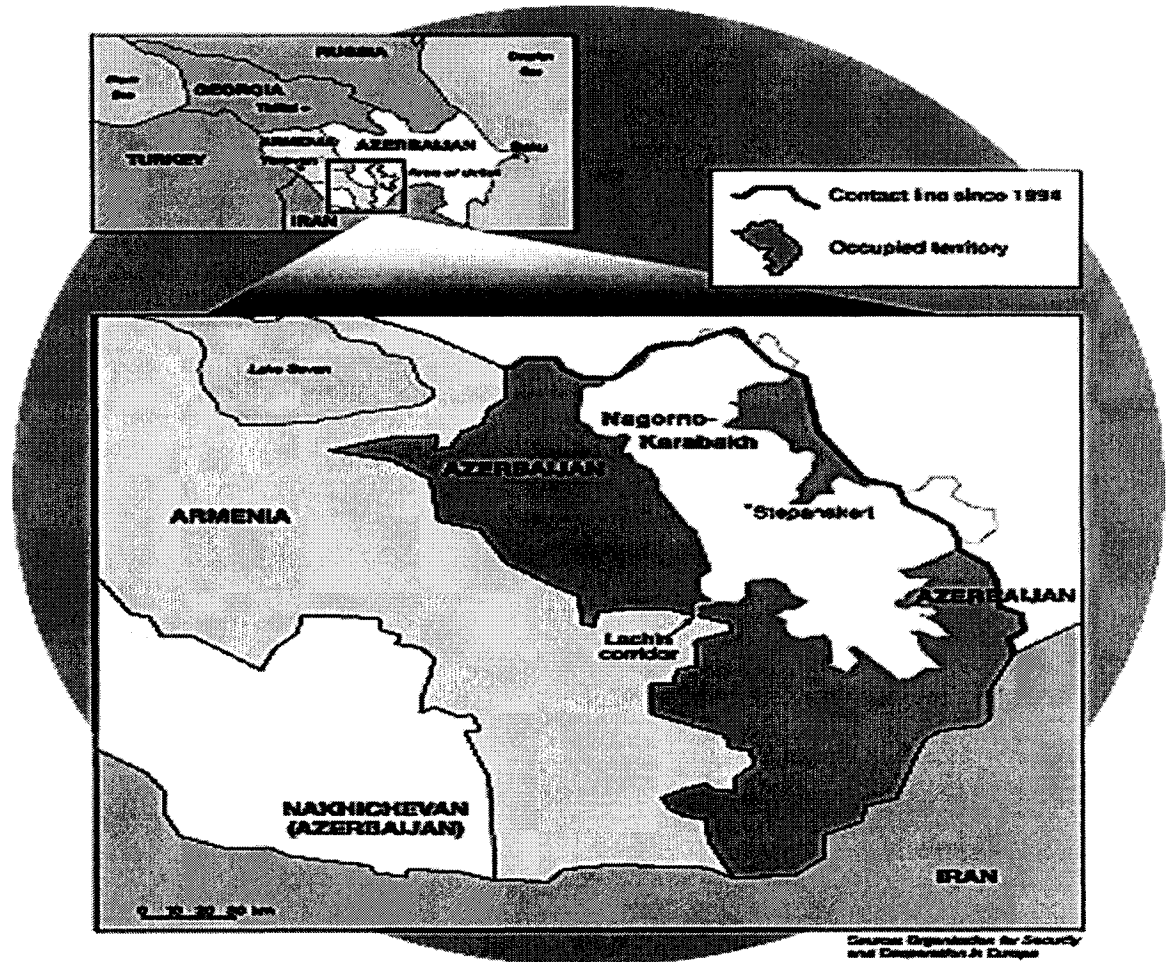
Nagorno-Karabakh dispute

Both Azeris and Armenians claim the absolute historic right to Nagorno-Karabakh and have battled over it periodically for generations. In the last century, Josef Stalin pointedly and cleverly exacerbated the dispute. Stalin knew that by including Armenian-populated Nagorno-Karabakh within the boundaries of the Soviet Republic of Azerbaijan, he would promote discord between the two republics, and thus ensure Moscow's position as power broker (in accordance with Sovietization and divide-and-rule policies implemented in the region in the 1920s). The most recent recrudescence dates from 1988, when, during Gorbachev's reforms, the Armenian majority in the Nagorno-Karabakh Supreme Soviet (the region's legislature) appealed to have the region join Armenia. Azerbaijan rejected the appeal out of hand. Violence ensued, with each side claiming that the other initiated the hostilities. Tens of thousands of Azeri and Armenian refugees were expelled or fled the fighting. In

1989, the Supreme Soviet of Armenia officially resolved to unify Nagorno-Karabakh with Armenia. To date the resolution has not been rescinded.

In the spring of 1991, the hostilities increased, involving not only the principals but also Soviet troops. In early 1992, after the collapse of the Soviet Union, the parliament of Nagorno-Karabakh rejected unification with Armenia and declared complete independence. The disintegration of the Soviet Union also resulted in a steep upgrade in the level of armaments and munitions available for use by both sides, sharply intensifying the lethality of the fighting. By mid-1992, the Armenians controlled most of Nagorno-Karabakh; the 20 to 25 percent of the enclave's population that was Azeri had fled, and *the Lachin corridor*, a land bridge from the region to Armenia, was established. The Armenians further expanded their captured land in 1993, when their forces occupied almost 20 percent of Azerbaijani territory outside of Nagorno-Karabakh and displaced almost a million Azeris from their homes. As of 2003, Armenians have refused to retreat from this land until independence of Nagorno-Karabakh is recognized and its security is guaranteed. This situation has not changed since the May 1994 cease fire. Before the fighting ended, more than fifteen thousand residents and soldiers had lost their lives.

Figure 4.2. Map of Nagorno Karabakh and invaded Azeri territories



Source: Organization for Security and Cooperation in Europe-OSCE.

Early mediation initiatives between the two warring parties were attempted by Russia, Kazakhstan, Iran, Turkey, and France. However, cease-fire agreements were routinely broken. When both Armenia and Azerbaijan joined the then Conference on Security and Cooperation in Europe (CSCE, now the Organization for Security and Cooperation in Europe, or OSCE) in 1992, the mediation baton was passed to that group, which continues to play the leading role in negotiation efforts. A subset of OSCE members, dubbed the “Minsk Group” of countries, so-called after the location of its first convening, was formed to

participate in the negotiation talks. (The members of the Minsk Group are Armenia, Azerbaijan, Belarus, the Czech Republic, France, Germany, Italy, the Russian Federation, Sweden, Turkey, and the United States.) Russia, the United States, and France chair the Minsk Group jointly. Unfortunately, little progress has been made through the Minsk Group negotiations. For a decade, the stalemate has remained in place.

In an attempt to tackle the impasse, in September 1997 the latest plan offered by the Minsk Group, a “phased” plan toward a political solution. This plan proposed an Armenian withdrawal from the seven occupied Azeri provinces, followed by discussions on the final status of Nagorno-Karabakh. This proposal was accepted by Azerbaijan. Signaling a slight shift in position, Armenia accepted the proposal as a basis for further talks, albeit with reservations. It was, however, rejected out of hand by Nagorno-Karabakh, which demanded that its independence be recognized and security guaranteed before any discussion of a withdrawal from other areas of Azerbaijan could take place. Rather than accepting the phased approach to a settlement, the Karabakh Armenians demand that all issues be solved simultaneously.

Opposition to the phased approach and solidarity with Nagorno-Karabakh by opposition groups in Armenia became so apparent in February 1998, that Armenian President Ter-Petrossian was forced to resign. After a presidential election that international observers considered deeply flawed, Robert Kocharian, the former “president” of Nagorno-Karabakh, who in March 1997 had been appointed prime minister by Ter-Petrossian in an attempt to shore up his enfeebled presidency, became the Armenian leader. After the events of February and March 1998, the possibility of achieving a solution to the Nagorno-Karabakh dispute

seemed as remote as ever (Carley 1998). After Kocharian's re-election in February 2003, there was speculation that he might return to the negotiating table with enough resolve to solve the problem.

There has been a tendency during the second half of the 1990s to overestimate the influence of oil and oil pipeline routes on the resolution of the conflict. On the one hand, the existence of oil in Azerbaijan cannot be said to be driving the international community's interest in Nagorno-Karabakh, for the involvement of the Minsk Group easily predates the world's awareness of the significance of the oil reserves in Azerbaijan's newly discovered fields (Azeri-Chirag-Guneshli fields). On the other hand, there are also views that Caspian Sea oil development efforts are ultimately going to provide an additional incentive to reach a settlement over Nagorno-Karabakh. It may also prove be a negative factor, however. Azerbaijan's oil wealth has sometimes caused that country to feel it has less reason to compromise, while pipelines running through the Caucasus may provide the Armenians with a kind of "hostage issue" that they can manipulate for their own purposes.⁵¹

Had the Karabakh conflict been settled in the late 1990s, Azerbaijan would have endorsed a pipeline through Armenia to reach Turkey, thereby ensuring that its own exclave of Nakhichevan (which borders eastern Turkey) received sufficient energy supplies. During the long wait, however, Baku was able to make other arrangements for Nakhichevan and, for that reason, no longer considers the route through Armenia necessary. The Armenian option nevertheless remains Azerbaijan's most natural and economical oil export route.

⁵¹ 13 December 2000 - RFE/RL

Georgia and beyond

Since independence in 1991, Georgia also has been struggling with numerous territorial conflicts and separatist movements. These conflicts have hindered its status as an oil-transit nation. One of the most serious threats to Georgia's stability has been the Abkhazian secessionist movement. Russian military support, which played a critical role in Abkhazia's wartime gains in 1993, has waned as Russia reestablished extensive military basing rights inside Georgia. Moscow now seems more interested in a peaceful resolution of the Abkhaz issue. Other flash points in Georgia include South Ossetia, Ajaria (a Muslim-Georgian autonomous region on the border with Turkey), and the Javakheti region (an Armenian-populated region of Georgia) and, in Azerbaijan, the Lezgin provinces.

Inequitable distribution of oil revenues among competing ethnic groups in the Caspian region could fuel continued, or even accelerated, ethnic unrest, which similarly could negatively impact the steady flow of oil exports. To the extent that oil production and transport revenues are perceived as contributing to the relative deprivation of any particular ethnic group by another, oil facilities or personnel could be terrorized by indigenous ethnic groups seeking to assert their claims.

With this background, the outlook is not so bright and there are a number of flash points that may erupt into an open armed conflict at any given time. Tension will continue to exist along the international borders between the Transcaucasian republics and the Russian Federation. Namely, stability in the Caspian will continue to be poisoned by:

- the Russian-Chechen conflict
- the Armenian occupation of 20 percent of the territory of Azerbaijan in and around Nagorno-Karabakh
- the disputes between the Ingush and North Ossetians;
- the tension along the Dagestan-Azerbaijan border, where the Lezgins span both sides of the border, as well as other ethnic boundary disputes within Dagestan.

It is important to note that, each conflict is unique and will require case-specific approaches for resolution. Moreover, new trouble spots may also emerge along the proposed pipeline routes from the Caspian, both along the northern route through Chechnya and the southern route through eastern Turkey.

D. LACK OF ORGANIZED CIVIL SOCIETY AND DEMOCRACY

None of the countries in the Caspian region are fully democratic or stable. Their stability, to the extent that it exists, depends on the existing leaders' political and physical health, leaving them prone to protracted instability and internal conflict. Besides, personal authoritarianism makes political power an inherently unstable endeavor.

Democracy has been sacrificed on the altar of stability in the region. Except President Gamsakhurdia of Georgia, none of the former communist leaders of the Caspian countries (and Central Asia) wanted independence. Indeed, most favored the 1991 coup attempt in Moscow.⁵²

⁵² Only Akayev of Kyrgyzstan immediately condemned the August 1991 coup in Moscow. Nazarbayev of Kazakhstan waited 36 hours (until the outcome was evident) before protesting. The leaders of Uzbekistan, Turkmenistan, and Tajikistan openly supported the coup from the start and used it as an excuse to crack down on their own dissidents. See Ahmed Rashid, The Resurgence of Central Asia Islam or Nationalism? (London: Zed Books, 1994), 39-40.

To be sure, regional leaders have implemented limited reforms. They have created parliaments and multi-party systems and have introduced elements of pluralism, along with the embryonic attributes of a market economy. Nonetheless, virtually every state in the Caspian and Central Asian regions features a political system, in which the executive branch is unduly strong and the legislature is comparatively weak. At the same time, judicial structures are arbitrary and often utilized for political purposes. In short, early constitutional efforts lacked genuine checks and balances or public commitment to their survival. When legislatures attempted to play a genuine role in the decision-making process, the executive branches progressively usurped their power; in the cases of Kyrgyzstan (September 1994) and Kazakhstan (March 1995), the presidents dissolved them outright. Authorities repressed organized opposition political parties, especially Islamic ones.

At their best, the political ideology that has replaced communism in the Caspian and the Caucasus can be characterized as a hybrid of semi-authoritarianism and something less than democracy. At their worst, they approach totalitarianism.

More than a decade after independence, most leaders have managed to gain greater power, bending constitutions to suit their needs, while exerting increasing influence over economic development. Entrenched authority is now anxious to preserve its accumulated wealth and power. Leaders rationalize their role by claiming that a period of authoritarian rule is a necessary stage in the transition from totalitarianism to democracy.⁵³ They also

⁵³ While the struggle for national identification goes on within each republic, authoritarianism provides a tempting solution as "the only way to keep the country together". That, of course, was the justification for the Soviet iron hand. It is disappointing to see the authoritarian approaches of most of the Caspian leaders and that these are presented as the sole rational response to potential ethnic divisions within their republics and as a rationalization for their hold on power. Also, this may be a source of long-term trouble as it puts a lid on boiling problems, preventing ventilation and possibly causing violent eruptions in the longer term.

suggest that an abundance of democracy can lead to anarchy in their developing nations (Martirosyan 2002, Croissant 1999, Carley 1998, Bradshaw 1997).

In the early 2000s, new factors are helping to sustain authoritarian rule in Central Eurasia, including military cooperation with NATO through the Partnership for Peace (PfP programme) and the United States in the anti-terrorism campaign waged after the September 11th attacks. The rise of Islamic radicalism in the region makes it even easier to justify authoritarian practices. At the same time, however, these new conditions present fresh opportunities for the development of open societies. Regular contacts with western countries and multinational energy corporations force the ruling elites to reform their former communist regimes and to introduce some key elements such as the rule of law, economic reforms to fully open domestic markets, improvements in human rights, and so forth to promote democracy,

Problem of succession

What will happen when the present generation of leaders passes from the scene -- which in the case of the ailing leaders of Azerbaijan and Turkmenistan may be soon-- remains uncertain. The change of political leadership, therefore, is one of the more unpredictable elements in Caspian geopolitics. In the absence of any clear mechanism of succession--whether democratic or oligarchic--some of these leaders intend to establish their sons as designated successors.⁵⁴ It is far from clear that other players in these regimes will accept the notion of hereditary dynasty, and equally important, most of the designated sons

⁵⁴ Economist, 02/07/98, Vol. 346 Issue 8054, Central Asia survey p16, 2p, 8bw

(or son-in-laws as in the case of Kazakhstan) are extremely unimpressive characters. Under Soviet rule, they lived the lives of playboy children of the Soviet elite, and subsequent exposure to Western millionaire lifestyles has led them to embrace decadent consumption on a scale not seen before. With or without the support of the West and especially the United States, these sons are not likely to succeed their fathers.⁵⁵

The abolition of the Communist Party in all three newly independent countries of the Caspian and the proto-pluralistic reforms that took place in Azerbaijan and Kazakhstan have opened a limited space that civil society could potentially fill. Currently it is filled by clans, ethnic groups, clientelistic networks, and criminal gangs; more usefully, it has been filled in a number of republics by quasi-private businesses and by NGOs.

At present, however, power in the region is still wielded by the old Communist Party bosses and their personal patronage networks. It goes without saying that they have been unable to check their countries' declines. Martha Olcott emphasizes the drastic decline in the ability of the Caspian governments to maintain even minimal levels of public services and social welfare protection, not to mention the kinds of benefits that the pre-independence population enjoyed (Olcott, 1994).

Though there have been setbacks in democratic reforms in all these countries since they gained independence in 1991, it is the existing leaders who managed to consolidate the state and its authority, bringing much-needed order and stability and permanence in policies. It is only with a strong state that foundations such as democracy, rule of law, and market

⁵⁵ Claudia Rosett, An interview with Azerbaijan's dictator-in-training. *The Wall Street Journal*, November 6, 2002

reforms can be built, as the state must have the necessary legitimacy to keep order, protect private property, enforce contracts, and so forth. Yet, at the same time that the state was being consolidated in these countries, governments were losing legitimacy. It is the nature of the post-Soviet regimes and the Soviet legacy, then, not Russian or Iranian pressure, that is crippling growth in the region.

Oil wealth itself will not help Azerbaijan, Kazakhstan and Turkmenistan to develop as nations. Only democracy can do that. Only the ability of the common people to change their governments in free and fair elections will help in finding—and preserving—a long-term solution to the conflicts in the region. All the above-mentioned problems have been summarized and may be observed in Table 6:

Table 4.6. “Nations in Transit 2002” Rating and Score Summary for the Transcaspian countries of the CIS

COUNTRY	PP	CS	IM	GPA	DEM	CLJF	CO	ROL	PR	MA	MI	ECON
Armenia	5.50	3.50	4.75	4.50	4.56	5.00	5.75	5.38	3.25	3.50	4.00	3.58
Azerbaijan	5.75	4.50	5.50	6.00	5.44	5.25	6.25	5.75	4.25	4.50	4.50	4.42
Georgia	5.00	4.00	3.75	5.00	4.44	4.25	5.50	4.88	3.25	4.00	4.00	3.75
Kazakhstan	6.25	5.50	6.00	5.75	5.88	6.00	6.25	6.13	4.00	4.25	4.50	4.25
Turkmenistan	7.00	7.00	7.00	6.75	6.94	7.00	6.25	6.63	6.75	6.25	6.50	6.50
Russia	4.50	4.00	5.50	5.25	4.81	4.75	6.00	5.38	3.50	3.75	4.50	3.92
Nations in Transit 2002⁵⁶ Average	3.86	3.55	4.02	4.25	3.92	4.11	4.85	4.48	3.66	3.87	3.93	3.82

Notes:

Democratization Score (DEM) = average of Political Process (PP), Civil Society (CS), Independent Media (IM), and Governance and Public Administration (GPA) ratings

Rule of Law Score (ROL) = average of Constitutional, Legislative, and Judicial Framework (CLJF) and Corruption (CO) ratings

⁵⁶ *Nations in Transit* study includes 27 former communist countries in Eastern Europe, Baltics and the CIS; Albania, Armenia, Azerbaijan, Belarus, Bosnia, Bulgaria, Croatia, Czech Rep., Estonia, Georgia, Hungary, Kazakhstan, Kyrgyz Rep., Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Slovakia, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan and Yugoslavia.

Economic Liberalization Score (ECON) = average of Privatization (PR), Macroeconomic Policy (MA), and Microeconomic Policy (MI) ratings
Ratings and scores are based on a scale of 1 to 7, with 1 representing the highest level and 7 representing the lowest level of democratic development. The 2002 ratings and scores reflect the period November 1, 2000, through December 31, 2001.
www.freedomhouse.org/research/nattransit.htm and *Transparency International*.

E. POLITICAL ISLAM & TERRORISM PROBLEMS

It is obvious that the long periods of Russian imperial rule and atheistic Soviet-era indoctrination failed to eliminate the influence of Islam from the Muslim-populated lands of the former Soviet Union. Islam's position as an important element of individual and collective self-identity in the region guaranteed its survival and present strength, which has become, since the late 1980s, an increasingly politicized vehicle.

Because of the perseverance of Islamic heritage, many outside experts observed during the early years of independence that Islam would be one of the key defining characteristics of Central Asia and the Caspian in forthcoming years (Galeotti 1995, 1998; Croissant 1999; Aydın 2000). Early reports from the region gave credence to this observation: the Islamic-dominated opposition took the upper hand briefly in the Fergana Valley in Central Asia, and the Chechen struggle in the Northern Caucasus has increasingly shown signs of fundamentalist Islamic elements and connections with radical Islamic groups in the region and elsewhere in the world.

Nonetheless, the reality is more complex within the Caspian region. During the first Chechen uprising, for example, a major concern from the Russian perspective was the fact that "a *de jure* independent Chechnya would speed the process of disintegration in the North Caucasus, leading to the creation of a much larger Islamic state", combining Chechnya with Dagestan (Galeotti 1995, 1998). However, both the Russian analysis and the idea of

unification among the Chechens were based on a more complicated line of reasoning than it appeared; Chechnya could not survive economically unless it joined with Dagestan in a much larger economic unit with access to the Caspian Sea.

Generally, the program of “nation building” throughout the region since independence has been represented by the largely secular and former communist elites, who almost from the beginning faced a dilemma, especially in the Caspian. The leaders of the Caspian three (Turkmenistan, Azerbaijan and Kazakhstan) soon realized, on the one hand, that Islam remained an important part of the region's social and cultural life, and, if exploited as a political tool, offered various advantages to them. Thus, Soviet educated leaders considered "an appeal to Islamic symbols and traditions" useful in their effort to reinforce their legitimacy, as "Islam and the values it espoused were attractive" to people, who had "little else to define themselves by". Furthermore, the Islamic heritage of the Caspian was one of the trump cards that these leaders could play in international relations "in order to receive massive amounts of credits, grants, and aid". Consequently, all the regional leaders have sought to introduce an Islamic dimension into their foreign policies by courting such countries as Saudi Arabia, Iran or even Libya (Aydın 2000, Croissant 1999, Amirahmadi 1999).

At the same time, however, they also feared too great a tilt towards Islam in their respective states, which could eventually might create problems for their authoritarian administrations and further aggravated the already complicated nation and state-building process. In Kazakhstan, especially the growth of Islam's role in public life would have easily eliminated the substantial Russian minorities, whose skills were needed in the short-term.

Thus, the leaders of the Caspian three had no intention of allowing Islamic activism to challenge their own positions. Accordingly, all the post- independence constitutions of the Muslim republics emphasize their *secular nature*, as well as the principle of separation of religion and state. In an attempt to combine these conflicting positions, the leaderships of the Muslim Caspian nations, since gaining independence, have embarked on a policy of co-habitation with a moderate type of Islam while preventing all political manifestations of radical Islam.

The rationale behind this co-habitation is that, while they do not want to see Islam developing into a viable political force capable of challenging their monopoly on power, administrations are, nevertheless, aware of the popular demand for Islamic institutions. The inevitable conclusion was since there is a demand, it is better that this demand be met by the state to prevent hard-liners from stepping in to meet it.

However, the strategy of simultaneous repression and limited tolerance by no means eliminates the danger of Islamic fundamentalism in the region, especially if secular and democratic political institutions are also not allowed to develop. Thus, the policy of co-habitation, by heightening the people's Islamic consciousness and leading to cultural Islamization, provides a favorable ground for Islam to emerge as a political force. This is highly likely, should economic, political and social conditions within the country not improve to the level of meeting mass population's urgent demands. These demands, among others, include: new jobs, balanced distribution of economic wealth, fight against corruption and cumbersome bureaucracies, elimination of government created hurdles before

privatization and effective foreign investment programs guided by unified and simplified mechanisms.

There is of course a present danger in the region that Islam, or rather extreme political Islam, could grow because of the unpredictable changes, disillusioned hopes, economic deprivation and lack of opportunities for employment. On the one hand, it was this concern that promoted the so-called "Turkish model" of secular democracy and market-oriented economic development⁵⁷, which broadly symbolized Western liberal democracy, to counter the Iranian, Taliban or Saudi model, representing the radical Islamic alternative. Despite the fact that the September 11th terrorist attacks in the U.S. revitalized and vindicated the relevance of this so-called Turkish model, since Turkey could not meet all the inflated expectations in the region in this respect (becoming perfect role model for transition to secular-democracy), the same concern led some Western analysts to view reassertion of Russian power as the lesser evil. On the other hand, Russia used the pretext of preventing Islamic militancy in Chechnya to retain its military forces in the region and to forestall outside criticism.

There is no doubt that, in the final analysis, the current growth of Islam is both a cause and a result of mistrust by the Caspian secular leaders, who have exaggerated the incursion of radical Islamic fundamentalism and have used it as the new "threat" to justify their suppression of internal dissent. They exaggerate to the religious elements of Islam. True, there has been a rapid increase in mosque building and Koran distribution (funded externally, especially by the Saudis), but at this stage much of the interest has been in "folk

⁵⁷ I will discuss this "model" in more detail in the coming chapters.

Islam"-the rituals of daily life and death--and in rediscovering a lost cultural identity rather than a purely religious conviction. Attempts to limit or control Islam and nip "fundamentalism" in the bud, without simultaneous dramatic attempts to reverse the economic and social decline, hasten the growth of a more strictly observed Islam. Martha Brill Olcott argues that secular leaders themselves are responsible for Islam's growth, since Muslim leaders of the Caspian basin seem to understand that Islam is not the agent of instability and the competing power they take it to be, but that its spread is instead a response to their own inability to control their economies, their societies and their states.⁵⁸

Whether the threat of Islamic fundamentalism is real or perceived, Islam as a cultural phenomenon remains a potent force that yet may come to play an important social and political role. Above all, if the development of secular democratic institutions and channels of popular expression are blocked while current governments fail to improve their people's living conditions, then political Islam may most likely emerge as the only vehicle for the expression of grievance and dissent.

F. ENVIRONMENTAL ISSUES

The world's attention is attracted to the region by regional rivalries over the highly competitive issues of oil extraction, transportation and profit sharing, and occasionally by ethnic tensions. However, there is another, equally important, danger about which politicians and oil-interests generally remain silent, namely the destruction of the Caspian Sea's unique

⁵⁸ Martha Brill Olcott, "Central Asia's Islamic Awakening," *Current History* 93, no. 582 (April 1994): 150, 154; Anatol Lieven *National Interest*, Winter99/2000 Issue 58, p69, 12p, 1 map

ecosystem. This is due to a lack of respect for overall regional development and the former Soviet Union's long-term violation of generally accepted environmental norms. The present rush of Western oil companies and a lack of control over oil exploration operations in most of the newly independent Caspian littoral states only exacerbate the situation. Soviet degradation of the environment in the Caspian region created massive economic distortions and mammoth environmental problems that have resulted in conflicting demands for limited state funds. The question is whether states will use their limited resources to rectify current problems or invest in the future.

Issues at Stake: Fisheries, Sturgeons, Caviar, Agriculture and Wildlife.

Unlike the Aral Sea, the Caspian has not been affected by shrinkage. It actually suffers from an opposite problem, a rise of the level of its waters, which have flooded some coastal areas and is threatening others. In addition to the rise of its level, the Caspian suffers from high levels of pollution. Tatyana Saiko, in her chapter in the book called Circum-Caspian, summarizes the Caspian's problems as follows: pollution by oil, industrial, agricultural and domestic wastes, air pollution, irrigation problems of the Volga delta, degradation of coastal lands, desertification in the Kalmykian steppes, and depletion of commercial fish stocks (Glantz & Zonn, 1997, Saiko 2001).

During the 1930s, however, the problem was the fall in sea level and it was provoked by a decrease of the Volga river flow, which supplies 75 per cent of the water inflow of the sea, and by increased evaporation. Half a century later, it is the increased Volga river flow and the decreased evaporation from the sea's surface that have caused most of the sea's rise and other negative developments, such as increased wind velocity and resulting wave surges

on the coast. The dam built in 1980, which isolated the *Kara-Boğaz-Göl* bay from the rest of the sea, and had contributed about 0.5 m of the approximate 2.5 m level rise that took place during its 15 years of existence, was destroyed in 1992, allowing the bay to take larger water intakes and thus to relieve the sea of some of its rising waters.⁵⁹

For years, ecologists have given warning that the development of Kazakhstan's oil deposits in the Caspian threatens the sea's flora and fauna. The Caspian basin is also a seasonal habitat for birds migrating from Europe and Asia, such as the flamingo and the rare white-tailed eagle. It is also home to about 400,000 seals and--crucial to caviar-production--more than 90% of the world's sturgeon live in the Caspian. Over a period of four weeks in May 2000, about 4,000 seals were found dead on the shores of Kazakhstan.⁶⁰ Their deaths might be connected to oil drilling at the massive Kashagan field, off the coast of Kazakhstan. Local environmentalists blame an international oil consortium that drilled its first well in the shallow waters of Kashagan. Another possible culprit is hydrogen sulfide gas, a by-product at the nearby Tengiz oilfield, which is released into the air. The waters of the Ural and Volga rivers that flow into the Caspian, which are polluted with heavy metals, could also be to blame. Politicians, responding to public criticism and pressure, are asking whether it is wise to risk the country's wildlife for the potential material riches of oil. The Caspian governments optimistically hope that they can have both: a balanced ecosystem and lots of oil, which sounds too optimistic.

Another problem has been created by the 100-200 oil wells in western Kazakhstan that were abandoned when the country was part of the Soviet Union. A few even date back to

⁵⁹ *Economist*, 05/12/2001, Vol. 359 Issue 8221, p47

⁶⁰ Oil And The Seals Of Kazakhstan, *Economist*, 06/03/2000, Vol. 355 Issue 8173, p44

tsarist times. Because of the rising level of the Caspian Sea, these onshore wells have since then been covered with water and have in effect become offshore wells. No one knows where they all are. Apparently, it is all up to Kazakhstan to find them and stop them from leaking. The cost of fixing only one abandoned well is estimated to be \$150,000 (Smith, 2001).

Fisheries are also in trouble. If the commercial catch is continued on the same level, there simply may not be enough mature beluga sturgeon to support a fishery in the future. The population of beluga needs to be restored to healthy levels with a normal age structure before sustainable fishing can resume. The Caspian sea is the only natural spawning ground of the beluga sturgeon, a creature that can grow up to 4 meters, weigh 2.5 tons and live more than a century. Its adaptability allowed it to prosper for 300 million years, but eventually a fatal flaw emerged: Its roe, the king of caviar, is so tasty that today it retails for \$3,000 per kilogram in the West -- and \$200 per kilogram in Moscow, almost all of it caught illegally.⁶¹

In June, 2001, *the UN Convention on International Trade in Endangered Species (CITES)* issued a moratorium for Russia, Kazakhstan, Turkmenistan and Azerbaijan -- the four main producers of world caviar -- to halt sturgeon fishing or face a ban on their exports of caviar. The CITES, however, exempted Iran, citing its effective conservation and policing of its fisheries. The extraction of caviar in the Caspian Sea has dropped to 145 tons in 2002 down from 3,000 tons in 1985 because of irregular poaching.⁶²

Local efforts are now being directed by the Caspian states toward environmental protection. International efforts, on the other hand, are being spearheaded by the United

⁶¹ Christopher Pala, "Environmentalists Claim Victory in Caviar Clash ." *The Moscow Times*, November 04, 2002

⁶² "Over 90% of Caspian sturgeon going extinct." October 27, 2002, *IranMania.com*

Nations Environment Program (UNEP), with assistance from the United Nations Development Program (UNDP) and the World Bank. Together these institutions have launched a Caspian initiative to coordinate the preservation of the Caspian's ecosystems at both a technical and legal level.⁶³ However, given the reluctance to commit substantial funds to solve these and similar environmental problems on the side of Caspian governments and international oil companies, these initiatives are far from creating tangible solutions.

The general ecological health is already beyond recovery throughout the region. In addition to the rising sea level and the flooding of coastal areas, the problem of the increasing saturation and greasiness of the soil further worsens the conditions. Because of rising pollution, disturbances caused by the hasty exploration of the coastal shelf and the development of offshore oilfields, various forms of aquatic life face the threat of extinction in the Caspian. Moreover, because of the concentration of hydrocarbon waste, which is three times higher than the permitted norm as a result of the development work on the Azeri, Chirag and Guneshli oil fields, the Azerbaijani coastline is now declared unsafe for humans.

This large-scale environmental and ecological damage underlines the need for international cooperation and some kind of an authority to enforce compliance with appropriate environmental norms in the Caspian Basin. However, as the negotiations on legal issues surrounding the Caspian Sea are intermingled with the resolution of environmental concerns, the ongoing dispute over access to resources presents a major obstacle to the effective management of such problems, particularly at the regional level.

⁶³ "Pollution Hits Caspian Fisheries" *UNESCO Courier*, Jul97, Vol. 50 Issue 7/8, p83

Both Iran and Russia oppose the construction of trans-Caspian pipelines and they objected to oil and gas development projects in the Caspian on environmental grounds. Following the agreement to divide the northern Caspian between Kazakhstan and Russia in July 1998, Russia called for uniform environmental requirements to be applied in the northern Caspian.⁶⁴ The accusations that both Iran and Russia are using environmental issues to block other countries' exploitation of the Caspian, however, complicate matters. In particular, the fact that Russia is still by far the largest polluter of the Caspian Sea and that its favored regime for environmental protection, which is the joint control of the sea, would also yield Russia a greater proportion of oil reserves, undermines its sincerity.

The issue of the Turkish Straits

Environmental questions surrounding the Turkish Straits⁶⁵ in particular and the Black Sea in general have also begun to weigh heavily in the choice of export routes for Caspian oil. The ports of the Black Sea, along with those in the Baltic Sea, were the primary oil export routes for the former Soviet Union, and the Black Sea remains the largest outlet for Russian oil exports. In the year 2000, a total of 77.5 million tons of crude oil and its products sailed through the Turkish Straits in both directions, 60 million of which was Russian oil alone.⁶⁶ However, the new figures for the year 2001 and 2002 were announced as 116 and

⁶⁴ *Economist*, 02/07/98, Vol. 346 Issue 8054; 06/03/2000, Vol. 355 Issue 8173; 05/12/2001, Vol. 359 Issue 8221.

⁶⁵ The Turkish Straits, comprising the Straits of Çanakkale (Dardanelles), the Sea of Marmara and the Istanbul (Bosporus) Straits, are unique in many respects. The very narrow and winding shape of the Straits is more akin to that of a river. It is an established fact that the Turkish Straits are one of the most hazardous, crowded, difficult and potentially dangerous waterways in the world for mariners. All the dangers and obstacles characteristic of narrow waterways are present and acute in this critical sea lane.

⁶⁶ CERA Transportation Forum discussion paper on *Black Sea Exports and the Bosporus Question* by Laurent Ruseckas and Thane Gustafson, CERA Week, February 15, 2001.

118 million of tons per annum (mta) ⁶⁷ which represent an enormous increase from the previous years. Exports through the Bosphorus have grown since the break-up of the Soviet Union in 1991 (see the Table 4.8. below), and there is increasing concern that projected Caspian Sea export volumes will exceed the ability of the Bosphorus to accommodate tanker traffic. To resolve the anticipated problems in the Bosphorus, Turkey declared new navigational rules in November 1998 and plans to install a new radar and navigation system to improve safety and operations in the Turkish Straits. However, these precautions would not be sufficient to protect the environment and provide for navigational safety through the Bosphorus in view of the expected increase in tanker traffic. For this reason, the only way to avoid further congestion and environmentally hazardous accidents in the area would be the development of alternative export routes that bypass the Straits. The Turkey's Ministry of Foreign Affairs has warned repeatedly that Turkey will not allow the Bosphorus to turn into some kind of an oil pipeline. In the year 2001, nearly 50,000 ships, including 6,000 tankers, passed through the 33.4-kilometer (21-mile) waterway, which is only about 700 meters (half a mile) wide at its narrowest. The Turkish Straits are the entrance and exit to the Black Sea and the sole sea outlet for Bulgaria, Romania, Georgia, Ukraine and southern Russia.

Because of the density of the traffic and other navigational risk factors peculiar to the Turkish Straits⁶⁸, accidents are not uncommon (please refer to the Table 4.7. below). In

⁶⁷ Laurent Ruseckas's presentation during CERA Week 2003 (10-14 February 2003) on February 12, 2003.

⁶⁸

- The Turkish Straits have unique physical hydrological and oceanographic characteristic and complicated navigational conditions prevail in the area.
- The Strait of Istanbul (Bosphorus) runs right across Istanbul, the largest city in Turkey with a population of 12 million. The Bosphorus Strait forms part of the port of Istanbul. It is included within the port limits.
- One of the legs of the two bridges in the Bosphorus is grounded in the waters of the Strait.

December 1999, a Russian-made tanker split in two at the mouth of the Bosphorus, spilling 235,000 gallons (893,000 liters) of fuel and blackening some 10 kilometers (six miles) of coastline. Many birds were soaked in sticky tar. The worst recent accident was in 1994 when an oil tanker and a cargo ship collided. Twenty-nine sailors died; the tanker burned for four days. In addition to installing a new radar system to improve safety, Turkey is also calling on ships to take aboard an experienced local pilot. Some 40 percent of the ships that cross the straits ignore that request and 85 % of all accidents are caused by ships that do not have Turkish pilots.⁶⁹

A recent study by BP-AMOCO displays the fact that no matter what measures are taken by the Turkish government to ensure safer navigation, major tanker accidents, on average of every two years, in the Turkish straits are inevitable.⁷⁰ This study has also been confirmed by the U.S. State Department.⁷¹

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- Bosphorus is approximately 31 km long, with an average width of 1.5 km. It is only 700 m wide at its narrowest. Bosphorus takes several sharp turns. The ships are bound to alter course at least 12 times at these bends. At the narrowest point, Kandilli (700 m), a 45' course alteration is required. The current can reach 7-8 knots at this point. At Yeniköy, the necessary course alteration is 80'.
 - At the turns (Kandilli and Yeniköy) where significant course alterations have to be made, the rear and forward sights are totally blocked prior to and during the course alteration. The ships approaching from the opposite direction cannot be seen round the bends.
 - The Sea Marmara is approximately 225 km long.
 - The length of the Straits of Çanakkale (Dardanelles) is about 70 km, with a general width ranging from 1.3 km to 2 km. A very sharp course alteration is needed at the narrowest point.
 - The ships in transit in the Turkish Straits must pass through 325 km of waters under the sovereignty and jurisdiction of Turkey. Overall transit time is about 16 hours.
 - Furthermore, strong currents and counter-currents (reaching 5 to 8 knots), constant change in their pattern, poor visibility due to thick fog, snow and rain are additional hazards in these narrow waterways.

⁶⁹ www.turkishpilots.org, www.mfa.gov.tr

⁷⁰ The BP Magazine, Issue One, 2002.

⁷¹ David L. Goldwyn, *Testimony before the Subcommittee on International Economic Policy, Export and Trade Promotion, Senate Committee on Foreign Relations*, April 12, 2000 & Ralph Alexander, BP Amoco's Group

Table 4.7. Foreign Merchant Vessels Operating or Transiting Through the Straits & Accidents

	Total passages	Monthly Average	Daily Average	Tanker Passages	Monthly Average	Daily Average	Total Accidents
1995	46954	3912	128	-	-	-	4
1997	50942	4245	142	4303	359	12	7
1998	49304	4109	137	5142	429	14	11
1999	47906	3992	133	4452	371	12	16
2000	48079	4007	134	4937	411	14	-
2001*	49000	-	-	6000	-	-	29

Source: Turkish Maritime Pilots Association www.turkishpilots.org

* Turkish Ministry of Foreign Affairs figures www.mfa.gov.tr

While evaluating these figures, one has to keep in mind that, hydrocarbon resource exports via Turkish Straits increased significantly as the new Caspian Pipeline Consortium (CPC) pipeline and Supsa (Georgia) terminals started to operate. In addition to aforementioned fact, the trend will be away from the smaller tankers that carry much of today's exports to larger, more efficient tankers with capacity of 100,000 to 120,000 tons (the largest that attempt the passage). Tankers of this size have their own type of complications-increased environmental damage risk and the need to halt all other Bosphorus traffic while these large tankers make their passage.⁷²

Vice President, *Testimony before the Subcommittee on International Economic Policy, Export and Trade Promotion, Senate Committee on Foreign Relations*, April 12, 2000.

⁷² In fact, the current Turkish regulations regarding the passage through Bosphorus call for such measures.

Table 4.8. Total crude oil transit through the Turkish Straits (in both directions) in view of the scheduled completion of the BTC pipeline. (mta-millions of tons per annum)

	Total transit	Fast BTC Scenario*	Average Annual Increase*	Slow BTC Scenario*	Average Annual Increase*
1998	65 mta				
1999	69 mta				
2000	77.5 mta				
2001	116 mta				
2002	118 mta				
2005		89 mta	2.1 %	102.5 mta	2.4 %
2010		95 mta		98 mta	

Source: Cambridge Energy Research Associates

Note: BTC refers to the Baku-Tbilisi-Ceyhan pipeline project. All figures in millions of tones annually.

Fast BTC scenario: Baku-Tbilisi-Ceyhan pipeline is completed and begins operation in 2005.

Slow BTC scenario: Baku-Tbilisi-Ceyhan pipeline is completed and begins operation in 2007.

* These figures are from CERA Transportation forum discussion paper on *Black Sea Exports and the Bosphorus Question* by Laurent Ruseckas and Thane Gustafson, CERA Week, February 15, 2001. However, during the 2003 CERA week meetings (February 10-14, 2003) on February 12, 2003 the very same co-author of the above study Laurent Ruseckas, was announcing the new figures for the year 2001 and 2002 as 116 and 118 mta. The increase was dramatic and clearly surpasses the author's original expectations for even the year 2005. One of the reasons for this dramatic increase is due to the completion of the CPC pipeline in 2001 by ChevronTexaco, which brings Kazakhstan's Tengiz field oil to Novorossiysk through Russian territory.

Between 1990-1994, 168 accidents were recorded at the Turkish Straits, 49 in 1991 alone.⁷³ Because of the increasing environmental risks, without exception, all the Turkish governments established after the end of the Cold War have argued that increased tanker traffic through the Bosphorus would present an unacceptable ecological risk to the large and growing urban sprawl of Istanbul, a city of 12 million inhabitants and priceless historical monuments and artifacts from Roman, Byzantine and Ottoman Empire eras.

⁷³ The average annual rate of accidents has increased 35 percent since 1988. What is at stake is the physical and environmental security of Istanbul. Any shipping calamity involving fire, explosion, toxic or nuclear material could endanger the health and lives of millions of people. (Temel Iskit, "A New Actor in the Field of Energy Politics", *Perceptions*, Vol.1, No.1, March-May 1996, p.65).

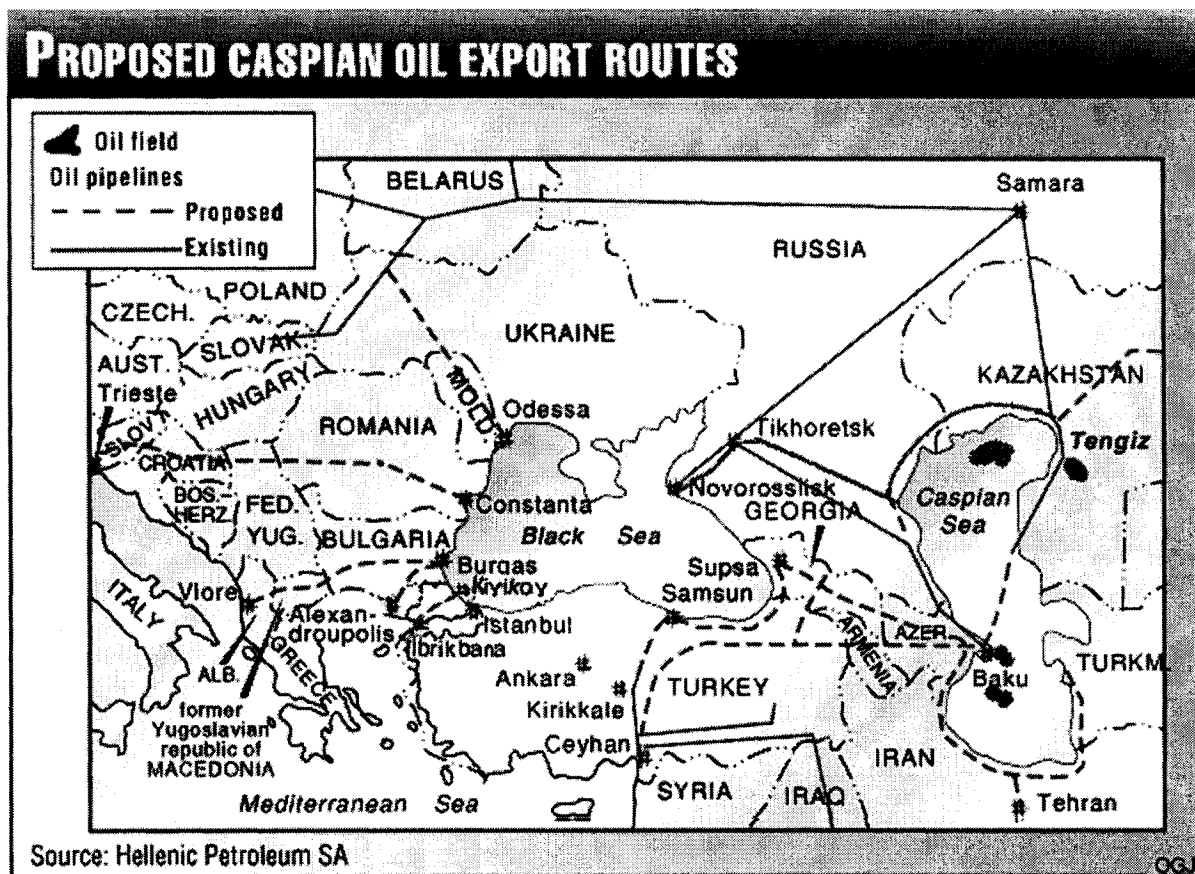
The *Montreux Convention of 1936*, which governs the use of the Turkish straits, provides for the unrestricted passage of commercial ships in peacetime.⁷⁴ But, as the country responsible for implementing the convention, Turkey has been regulating this traffic on grounds of safety. For example, it has on occasion closed the straits to other traffic to allow extra-large ships to pass through. Even if *the Montreux Convention* prevents a ban, Turkey apparently can make ships wait until the passage is clear, thus raising the cost of transport by tanker to an uneconomic level. A collision or an environmental disaster may force the closure of the Straits for unpredictable periods. This *force majeure* situation will have the practical effect of denying, impairing and impeding the exercise of the right of navigation as well as increasing the transportation costs.

One way of reducing dependence on the straits would be to build terminals on the northern coast of Turkish Thrace (or in Bulgaria) and then pipe the oil to terminals on the Aegean coast of Greece or Turkey.⁷⁵ The Burgas-Alexandroupolis pipeline project then called for a 350-km, \$670 million line from the Bulgarian port of Burgas to the Greek Aegean Sea port of Alexandroupolis (see the map below showing the existing and proposed pipelines originating from the Caspian region). Russian oil could then be sent across the Black Sea by tanker from Novorossiysk to Burgas, then make the rest of the journey to western markets, bypassing the Turkish Straits tanker route (Figure 4.3.).

⁷⁴Under *Article 2 of the Montreux Convention*, Turkey is obliged to allow free passage to merchant ships of all nations in peacetime. See H. N. Howard, *Turkey, the Straits and US Policy* (Baltimore: Johns Hopkins University Press, 1974), pp.292-99.

⁷⁵Russia has already taken initiative by signing a protocol with Bulgaria and Greece concerning a building of a 350 km long pipeline from Burgas, Black Sea coastal city of Bulgaria, to Alexandroupolis, Aegean coastal city of Greece, in September 1994. Russia's aim was obvious: to decrease the strategic importance of the Turkish straits. However, it later became clear that nothing has come from this project. OGI, Nov. 6, 1995, p. 25

Figure 4.3. Map of the Proposed Caspian Oil Export Routes as of December 2002.



The pipeline would be short and therefore comparatively cheap to build. But transferring the oil twice—from ship to pipeline and then back again—would add to transport costs. The same objection would apply if the sea/land route were shifted further east and if oil were moved by tanker across the Black Sea from the Russian port of Novorossiysk to the Turkish port of Samsun, and then by a new pipeline to the existing Turkish oil terminal at Yumurtalik on the Mediterranean. The alternative Turkey prefers is the so-called “*East-West Energy Corridor*,” a route running from Central Asia across the Caspian Sea to Azerbaijan

and then through Georgia to Turkey and the West.⁷⁶ More specifically, this is the Baku-Tbilisi-Ceyhan (BTC) main oil pipeline, which will be discussed at greater length in later chapters. The Turkish government always made it clear that its support for East-West Energy Corridor was linked to the realization ultimately of the BTC pipeline.

G. ISSUE OF THE LEGAL STATUS OF THE CASPIAN SEA

During the Soviet period, most of the Caspian Sea coastline, apart from a small Iranian portion in the south, belonged to the Soviet Union. The collapse of the Soviet Union, however, brought about five states sharing the coastline and claiming jurisdiction over parts of the Sea. Although it is not difficult to see the urgent need for an explicit definition of the legal status of Caspian, the ongoing discussion among the littoral states has tended to dwell on the definition of the Caspian as a sea or a lake, while the real problem appears to be one of sharing the profit.

In general, the choices regarding the status of the Caspian Sea under international law is between common ownership of the Caspian, thus subject to the joint sovereignty of all the littoral states, and delimitation based on some sort of formula to be agreed on. However, there is no historical precedent that can illuminate a solution to the Caspian's status. There is, of course, the fact of an exclusive Russian naval and military presence for about 200 years and the signing of a number of treaties between Russia/Soviet Union and Persia/Iran concerning freedom of navigation, maritime activity and trade in the Caspian Sea. Russia has

⁷⁶ The East-West Energy Corridor concept is mainly based on the construction of trans-Caspian and trans-Caucasian oil and gas pipelines traversing Georgia and ending in Turkey. The East-West Energy Corridor essentially aims at transporting the Caucasian and Central Asian energy resources to the Western markets through safe and alternative routes. The corridor mainly comprises the Baku-Tbilisi-Ceyhan (BTC) Crude Oil Pipeline, South Caucasian Natural Gas Pipeline (Baku-Tbilisi-Erzurum Natural Gas Pipeline) and Turkmenistan-Turkey-Europe Gas Pipeline projects and has strong support of the U.S., Turkish and Azeri governments. E.U. also supports the corridor policy.

been quick to use the 1921 and 1940 treaties to make its point, especially with Azerbaijan and Kazakhstan, that the Caspian is an object of common use by the littoral states on an equal basis. Azerbaijan, in particular, has increasingly emphasized that these treaties are not applicable to the present-day problem of defining the status of the Caspian, because they only applied to navigation and fishing, leaving the problem of the exploitation of mineral resources on and under the seabed out of their scope. Besides, these treaties were accepted when there were only two littoral states. The emergence of new states, at least, throws the validity of these treaties into question.

According to Russia's original position on the status of the Caspian, which Iran and Turkmenistan supported, the Law of Sea could not apply to the Caspian, since it has no natural connection with other seas. Russia argued that it was an inland lake and should be governed as such and that joint utilization was the only way forward. Further, the Russians argued, the legal regime of the Caspian could not be changed unilaterally. They also advocated 20-mile territorial waters plus an additional 20-mile *exclusive economic zone*, with common ownership of the central area of the Caspian. Russian claims were based on the argument that both the 1921 and 1940 treaties and the Almaty Declaration of 21 December 1991 require the littoral states to respect the present status of the Caspian. This Russian position was delivered to the United Nations on October 5, 1994 with a most forceful accompanying note stating, "Unilateral action in respect of the Caspian Sea is unlawful and will not be recognized by the Russian Federation, which reserves the right to take such measures as it deems necessary and whenever it deems appropriate to restore the legal order and overcome the consequences of unilateral actions." (Aydın 2000; 48-56)

This was in accordance with earlier recommendations of the Russian Institute of Defense Studies' report on "Countering Major Threats to the Security of the Russian Federation", which, among other things, called for, "The use of force in order to stop any activity of foreign companies in the former Soviet part of the Caspian until its legal status is defined." In November 1996, however, Russia declared that, as a compromise, it was ready to recognize a 45-mile "off-shore economic zone for each country" and "the littoral states jurisdiction over the oil fields whose development has already started or is about to start." This apparent "softening" in the Russian position was mainly due to the realization that "it cannot stop the division of the sea. [...] The only question [was] how the division will now be formalized *de jure*." Even then, the navigation rights, management of fisheries and environmental protection would be jointly exercised and an interstate committee of all boundary states would to license exploration in a joint-use zone in the centre of the Caspian beyond a 45-mile exclusive national zone. Moreover, the Russian proposal suggested giving littoral states first claim in any future oil and gas contracts.⁷⁷

Russia's position regarding the legal status of the Caspian has further wavered with the passage of time and there have been conflicting signals from different government agencies. Notably, the position of the Russian Foreign Ministry contradicts the position of the Russian Ministry of Fuel and Energy, which supports the signing of contracts in which the Russian oil companies are participating. Considering Russia the regional superpower and the Caspian Sea a "Russian lake", and alarmed by the projects to circumvent Russia in energy transportation from the region, the Russian Foreign Ministry has worked for a legal status

⁷⁷ *Economist*, 02/07/98, Vol. 346 Issue 8054; "Central Asia Survey" *Economist*, 03/07/98, Vol. 346 Issue 8058, p5,66.

that would assure Russia's veto on any Caspian development projects, thereby ensuring that they could only be developed with Russian participation and under Russian control. Apparently, "expanding Russia's influence in the area of energy production" and transportation was seen as an important tool for re-establishing Russia's predominant role in the "*Near Abroad*." In 1997, however, despite the Russian Foreign Ministry's continuing condemnation of the "unilateral seizure of oil and gas fields", the Ministry of Fuels and Energy announced a tender for the exploration of the shelf in the northern section of the Caspian Sea. The international community interpreted this as Russian acceptance of the sectoral division. In the same way, while President Yeltsin warned in February 1998 that his country would not tolerate its neighbors attempts with the support of Western companies to marginalize Russia in the Caspian and to impose an unfavorable partition into sectors, experts from Russia were discussing with their counterparts from Kazakhstan the division of the Kazakh-Russian part of the Caspian seabed on the median line principle.⁷⁸ Later, an agreement for the northern part of the Caspian Sea stipulating the median line principle for the seabed but preserving joint ownership of the water surface was signed between the two countries during President Yeltsin's official visit to Kazakhstan in July 1998.⁷⁹

However, the parliaments of neither country have ratified this agreement. The signing of this agreement signaled a change in the Russian Foreign Ministry's position regarding ways to control the Caspian Sea. The catch with the Kazakh-Russian agreement was that by

⁷⁸ The median line principle refers to a geographic median line dividing bordering areas of the Caspian Seas' floor between the littoral states, which is to be drawn on the basis of equal distance from the original reference points onshore and on islands (determined through negotiations), to enable these countries to exercise their sovereign rights to economic activity related to the use of sea bottom resources. However, according to the specialists, there are from 14 to 16 forms and definitions of the median line. The whole matter and the dispute is namely about which to be chosen. BBC Monitoring Central Asia Unit, June 24, 2003.

⁷⁹ *Current Digest of the Post Soviet Press*, August 30, 2000, Vol. 52 Issue 31, p21, 2p

putting the water and sea surface under common ownership, it gave a say, in fact a veto, to Russia on any project to build pipelines across the Caspian. Moreover, this kind of agreement, if accepted by all the littoral states, would give Russia free navigating rights in the Caspian, raising fears of an increased Russian naval presence. Later in 2000 and in 2001, however, following the new discovery at Kashagan oil field in the Caspian Sea, Kazakhstan reopened the negotiations. Finally on May 13, 2002, Russia and Kazakhstan agreed on a joint boundary dividing their interests in the northern Caspian Sea according to a modified median line principle.⁸⁰ As part of the deal, the two countries agreed to equally develop petroleum reserves, in areas previously disputed, in *Kurmangazi*, *Tsentralniye*, and *Khvalinskoye* fields.⁸¹

In contrast to the original Russian position, the Azeri position was described as the "border lake" concept, which basically refers to the national sectors established by dividing the sea evenly (by central median line) among the five littoral states and the extension of international borders into the Caspian. Accordingly, each littoral state in its own sector would have exclusive sovereignty over biological resources, water surface, navigation and exploitation of the seabed. At times, it has also aired the "open sea" concept for the Caspian Sea with 12-mile territorial waters and adjoining exclusive economic zones (EEZ) not exceeding 200 miles, in agreement with a median line principle.⁸² Kazakhstan generally

⁸⁰ The modified median line principle, refers to modifications made over the geographical median line principle on the basis of negotiated geographical coordinates to divide neighboring sections of the seabed between the littoral states. This principle helps to better address interests of individual countries by increasing the resource development potential of the national sectors, as compared to an option to delimit the floor along the geographical line.

⁸¹ Editorial. *Oil & Gas Journal*, May 15, 2002.

⁸² Azerbaijan has claimed that the 1982 United Nations (UN) Convention on the Law of the Sea should be applied to the Caspian. Given its provisions, a compelling case can be made for the Azeri argument that the

supports Azerbaijan's position, though with a variation regarding the exclusive economic zones formed by a central line equidistant from points on coastline. Accordingly, Azerbaijan and Kazakhstan in a unilateral manner have already divided the Caspian to suit to their own designs, though Iran, Russia and Turkmenistan object to such moves.

Negotiations between the Russian Federation and Azerbaijan in 1999-2000 have indicated that, perhaps as a result of pressure from the Russian oil company Lukoil, there was a possibility that Russia's stance on common ownership might become less rigid, moving towards the Azeri "border lake" concept, even though the joint operation of an exploitation project in the central part of the Caspian is still, in essence, a projection of the common usage approach⁸³ (Figure 4.4.). The Russian approach to Azerbaijan has been further modified following the negotiations, and, on 23 September 2002, the two countries signed the Caspian Delimitation Agreement. Together with the Kazakh-Russian accord on delimitation, this agreement creates the conditions to attract new investment into the region.⁸⁴

Although Turkmenistan had earlier supported the Russia's Caspian position, its stance has remained ambiguous since February 1997, when Turkmenistan's President, Saparmurad Niyazov, announced that the Azeri and Chirag oil deposits, which Azerbaijan had exploited

Caspian falls under the jurisdiction of the Law of the Sea and can be divided accordingly. Some relevant provisions of the convention are:

- States are entitled to claim up to 12 nautical miles (NM) of sovereign territorial sea, between 200 and 350 NM of continental shelf depending on the configuration of the continental margin, and a 200 NM Exclusive Economic Zone (EEZ)
- Where claim to continental shelf and EEZ overlap (as in the Caspian Sea), it requires that : "The delimitation of the continental shelf... shall be effected by agreement on the basis of international law...in order to achieve an equitable solution (emphasis added)." (Croissant & Aras, 2000; 25)

⁸³ Also known as condominium model, it refers to the principle of joint and equal development of key oil and gas fields as well as common usage of fisheries and surface of the body of water located in the common usage area beyond 45 miles of national economic zones.

⁸⁴ *Rigzonenews.com*. September 24, 2002; *Turkish Daily News*, September 24, 2002.

unilaterally, were on Turkmenistan's territory. A fierce disagreement between the two countries ensued and, since then, Turkmenistan has claimed full rights to the Azeri and Kyapaz/Serdar oil deposits and partial rights to the Chirag oil deposits. However, the lack of Russian support for Turkmenistan has led the latter to search for a deal with Azerbaijan. Azerbaijan and Turkmenistan issued a statement in February 1998 to the effect that both countries agreed that the Caspian Sea area between them would be divided along the median line, but disagreements over where to draw that line continue. If a de facto deal is finally agreed between Azerbaijan and Turkmenistan, the implementation of the sectoral principle of delimitation of national jurisdiction in the Caspian Sea would become almost inevitable, and this will leave no room for any "condominium" arrangement (Figure 4.4.). In fact, in October 1998, President Niyazov agreed publicly to a division of the Caspian into national sectors, although no specific proposals were given and no further development has taken place.⁸⁵ (Figure 4.5.)

In 2001 and 2002 Russia, Kazakhstan and Azerbaijan advocate bilateral agreements among littoral states to divide Caspian exploration rights along a modified median line principle which would give countries with long shorelines broader claims. Iran, which has a relatively short shoreline, insists on dividing exploration rights equally, and Turkmenistan has provisionally sided with Iran. When Aliyev signed the border agreement with Putin, three of the five littoral states officially endorsed Russia's proposal. Putin described the deal as a vindication of Russia's idea "to share the seabed but not the water itself." Under the modified

⁸⁵ "Central Asia Survey," *Economist*, 02/07/98, Vol. 346 Issue 8054, p5.

median line approach, Azerbaijan would control access to 4 billion tons of reserves, twice Russia's allotment and more than four times Iran's share.⁸⁶ (Please refer to Figure 4.5.)

Another round of Caspian Sea talks took place in May 12-14, 2003 in the Kazakhstani city of Almaty, involving officials from Azerbaijan, Iran, the host country, Turkmenistan and Russia. During this round of negotiations, the main stumbling block remained to be the division of the Caspian's surface and seabed. Iran has insisted that the sea be divided into equal 20 percent shares, while Azerbaijan, Kazakhstan and Russia supported a median-line principle that would leave the five countries with differing shares. Under the Azeri-Kazakhstani-Russian proposal, Iran would receive only a 13 percent share of the Caspian. Turkmenistan, again, has staked out an independent and somewhat unpredictable position on the negotiations.

Following the Caspian Sea talks, officials from Azerbaijan, Kazakhstan and Russia signed an agreement demarcating the seabed. Kazakhstan received a 29 percent share, while Russia and Azerbaijan each obtained about a 19 percent share. The three states expressed the hope that the trilateral seabed pact could set a precedent for the ultimate resolution of the Caspian Sea treaty.⁸⁷

For obvious reasons, Iran continues to insist on a condominium solution, protesting against plans to construct underwater pipelines across the Caspian, favoring the transportation of oil by the existing pipelines through Iranian and Russian territory.

⁸⁶ www.eurasianet.org 26 September 2002

⁸⁷ Sergei Blagov "Caspian States Make Progress on Accord, But Territorial Differences Remain" May 15, 2003 www.eurasianet.org

Nevertheless, Iran could accept a sectoral principle of Caspian Sea division if its interests are taken into account, primarily in the Azerbaijan-Turkmenistan negotiations concerning the partition of the southern Caspian. Indeed, it has already softened towards Azerbaijan after the latter awarded exploration rights in Shah-Deniz to Iran. Nevertheless, the Iranian Foreign Minister, Kamal Kharrazi, reiterated the traditional view that Iran would agree to the sectoral partition of the Caspian only if it was divided into "equal shares". Iran maintained this view in May 2003 round of talks in Kazakhstan, too.

Behind all these controversies lies the fact that the yields from exploitation rights for individual states would differ greatly depending on the status of the Caspian. Were the Caspian to be divided among the littoral states, Azerbaijan and Kazakhstan would have the largest share of proven oil deposits and exploitation rights and, in particular, under the "border lake" concept, they would obtain more than twice the amount that Russia would enjoy under the same concept of allocation (See Figure 4.5.). Under the "enclosed sea" concept, however, the gap is somewhat reduced and under the Russian 45-mile proposal, most Azeri offshore oil would be transferred to collective ownership (Figure 4.4.).

Figure 4.4. Map of the alternative models for sharing oil and gas (Model 1: Condominium)



Figure 4.5. Map of the alternative models for sharing oil and gas (Model 2: Sectoral division based on median line principle)



Source: "Central Asia Survey," *Economist*, 02/07/98, Vol. 346 Issue 8054, p5.

If Russia succeeds in her condominium approach, which is unlikely because of the developments in 2001 and 2002, then it would also negatively affect the political independence of the other former Soviet countries. If applied, the condominium approach would definitely strengthen the dominant regional actor: Russia, giving it a veto power to undercut all the independent international investment that would enable these countries to break free from Russian political and economic pressures. Russia's Prime Minister, Victor Chernomyrdin stated in May 1996 that Western oil companies pose a security threat to the CIS because they seek to control the region's strategic resources, that gave credence to the argument that Russia is attempting to use the discussion over the legal status of the Caspian to keep regional countries under its control, that it sees the region as within its security zone and attempts to break from Russian dominance as threats to its security.

Other littoral states, however, are eager to realize their potential wealth from the Caspian in order to stabilize their shaky economies and domestic politics, as well as enabling them to distance themselves from the Russian sphere of influence, an endeavor that the United States supports.

The United States continues to strongly object to the condominium approach since it would give Iran and Russia too much power in the region. Given that the significant numbers of oil companies operating in the region are American and that, because of the Iran-Libya Sanctions Act of 1996, they would be blocked from participating in any project for Caspian development if it involves Iran, the views of the United States government assume greater importance. It is obvious that any Caspian compromise will require the agreement of five littoral states and at least half a dozen other regional players with conflicting political and

economic goals. In the absence of an agreement, however, a worst-case scenario might even include the possibility of a military confrontation between rival states.⁸⁸

An agreement on the Caspian's status is urgently needed to avoid a miscalculation that could lead to serious confrontation. In the absence of an agreement on status, which would also assist in the preservation of the Caspian ecosystem, the continuing dispute about oil extraction rights will simply drag on with the possibility of new complications emerging over time.

⁸⁸ State Department Press Release, October 1, 2002

CHAPTER FIVE

This chapter will introduce and discuss extensively the actors that are considered to have stakes in energy resource development of the Caspian region. As it was declared in the preface of this dissertation, these actors are: Russia, Iran, Turkey, United States, Companies, Azerbaijan, Kazakhstan, Turkmenistan, European Union, and China. For analytical purposes, I will divide the chapter into two parts. The first part will include discussion about Russia, Iran and Turkey, as they are widely considered to be the three major actors in terms of providing alternative routes to export Caspian oil and natural gas. The second part will discuss other actors considered (by the literature about the region and area experts) to be effective in energy resource development of the region; namely the United States, oil and gas companies, countries of the region who have the hydrocarbon resources - Azerbaijan, Kazakhstan, Turkmenistan, and the European Union and China. The question of relevancy of the considerations and perceptions about the actors will be answered in chapter seven by the empirical data gathered through interviews with area experts.

This chapter will also have a discussion on each actor's perceived interests and declared policy objectives toward the hydrocarbon resources of the region. Since I will base my model of prediction on area experts' judgmental scores on each actor's saliency and resources, it would be instrumental to discuss each actor's assets as well as problems and limitations in more detail.

PART I.

THREE MAJOR ACTORS IN TERMS OF PROVIDING ALTERNATIVE ROUTES TO EXPORT CASPIAN OIL AND NATURAL GAS

1. Russia

Russia has had a long and important role in the Caspian Basin. It remains an important influence in the area as the largest trading partner for each nation, as a littoral state of the Caspian Sea, and the principal current transportation channel for oil and gas out of the region. Therefore, discussions of Caspian energy should not underestimate the role of Russia.

Russian energy policy toward the Caspian basin

Until the opening of an “early oil” pipeline from Baku, Azerbaijan to Supsa, Georgia in April 1999, Russia provided the only pipeline transportation (Baku-Novorossiysk pipeline) and most of the rail transportation from the region. Kazakhstan and Turkmenistan currently ship oil through Russia, and with the completion of the Chechen by-pass pipeline, Azerbaijan resumed oil shipments through Russia in the second half of 2000. Moreover, by the end of 2001, Kazakh oil exports from the Tengiz oilfield have begun flowing through the Caspian Pipeline Consortium (CPC) pipeline to the Russian Black Sea port of Novorossiysk.⁸⁹

⁸⁹ In May 1997, the Caspian Pipeline Consortium-CPC-including Chevron, Kazakhstan and Russia--agreed to build a 990 mile new pipeline from Tengiz oil field in Kazakhstan to Russian's Black Sea port of Novorossiysk by late 2001. The project partners of the CPC pipeline (also known as “Tengiz-Novorossiysk Oil Pipeline”) are as follows: Russia 24%; Kazakhstan 19%; ChevronTexaco (U.S.) 15%; LukArco (Russia/U.S.) 12.5%; Rosneft-Shell (Russia-U.K./Netherlands) 7.5%; ExxonMobil (U.S.) 7.5%; Oman 7%; Agip (Italy) 2%; BG (U.K.) 2%; Kazakh Pipelines (Kazakhstan) 1.75%; Oryx (U.S.) 1.75%. Phase I capacity of the pipeline is expected to reach 565,000 b/d in 2007 with \$2.6 billion investment. Phase II capacity is expected to be 1.34 million b/d by 2015. Projected investment for the second phase is \$4.2 billion. First tanker loaded in Novorossiysk in October 2001, exports reached 240,000 b/d in April 2002 and volumes rised to 400,000 b/d by the end of 2002. <http://www.eia.doe.gov/cabs/kazakh.html>

For its part, Russia continues to develop its own oil fields and expand its existing pipeline system in the Caspian region. Lukoil, for example, has begun to develop the Severnyy oil field in the Caspian Sea. Meanwhile, in an effort to maintain Russian dominance over Caspian energy transportation, the state-owned Transneft, the world's largest pipeline network operator, has built a line from the Dagestani port of Makhachkala, as well as additional stretches of pipeline in a bypass around Chechnya.

June 2002 marked a potentially decisive win for the Russian strategy in the Caspian. On June 5, Presidents Vladimir Putin of Russia and Nursultan Nazarbaev of Kazakhstan signed a wide-ranging set of agreements that ensure Russian dominance on the transit of oil from Kazakhstan for the near future. The accompanying agreements, moreover, set the stage for a similar Russian move on Kazakhstan's gas.

One of the agreements guarantees that 15 million tons of Kazakhstani oil will be pumped through the Atyrau (Kazakhstan)-Samara (Russia) pipeline each year from late 2003 on, for fifteen years. Another will send 2.5 million tons of Kazakhstani oil annually, also for fifteen years, by tankers to Russia's Caspian port of Makhachkala, then to be pumped into the pipeline via Tikhoretsk to Novorossiysk on Russia's Black Sea coast.⁹⁰

Novorossiysk is already slated to receive 28 million tons of Kazakhstan's oil through the CPC pipeline, which was built by a consortium led by ChevronTexaco and commissioned in 2001, and is due to operate at that capacity from 2005 on. Thus, in total, approximately 45 million tons of Kazakh export oil is already committed to Russian export routes. Such a

⁹⁰ Vladimir Socor, *Russia and Eurasia Review*, Volume 1, Issue 3, July 2, 2002

commitment almost matches Kazakhstan's annual oil exports, which stood at some 47.2 million tons in 2002.⁹¹

By comparison, Kazakhstan's oil exports in other directions amount to around 3 million tons in 2002. Those directions--by sea and rail to Batumi, Georgia, and by sea to northern Iran--have little or no chance of rivaling those transiting Russia.

In short, Russian strategy is quite effective in Kazakhstan. A prime example is Kazakhstan's promising Kurmangazy offshore oilfield. Under agreements dividing the northern Caspian seabed, which Putin and Nazarbaev signed in May of 2002, Kurmangazy was assigned to Kazakhstan's jurisdiction, but is to be developed "jointly" by Kazakhstan and Russia on a parity basis. Its projected output is already slated to be pumped through the CPC pipeline to Novorossiisk. Work is also underway to connect the onshore Karachaganak field to the CPC pipeline.

Meanwhile, to accommodate the projected increases in the Caspian oil exports, Moscow has announced ambitious plans to increase the total capacity of its pipeline network around the Caspian. These plans are moving in three directions.

First, it envisages a massive increase in the CPC pipeline's capacity. The CPC announced plans to double the line's capacity to 56 million tons annually in a second stage, after 2010. However this prospect has stalled because of disagreements between the CPC operators and the Russian government over the investment timetable and taxation issues.

⁹¹ From the speech delivered by Kaigeldy Kabyldin, Managing Director of KazMunay Gas, Kazakhstan's main oil and gas company, during the CERA week conferences on February 12, 2003.

Secondly, besides tapping Western investors, Moscow plans to spend some of its own scarce funds for expanding the capacity of its internal pipeline network, so as to pump Kazakhstani oil through Russia's Baltic Pipeline System (BPS, in progress) to the Primorsk terminal, under construction at the Russian east end of the Baltic Sea. Despite objections from the Kazakh government, the Russian government expects Kazakhstan to share, in one form or another, the cost of this project.

The third move is to create an entirely new transport route for Caspian oil--from both Kazakhstan and Azerbaijan--in a westward direction from Novorossiysk. The plan is to have the oil shipped by tankers across the Black Sea to the Bulgarian port of Burgas, then by an overland pipeline to terminate at the Greek port of Alexandropolis on the Aegean Sea, and from there by tankers to the market. The Burgas-Alexandropolis pipeline project is an age-old Soviet idea, favored also by some Greek interests. It has been thwarted by insufficient resources and questionable economics. Moscow has recently resurrected this project with a new rationale: to divert some of the oil tanker traffic from the Turkish Straits.

In short, Moscow's goal is to concentrate Russian and Caspian oil and gas into a single pool for export under Russian physical control. If successful, it would gain leverage over European consumer countries and renewed predominance over Caspian countries.

Weaknesses and some limitations of the Russian energy policy

One weakness in the strategy lies in the fact that the Russian government continues to load supertankers with Caspian oil from Novorossiysk and ignores the danger these tankers poses to Turkey's biggest city, Istanbul. This poses unacceptable risks and hazards to other maritime traffic and to the huge city itself. Inevitably, Turkish authorities are taking

measures to limit tanker traffic through the Bosphorus. Such measures indirectly place a cap on oil tanker loadings at Novorossiysk itself. Moscow, however, wants to expand Novorossiysk's oil-loading role, because it is crucial to Russia's strategy to control Caspian oil flows. Recognizing that it cannot continue to dismiss the Turks' concerns over the Bosphorus, the Russian government is again promoting the Burgas-Alexandropolis pipeline, this time as a second outlet from Novorossiysk, bypassing the Turkish Straits. A second outlet would ensure that Novorossiysk absorbs ever-growing volumes of Caspian oil. However, Turkey can always develop her own bypassing project within her European territory (Turkish Thrace), which would be half the distance and, thus, cheaper than the Burgas-Alexandropolis pipeline. Although, the project would make a lot of sense from the economic point of view,⁹² a pipeline proposal (see Figure 4.3. on page 105) crossing over Turkish Thrace (connecting Kiyikoy on the Black Sea with the Ibrikbana on the Aegean coast) was rejected by the Turkish Government in 1998 on the grounds that it would turn the Bosphorus into a subsidiary of Russian Black Sea ports, and it could hinder the efforts to build

⁹² A 1998 study by Rice University's Baker Institute for Public Policy concluded that transportation of oil through a Baku-Ceyhan pipeline would be the most expensive way of getting oil to market, costing at least a dollar per barrel more than any of the other alternatives. The study estimated total cost of construction of a pipeline from Baku to Ceyhan at anywhere between \$3 billion and \$4 billion. At a capacity of 800,000 barrels a day, it would cost \$2.80 per barrel to ship oil from Baku via Ceyhan to ports in Italy, "The bottom line is clear: any Turkish pipeline is a bad deal for Azerbaijan and the oil companies and Baku-Ceyhan a very bad one," the study said, asserting that sellers could lose up to \$1 billion a year by opting for Baku-Ceyhan. By comparison, the study calculated that shipping oil from Baku to Supsa (Georgian port city on the Black Sea coast) and hooking up with an 800,000-barrel-a-day line that would bypass the Bosphorus and cross Thrace from Kiyikoy on the Black Sea to Ibrikbana on the Aegean would cost \$1.90 per barrel, or \$0.90 less than Baku-Ceyhan. "The advantage over Baku-Ceyhan, already significant, would be even greater were a larger Thracian pipeline built," the study said. "This would have the advantage of accommodating Russian as well as Azerbaijani exports." The study estimated that a pipeline with a capacity of 1.5 million barrels a day would increase the cost differential compared to Baku-Ceyhan to one dollar per barrel. "Unlocking the Assets: Energy and the Future of Central Asia and the Caucasus. A Political, Economic, and Cultural Analysis" James A. Baker III Institute for Public Policy, Rice University, April 1998, prepared in conjunction with an energy study sponsored by the Center for International Political Economy and the James A. Baker III Institute for Public Policy.

the BTC pipeline. Given the realization that the BTC, as a project, is far beyond being stopped, Turkey may want to re-consider this proposal if for no other reason than to simply to derail Burgas-Alexandropolis pipeline project.

The second weakness in this strategy is Azerbaijan. The Russian strategy has failed in Azerbaijan, where the anticipated oil output is already committed to the Baku-Tbilisi-Ceyhan pipeline project, which the United States and the region's pro-Western countries favor (Turkey, Georgia and Azerbaijan). In April 2001, Russia's Caspian negotiator and former energy minister, Viktor Kalyuzhnyi, suggested that Russian pipeline tariffs⁹³ should be reduced so as to divert oil from the BTC route, revealing Moscow's persistent interest in undermining alternatives to its pipeline system.⁹⁴ However, as will be discussed later, this kind of strategy can be counterproductive and may very well facilitate the alternative solutions for both Kazakh and Turkmen governments and Western oil companies.

The third and most important weakness is the future development of the super giant offshore oilfield Kashagan, which may offer a last chance to reduce Kazakhstan's dependence on Russian transit, and the first chance to bring major volumes of Kazakhstan's oil to the western Caspian shore and from there directly to international markets. Kashagan will be a make-or-break test of Russia's policy to monopolize the transit of oil from Kazakhstan. And that monopoly means controlling the lion's share of Caspian oil flows.⁹⁵ I shall return to this argument and explain it in more detail in Chapter 8 (Kashagan & Beyond).

⁹³ A "tariff" is a user charge paid to the operator of a pipeline by a shipper of oil or gas through that pipeline.

⁹⁴ Jan H. Kalicki, *Caspian Energy at the Crossroads*, *Foreign Policy*, September 1, 2001

⁹⁵ Vladimir Socor, *ibid.*

There are also wider issues about the general energy policies of Russia that ultimately may also affect the Caspian basin. Those are:

1) The Russian oil sector is in critical need of foreign investment. Production peaked at over 11 million b/d in 1987, but has fallen to about 4 million b/d in 1998 and barely reached little over 7 million b/d at the end of 2002. Although high oil prices have brought some relief in 2001 and 2002, long-term transportation capacity is in danger of not being able to match the increase in production level without an infusion of foreign investment to rationalize upstream activities.⁹⁶ Gas production also faced a sharp decline because of limited upstream investment, and deliveries have been cut back as a result of systemic problems and non-payments to Gazprom, the biggest gas producer, during the 1990s.⁹⁷

In addition, in order for Russia to meet the increasing natural gas demand of Europe, starting from the year 2000, \$4-5 billion of annual foreign direct investment (FDI) into the country's energy sector should be realized until 2011. However for the years 2000 and 2001 combined, the FDI amount was approximately 2.5 billion dollars. Western companies, in fact, were exploring projects in Russia even before the Soviet Union fell apart, but a decade later they could point to few successes. Over that period, Western companies invested

⁹⁶ Upstream Activities - In the Oil and Gas Sector, refers to Oil & Gas exploration, production up to the sales point. The product is crude oil and or natural gas. The upstream activities involve the marshaling of capital and technology in the search for and development of new supplies. When crude oil is perceived to be in short supply, a great deal of capital is dedicated to exploration and production, almost inevitably resulting in the development of large new oil fields.

Midstream Activities (not often used) refers to crude oil refinery, LNG and petrochemicals. The midstream products are natural gas, gasoline, diesel,..., LPG, industrial gases, etc.

Downstream Activities generally refers to marketing and distribution of midstream products. Like the upstream, the downstream activities are highly capital-intensive.

⁹⁷ From the remarks by Jan Kalicki, Counselor to the U.S. Department of Commerce and U.S. Ombudsman for Energy and Commercial Cooperation with the New Independent States before the Houston World Affairs Council, on the subject of "Caspian and Eurasian Energy Futures on April 18, 2000.

approximately \$5 billion. In comparison, foreign oil companies have invested \$13 billion in neighboring Kazakhstan since 1993, and about \$8 billion in Azerbaijan since 1994, according to the U.S. States Department of Energy and the Petroleum Finance Company, a consulting group in Washington.⁹⁸ With the existing old and unreliable energy infrastructure, Russia cannot meet the increasing energy demand of Europe.⁹⁹

2) Russia, by manipulating the uncertain legal status of the Caspian Sea, tries to undermine confidence in order to prevent unilateral offshore oil developments. Russia has argued that new projects are unacceptable in the area unless sanctioned by all five surrounding states including Russia, Azerbaijan, Kazakhstan, Iran, and Turkmenistan. Russian Caspian policy on the legal status of the Caspian Sea combines elements of the “carrot and stick” approach. After Russia staged major naval war games in the Caspian Sea during the first half of August 2002, its neighbors along the seacoast seemed to lose momentum in negotiations on claims to the seabed. In late August that year, Russia offered to extend other Caspian countries’ exploration rights into the sea by five miles per country, but this offer was no concession, because, all littoral countries, in fact, were exercising this right already. The offer, however, represents the carrot, as the promise of broader Caspian territory may induce Azerbaijan, Iran, Kazakhstan and Turkmenistan to reach accord on how to divide the sea’s resources. And the threat of Russian dominance, which the naval exercises invoked, works as the stick.¹⁰⁰

⁹⁸ Neela Banerjee and Sabrina Tavernise “Why US Oil Companies and Russian Resources Don’t Mix”, *The New York Times*, November 24, 2002

⁹⁹ Dirk L. Bendsch, “Selling natural gas in a liberalizing market,” a paper presented during the European Energy Markets Conference which was held in Houston on September 27, 2002

¹⁰⁰ *Oil&Gas Journal* June 3, 2002

Political and military sources of Russian influence in the region

a) Old establishment's perception of the region.

The Russian military and political establishment still seeks a sphere of influence on the Caspian including secure control of much of the region's oil. Strangely, however, there appears to be no singular, coordinated Russian policy. Rather, different ministries seek different goals. The Ministry of Defense and Ministry of Foreign Affairs focus on security interests in the area, while the Ministry of Energy and Minerals evaluates economic interests that include foreign investment and trade opportunities.¹⁰¹ There is one common underlying feature, however, that is apparent behind all the different approaches and that is; Russia has yet to accept the post-Soviet realities in the Caspian Basin. In February 2003, Putin's Special Envoy for Caspian affairs and former Minister of Energy and Minerals, Deputy Minister of Foreign Affairs Victor Kalyuzhnyi criticized the United States for appointing a special envoy for Caspian Energy Affairs in the very same panel that he attended with the senior U.S. adviser on Caspian Basin Energy Diplomacy, Ambassador Stephen Mann.¹⁰² His argument was that,

“Russia is not trying to portray herself as a monopoly in the basin but wants to be seen as a normal country and respects all individual countries' own decisions on how to develop their energy resources. However, nobody should try to tell us what to do in the region or how to act. How would the United States react if Russia had decided to appoint a senior representative for the problems of the great American lakes? For the Russians it is the same thing to see an American envoy working to solve energy related issues and problems in the Caspian basin.”

¹⁰¹ Ole Maksimenko, and Vitaliy Naumkin, 'New Oil Policy Will Inevitably Lead to Geopolitical Changes', *Nezavisimaya Gazeta (Sodruzhestvo NG Supplement)*, 25 November 1998, No. 10, pp. 9-10 as translated by FBIS and down-loaded from their web site.

¹⁰² At the special Caspian Energy panel discussion held during the CERA week conference series on February 12, 2003.

U.S. Ambassador Mann's response to this blunt comment was simple:

"If Russia was the signatory of the Energy Charter Agreement¹⁰³ which highlights basic market economy rules for the energy sector for fair competition and openness for the foreign investment, I would be unemployed right now. Besides Russia does not have countries like Canada to ask for her involvement in solving problems of 'great American lakes,' however we do have Azerbaijan, Kazakhstan and Turkmenistan asking the United States to assist them to address their energy development needs in the region."

This debate reveals that, a very important part of the Russian establishment still thinks of the Caspian as "their great lake" and they do not want to see anybody else complicating the issues for them.

For Russia, the Caspian Sea region offers the government a unique challenge. In an area that once was totally under its influence, Russia now finds itself marginalized and unable to employ the brand of power politics and party brokering to keep its leadership intact. Yet in spite of this situation, Russia cannot abandon the area for a mixture of geo-strategic, political, economic and ecological reasons. As the U.S. former Secretary of State James Baker noted, the Caspian is not an economic or geological or engineering problem, but a geopolitical problem of the first magnitude.¹⁰⁴

b) Russia's role in solving and prolonging the ethnic conflicts in the region

Russia possesses valuable instruments either to finish the various ethnic conflicts in the region or to prolong them. As with Yeltsin, Putin sees instability as an asset to its policy in the region. In an attempt to maintain its influence, Moscow has used, and is still using,

¹⁰³ The 1994 Energy Charter Treaty of Europe represents an attempt by more than 50 countries (54) to create an international investment and trade regime and facilitate financing and cooperation in the energy industry.

¹⁰⁴ Timothy L. Thomas, & John. Shull, *Perceptions* December 1999-February 2000 Volume IV – Number 4 2000

ethnic conflicts in and around the region. For example, Russia supported Armenia in Nagorno-Karabakh as a lever against Azerbaijan. Conversely, Armenia's dependence on Russian support allowed Moscow to pressure the regime in Yerevan. In Georgia Russia supported Abkhaz separatists to destabilize Georgia's domestic affairs.

Both Georgia and Azerbaijan's leaders say that, Moscow has sought to interfere in their domestic affairs. Georgian President Eduard Shevardnadze has been the target of two assassination attempts, which he says were masterminded by political opponents supported by Moscow.¹⁰⁵ Azerbaijani President Aliyev accuses Russia of standing behind a series of failed attempts to overthrow his regime. Turkmenistan President Niyazov also made similar statements after an assassination attempt against him on November 25th 2002.¹⁰⁶

Moreover, Shevardnadze and Aliyev both say that Moscow supports -- politically, financially, and militarily -- separatist movements in Georgia's South Ossetia and Abkhazia, and in Azerbaijan's ethnic Armenian Nagorno-Karabakh enclave. Some Russian as well as Western analysts believe that Putin is not particularly interested in bringing stability to the region. These analysts believe that the lack of an effective and constructive policy from Moscow complicates the already acute ethnic conflicts in the region.¹⁰⁷

c) Russian military power and its implications for the region.

The collapse of the Communist Bloc and the Soviet Union brought out hopes for a more secure environment in Eurasia. However, with the emergence of ever-increasing and

¹⁰⁵ *Newsweek*, 02/09/98, Vol. 131 Issue 6, p57, 2/3p,

¹⁰⁶ The Associated Press, 27 November 2002

¹⁰⁷ 13 December 2000 - RFE/RL

intertwined security risks such as ultra-nationalism, ethnic conflicts, religious fundamentalism, terrorism and mass migration prospects for stability declined.

The outcomes of Russian initiatives complicate the current security concerns of Caspian nations. Almost immediately after the USSR's break-up, Moscow staked its claim as regional hegemon in Central Asia and the Caspian. Even after the division of Soviet assets and the creation of republican armed forces, the new states were incapable of ensuring their own territorial integrity and domestic security; in military affairs the Central Asian states remained dependent on Moscow. On May 15, 1992, a formal collective security agreement was signed, which regarded Central Asia and Caucasia as a vast buffer zone over which Moscow exerted a benign equivalent of the Monroe Doctrine--"We aren't going to get actively involved ourselves, but everyone else stay out."¹⁰⁸ President Yeltsin was intent on promoting a Russian version of the doctrine in the 'near abroad'. "We have" said his Defense Minister Pavel Grachev "certain strategic interests there and must take every measure to ensure that our troops remain there; otherwise we will lose the Black Sea."¹⁰⁹

Moscow negotiated bilateral defense treaties with each of the five Central Asian states. Under these treaties Russian Border Guard forces were responsible for patrolling Central Asia's external boundaries, while a coordinated CIS air-defense system guarded the skies above. In March 1994 Moscow signed an additional twenty-two bilateral military agreements with Kazakhstan, to include the Russian lease of the *Baikonur Cosmodrome* (for

¹⁰⁸ Within Central Asia, only Uzbekistan refused to sign the treaty on joint protection of the Commonwealth's external borders. Uzbek Foreign Minister Adbulaziz Komilov stated, "We are able to reliably monitor the 156-kilometer border with Afghanistan with our own forces without involving foreign troops from other countries, primarily Russia." Nikolay Musiyenko, "Fearing Even a Hint about USSR," Moscow, PRAVDA (in Russian) 22 February 1996, 2, in FBIS-SOV-96-037, 23 February 1996, 51.

¹⁰⁹ BBC Summary of World Broadcasts, 23 February 1993, quoted in S. Goldenberg, The Pride Of Small Nations (London: Zed Books Ltd., 1994), p.62.

an initial period of twenty years with an option to extend a further ten years) for \$115 million annually (deducted from its debts to Moscow). It also arranged for the transfer of the strategic nuclear forces temporarily deployed in Kazakhstan.¹¹⁰ Moscow also agreed to train five hundred Kazakh officers per year at its various military academies.¹¹¹ A January 1995 agreement gave Russia continued access to several missile test ranges, proving grounds, and military communications sites in Kazakhstan. Both nations also promised to cooperate on forming joint armed forces, conducting joint planning for the training and use of troops, and providing weapons and military equipment.¹¹²

According to Gareth Winrow, Moscow, was aiming to:

- re-establish permanent Russian military bases in the Transcaucasus (Armenia, Azerbaijan, Georgia) and Central Asia,
- deploy Russian border troops to guard the external frontiers of the Caspian and Central Asian states,
- press for an exclusive CIS (i.e. Russian) peacekeeping presence in the region,
- station more Russian tanks and armored vehicles in the north Caucasus even though this violates the terms of the CFE Treaty. (Winrow 1995; 44)

¹¹⁰ These include the Treaty on Military Cooperation, the Agreement on the Basic Principles and Terms of Use of the Baikonur Cosmodrome, the Treaty on the Furtherance of Integration and Economic Cooperation between the Republic of Kazakhstan and the Russian Federation, and the Agreement on the Strategic Nuclear forces Temporarily Deployed on the Territory of Kazakhstan.

¹¹¹ Dmitry Vertkin, "Prospects for Stability--The View from Kazakhstan," *Jane's Intelligence Review* 6, no. 6 (June 1994): 287.

¹¹² Douglas Clarke, "Russia's Military Presence in the 'Near Abroad'" *Transition* 1, no. 19, 26 October 1995: 8-9 & *Current Digest of the Post-Soviet Press* 47, no. 3, 15 February 1995: 27.

Although it had been previously agreed that Russian troops would depart from Georgia by 1995, Russia maintained four bases in this country: at Abkhazia, at Tbilisi, at Batumi, and at Akhalkalaki. The selection of the sites for the bases makes it apparent that the Russian military continues to view Transcaucasia as a bulwark against Turkey and any other outside power. Together with the installations at Goumri (formerly Leninakan), the Akhalkalaki and Batumi bases preserve the old defensive line along the southern edges of the Transcaucasia (Goldenberg 1994; 62). There are also Russian soldiers stationed in Abkhazia and Javakhetia, the Armenian-populated region in Georgia. Note that a large proportion of the "Russian" soldiers stationed in Javakhetia are actually local Armenians. It is therefore an open question as to which is better for Georgia, a Russian presence or a Russian withdrawal leaving behind a heavily armed local militia.¹¹³

Moscow also seeks a special position in Armenia. Both countries maintain very close ties, and this is likely to continue until the Nagorno-Karabakh dispute is resolved. After procuring over \$1 billion worth of weaponry from Russia between 1994 and 1996, in 1997 Armenia and Russia concluded a Treaty of Friendship, Cooperation and Mutual Assistance. Each promised to assist the other if attacked by a third party. Russia has gained special privileges—such as a 25-year military base agreement and control of the border (Henze 1996; 49-50). In 1999 MiG-29 aircraft and S-300 missile systems were deployed in Russian bases in Armenia, and the Russian-Armenian air defense system was integrated. In September 2000 Russian and Armenian leaders signed a Declaration on Cooperation in the Twenty-First Century. These developments create concerns among countries of the region

¹¹³ Anatol Lieven *National Interest*, Winter99/2000 Issue 58, p69, 12p.

like Turkey, Azerbaijan, and Georgia.

Another point of conflict was the Russian demand, voiced in late 1993 that NATO should accept a revision of the Treaty on Conventional Armed Forces in Europe-CFE¹¹⁴ to allow it to maintain a larger armed presence in Transcaucasia than had originally been allowed. Allied to this was the apparent Russian determination to exclude other powers from any role in policing a settlement between Armenia and Azerbaijan.

Turkey firmly rejected these proposals and was generally supported by the western powers. At the NATO summit in Brussels on 10-11 January 1994, the principle that the CFE treaty could not be altered was confirmed.¹¹⁵ However, Turkish officials were bitterly disappointed when Russia failed to adhere to Article 5 of the CFE Treaty with regard to the restrictions on the number of tanks, armored combat vehicles and artillery pieces in the so-called flank areas by the November 1995 deadline. North Caucasian conflicts such as Chechnya were the reason given by Russia.¹¹⁶ Two weeks later, at Turkey's urging the issue was discussed in the NATO Defense Planning Committee. In article 11 of the final communiqué, Alliance members expressed their concern at the violation of the CFE Treaty

¹¹⁴ In a December 1988 United Nations speech, Soviet President Mikhail Gorbachev announced large-scale unilateral reductions in Soviet military forces, including force reductions in Eastern Europe and in the wider Atlantic-to-the-Urals area that went far beyond what Western military planners only a short time earlier had dreamed possible. His dramatic announcement, later followed by voluntary cuts by Eastern European nations, set the stage for new negotiations between NATO and the Warsaw Pact on *The Treaty on Conventional Armed Forces in Europe (CFE)*. CFE was concluded in 1990 and entered into force in July 1992. The CFE Treaty ensured significant reductions in five categories of conventional arms and equipment, namely battle tanks, armoured combat vehicles, artillery systems, combat aircraft and attack helicopters and imposed certain numerical limitations on states parties. As such, NATO considers the Treaty as the cornerstone of the European security architecture. (Kegley & Wittkoph, AFP, 93)

¹¹⁵ *Briefing*, 31 January 1994, p.9.

¹¹⁶ *Yeni Yüzyıl*, 22, 30 November 1995.

(Winrow 1995; 133). Similarly, the CSCE refused to endorse Russia's claim that it should be given the sole right to peace-keeping functions in the ex-Soviet republics.

Eventually, the Agreement on Adaptation of the Treaty on CFE was signed in Istanbul on 19 November 1999, during the OSCE Istanbul Summit. It placed legally binding limits on the armed forces of every individual country that is party to it. It will also strengthen the requirement that host nations must consent in advance to the deployment of any foreign forces on its territory. Thus, it will contribute to enhancing peace, security and stability throughout Europe. The maintenance of the "*Flank Regime*" and its reconciliation with the structure of the new Treaty was the most vital and determining aspect of the adaptation process. The substance of this important element of the Treaty is maintained under the adapted CFE.¹¹⁷

Some Unknowns for the Future

a) Russia's Capitalism Experience and Relations with the West

For the energy security of the region, it is crucial to ensure that Russia is not a dominant, but rather an equal partner in developing the oil resources of the Caspian. Forming partnerships with Western oil companies could turn the Russian business sector into an ally of the West. In the early 1990s, the West opposed attempts by the Russian Government to

¹¹⁷ The term 'Flank' has no official standing in either the original or the adapted Treaty. It is a convenient shorthand for referring to the discrete regime of limits and provisions contained in Article V of the original Treaty and the States to which it applies. The substance of the Flank regime has been preserved in the Adaptation Agreement, being captured principally in Articles IV, V and VII and the Protocols on national and territorial ceilings.

The original CFE treaty, as an aspect of the zonal limits, created "flank zones." In these "flank zones," each group of states parties could station 4,700 battle tanks, 5,900 armored combat vehicles, and 6,000 artillery pieces. These limits were intended to prevent attacks along the two secondary fronts of any European conflict: Norway in the north and Southern Europe and Turkey in the south.

impose a single direction for the pipelines - i.e., north, via Russian territory. This single route eventuality according to the United States and other Western allies would give Moscow an unacceptable level of control over the flow of oil to Western markets and would make the West vulnerable to Russia's political whims.

As we try to distinguish where Russia is headed, there are uncertainties, regarding how the country will act in the Caspian.¹¹⁸ Russia's relations with the West and with the United States are the key. To what extent will they be adversarial?¹¹⁹ If Russia pursues a "cooperative engagement with the West in the Caspian," economic and political integration with the West will be strengthened. However, if it chooses to challenge the West, relations will deteriorate. However, it seems that the September 11 terrorist attacks on the United States did drastically change Russo-American relations. President Putin was among the first to call President Bush to offer his country's condolences to the American people and support and cooperation in the war against terrorism.

In the aftermath of September 11, Russia has leaped out of its post-Communist muddle, heading determinedly west. In May 2002 it crossed a remarkable threshold by joining NATO as a non-voting partner under the umbrella of the newly formed NATO-Russia Council. Close to the center of this historic embrace between former antagonists lie two tantalizingly related developments. One is the growing camaraderie between Russian President Vladimir Putin and U.S. President George W. Bush. The other is the steady recovery since 1994 of Russian oil exports. Also important was over-flight rights granted to

¹¹⁸ A. Saikal & W. Maley, Russia In Search of Its Future (Cambridge: Cambridge University Press, 1995).

¹¹⁹ Sam Nunn & Adam N. Stullberg, "The Many Faces of Modern Russia", *Foreign Affairs*, March-April 2000, pp.45-63.

the U.S. military planes, sharing intelligence with U.S. and accepting U.S. bases in Central Asia.

b) The United States-Russia Commercial Energy Dialogue

The Bush administration has championed the importance of developing more diverse energy supplies as a means of both national and global energy security especially in light of the new geopolitics created in the aftermath of the September 11, 2001 attacks on the United States. The U.S. administration would like to prevent future oil price shocks and reduce dependence on supplies from the unpredictable Middle East. In May 2002, U.S. President George W. Bush and Russian President Vladimir Putin announced a new U.S.–Russian dialogue. This “dialogue” represents an unprecedented political alliance, friendship, and economic partnership between the two countries at the highest levels of government, creating opportunities for strengthening ties and developing many spheres of cooperation. Among the many important strategic areas for potential cooperation is the energy sector.¹²⁰

In a follow-up to the May 2002 announcement, Washington and Moscow convened the First U.S.–Russia Commercial Energy Summit on October 1–2, 2002, in Houston, Texas. The meeting was aimed at the development of Russian/American joint strategies for cooperation in the energy sector. This inaugural summit brought together senior government officials and corporate executives representing more than 70 American and Russian energy companies. The session led to the creation of a commercial working group to focus on key issues such as market development, strategic reserves, investment, regulations, education, and problem solving.

¹²⁰ Sabrina Tavernise & Birgit Brauer “Russia becoming an oil ally of the U.S.”, *The New York Times*, October 19, 2002

In the keynote address that closed the summit, James A. Baker, III, former U.S. Secretary of State stated that “the full development of Russia’s immense potential by increasing diversity of international supply will reduce considerably the risk of instability in a world petroleum market that remains dominated by the volatile Middle East.”¹²¹

Presidents Bush and Putin, during a meeting they held in St. Petersburg on November 22, 2002, also highlighted the first Commercial Energy Summit as a key step in the energy dialogue launched by the leaders earlier in the year. In a joint statement, the presidents said, “The Houston Summit created new avenues for dialogue and cooperation on energy issues and led to decisions on concrete new investment projects and programs and business arrangements.”¹²²

As Russian export infrastructure expands, Russian oil firms are expected to be able to supply at least 13 percent of U.S. oil imports, up from the less than 1 percent currently supplied in 2002. In order to reach American markets, there is a need for a transportation route that has fewer investment risks and could maintain competitive transportation rates. A pipeline projected from Yaroslavl (in Central Russia, Siberia) to Murmansk has long been urged as a solution. Unlike the remainder of Russia’s ports, which are shallow and iced-over much of the year, Murmansk is ice free and can receive oil tankers with dead weight of 300,000 tonnes.

However, this new dialogue has aroused some skepticism and criticism from the energy companies and was not welcomed by them as eagerly as the U.S. administration had

¹²¹ U.S.–RUSSIA Commercial Energy Summit, Baker Institute Study, Number 21 - February 2003

¹²² Ibid.

hoped. A few critics went so far as to suggest that the sudden, radical U.S. encouragement of imports from now- “friendly” Russia to displace oil from the presumably unreliable Middle East was a “bad idea” (*Oil&Gas Journal* June 3, 2002) because the United States and other consuming nations should seek the maximum availability of oil in trade from as many sources as possible. It would be self-defeating, however, to promote logistically difficult bilateral energy trade with Russia for no reason other than to shut off supply from politically disfavored sources. Proponents of this view argued that in the long-run strategic preference for Russian over Middle Eastern oil would not prevail.¹²³ To be sure, growth in Russian oil exports from 3.16 million b/d in 1994 to 5 million b/d in 2002 is good for the United States and other major oil consumers. It is also a legitimate source of competitive concern for Middle Eastern exporters. The Russian economy, of course, hinges on oil production, which has recovered to a projected 7.4 million b/d in 2002 from a 1996 low of 6 million b/d. A dozen major oil and gas companies have emerged from Russia's sometimes-turbulent privatization of the 1990s (OGJ, May 27, 2002, p. 20). Their vitality is beginning to attract investment from abroad; for which Russia's enormous oil and gas resource has long been starved. Russian oil production is reasonably projected to reach 10 million b/d by 2010. However, if Russia would like to play a part in the global oil and gas market it had better start being a more attractive partner with something to offer in return. This offer must include the following aspects:

¹²³ Neela Banerjee and Sabrina Tavernise “Why US Oil Companies and Russian Resources Don't Mix”, *The New York Times*, November 24, 2002

- Domestically, Russia needs to do more from a legislative standpoint in order to attract the Western investment necessary to expand its oil production base. It is essential to establish a working production-sharing agreement (PSA) regime that makes Russia's oil and natural gas sector competitive with other countries for the investment dollars spent by multinational energy companies. In 2001, companies were encouraged to hear Russian President Vladimir Putin express his strong support for lifting the PSA-related bureaucratic hurdles. However, due to the easy revenues brought by high oil prices and the lack of political will for reforms that will harm Russia's domestic oil industry, nothing came out of these strong political statements. It has been said for almost a decade that more than \$50 billion in foreign investment is waiting to enter Russia's upstream¹²⁴ oil sector. Slow progress in establishing an acceptable PSA regime, implementing specific types of legal guarantees and passing the new tax code thus far have held foreign investment in the upstream sector at a relative trickle.

- The development of Russian energy companies is equally important. Buoyed by high world oil prices, Russian oil companies such as Lukoil and Yukos now have the financial resources to conduct much-needed oil exploration and development work in a sector that stagnated in the 1990s due to lack of investment. Russian oil companies are even looking outside of their borders for financing and new business opportunities. Tyumen Oil Co., for example, has received \$500 million in financing from the U.S. Export-Import Bank to purchase U.S. petroleum equipment and technology. Other companies are seeking listings on European and U.S. stock markets. But continued moves to ensure transparency, shareholder

¹²⁴ As explained in earlier footnote (#7) "Upstream" is the term used in the oil and gas industry to refer all exploration and production related activities.

rights, and conformity to international legal standards are key elements that will determine whether the internationalization of Russian oil companies will succeed. This progress by Russian companies will also depend, to some extent, on whether Russia may be viewed as a responsible participant in the international energy arena.¹²⁵

- Bringing Russian oil to world markets interests both Russian and Western companies. However, a single, state-owned entity, Transneft, which owns and operates the world's largest crude oil pipeline network, dominates oil transportation in Russia. Fully 40 per cent of the pipeline network in the Transneft system has exceeded its planned service life and the system can only operate at 50-60 percent capacity.¹²⁶

Export quotas, tariffs, and other restrictions detract from the free flow of oil and the development of a competitive, cost-based environment in Russia's transportation sector. Transneft has not attracted foreign investment in projects such as the Baltic Pipeline System (BPS). Instead, it seeks to pay for the BPS project-which will cost more than \$2.5 billion-by increasing tariffs that Russian and Western oil companies pay trying to export their oil out of Russia. An alternative and better approach would be to open Russia's oil transportation sector to private investment and to bring in Russian and Western companies to build, own, and operate large export projects.

- Transparency, rule of law, contract integrity, and compliance with international standards are essential to establishing and maintaining the long-term relationships that would enable Russia to integrate itself further into the world economic community. Russia has made

¹²⁵ *Oil&Gas Journal* June 3, 2002

¹²⁶ Timothy L Thomas, & John. Shull, *ibid.*

laudable progress toward these goals during the past decade. Unfortunately, some Russians are more tempted to wield power as monopolistic energy suppliers in regional markets in order to obtain certain desired political and commercial gains in some of the CIS countries, especially in and around the Caspian region. The most egregious example is Russia's off-repeated interruption of natural gas supplies to Georgia. The gas cutoffs have also occurred against the backdrop of increasingly tense relations between Russia and Georgia on issues such as the closure of Russian military bases and the presence of Chechen rebels in Georgia.

If Russia is in fact attempting to use energy exports for political pressure, then it will have sent a chilling message regarding the commercial reliability of its energy companies. This is a lesson that Russia's commercial partners in Europe and elsewhere would not soon forget.¹²⁷

- Russian policy must take into consideration the new realities of the situation in the Caspian. Leaders recognize that Russian influence has declined precipitously and Russian oil and gas firms need Western technology to access both Caspian and Siberian resources. Russia also recognizes that the Caspian region grows in importance as the Siberian fields decline in importance, especially since gas and oil account for 40 to 45 percent of Russian export earnings. A motive behind Russia's strong intention to build the Murmansk pipeline in order to immediately export oil to the United States might very well be a direct result of this fact. There is also a cost issue that few presently divulge.¹²⁸ Pumping one ton of Persian Gulf oil costs an average of \$2-\$5, North Sea oil costs \$10, while Azerbaijani oil costs \$17. It

¹²⁷ Jan Kalicki, "High stakes hinge on Russia's energy choices", *Oil&Gas Journal*, March 19, 2001.

¹²⁸ *Oil&Gas Journal* June 3, 2002 & 'International Perspectives: the Russian Factor', 1998. Politics and Decision-Making, Caspian Investor, Volume III, pp. 55-60.

costs \$35-\$45 a metric ton to get oil out of Siberia. Thus, Caspian markets are twice as cheap as Siberian markets, so it is clear why Russia fears the loss of cash revenues if both are exporting to the same markets.¹²⁹

To increase the level of cooperation shown from the Russian side, the United States and the West have yet to convince the Russians about the fact that Russian companies alone do not have the technological and financial resources to develop the hydrocarbon reserves of Eurasia. They will need Western oil companies to do that. To become richer and more stable, Russia needs American and Western help. To foster peace and stability in Eurasia, America needs Russian help. A *modus vivendi* can be reached only if Russia accepts that the principles of free market. Democracy and state sovereignty take precedence over the outdated geopolitical practices of the past century.

2. Iran

The actors, in this competition include Iran as an important player. Iran has huge energy assets including 9% of the world's conventional oil reserves and 15% of global natural gas deposits.¹³⁰ Undeniably, Iranians have many other assets, such as their energy technology, experience and geographical location. The Iranians employ these advantages fully in pursuit of their regional ambitions. They strive to weave a web of energy cooperation with all the Caucasian and Central Asian countries proximal to Iran. Iranians plan to

¹²⁹ Andrey Grozin, Karina Gevorgyan, 'Caspian Global Solitaire and Russian Interests: 'Black Gold' of Caspian Region Divided Up without any Rules, According to Principle of 'Whoever is Brave Takes it All,' Nezavisimaya Gazeta (Sodruzhestvo NG Supplement), 5 May 1998, pp. 12-13 as translated and down-loaded from the FBIS web page. & Ole Maksimenko, and Vitaliy Naumkin, 'New Oil Policy Will Inevitably Lead to Geopolitical Changes', Nezavisimaya Gazeta (Sodruzhestvo NG Supplement), 25 November 1998, No. 10, pp. 9-10 as translated by FBIS and down-loaded from their web site.

¹³⁰ *Oil & Gas Journal*, Feb. 19, 2002.

modernize all their major ports and to make their road and railway system a gateway.

Although limited in volume, they have already signed contracts to transport Kazakh oil and Turkmen gas across their territory.¹³¹

Transport of Turkmen oil to Iran and on to the Persian Gulf by the Kazakhstan-Turkmenistan-Iran (KTI) pipeline is considered the most promising of all Iranian proposals. Some 550 km of this 2,500-km pipe are to be laid in Turkmen territory.

A capacity of between 25 and 50 million tons/year (500,000-1 million b/d) of oil is under consideration. TotalFinaElf SA of France, which in 1998 was authorized by the Turkmen government to study the proposal, submitted a preliminary feasibility study for the Turkmen section to Ashgabat in May 1999.

The document affirmed that the Turkmen section would not involve any technical difficulties that may hold back implementation. TotalFinaElf has signaled its growing interest in implementing the project. The KTI oil pipeline will cost around \$1 billion. As Iran's Ambassador Morteza Safari said in Astana in June 2002, Iran "is ready to begin negotiations on a giant project of building an oil pipeline from Kazakhstan to the Persian Gulf via Turkmenistan."¹³²

Iran has also proposed a pipeline that would transport oil from Baku via a 190-mile pipeline to Tabriz in northwest Iran, where it would also connect with the existing Iranian pipeline network and refineries. Again, France's TotalFinaElf has proposed building a

¹³¹ Kazakhstan signed an agreement in 1996 to begin oil swaps with Iran under which Kazakhstan sends oil to Iran's sea ports on the Caspian while Iran will simultaneously export an equivalent amount of its oil from its Persian Gulf ports on behalf of Kazakhstan resulting in greater efficiencies and reduced transport costs for both countries. Large-scale swaps of this type by American companies with Iran have been opposed by the United States. U.S. Energy Information Agency, (December 1998) <http://www.eia.doe.gov/emeu/cabs/caspian.html>.

¹³² *Oil & Gas Journal* editors Feb. 4 2003

200,000 - 400,000 b/d pipeline for this plan. Azerbaijan has indicated that progress on disputes with Iran concerning the division of the Caspian as well as Iranian progress towards improved relations with the West would need to occur before such a project moved forward.

In implementing a strategy to establish itself as an oil and gas transportation corridor, the Iranian government has several objectives:

- to realize the earnings potential that its strategic location confers,
- to secure leverage over neighboring states that become reliant upon the use of Iran's transportation facilities,
- To continue to reduce isolation from the international oil and gas industry that US policy has sought to impose.

In seeking these objectives Iran does not hesitate to put military force behind them. Contrary to the aforementioned Russian "carrot and stick" policy, Iran has only sticks to throw at its neighbors. This approach is not more visible than in Iran's policy towards the issue of legal status of the Caspian Sea. In the summer of 2001, warships and jets belonging to Iran attacked a BP owned research ship holding exploration works at the "Araz", "Alov", and "Sharg" oilfields of the Azerbaijani sector of the Caspian Sea and caused serious tension between the two countries, as well as in the wider Caspian region.¹³³ In February 2002, Iranian warships again violated the territorial waters of the Azeri sector of the Caspian Sea. Following the second incident, the Iranian ambassador to Azerbaijan, Ahad Gazai, stated that his country does not recognize any frontier or territorial waters on the Caspian Sea and, therefore, it was not right to characterize the incident as an illegal crossing of the frontier.

¹³³ *Azerbaijan A Weekly Analytical-Information Bulletin* No: 09 (311), February 28 2002.

Later in 2002, the Iranian Foreign Ministry special envoy for Caspian Sea affairs, Mahdi Safari said that “Iran will continue to pursue and protect its own interests in the Caspian region. Tehran has always insisted on establishing a condominium (equal share for all littoral states) for the use of Caspian Sea resources.”¹³⁴

The United States strongly criticized the Iranians for their acts of aggression. “Iran should stop trying to pressure its oil-rich Caspian neighbors to follow an agenda not supported by US political or commercial interests”, a top US official told government and industry officials at a US-Azerbaijan Chamber of Commerce meeting Mar. 7, 2002. “We will not stand idly by and watch them pressure their neighbors,” said Deputy Secretary of State Richard Armitage, who prior to his return to government service was a past co-chairman of the chamber. “Everyone must understand this,” he said.¹³⁵ Those comments by Armitage and similar remarks by White House officials have given Iranian government the clearest indication yet that the administration is not going to tolerate such violations and pressure from Iran.

Iranian government considers its Caspian policy as key to creating a counterweight to the United States. However, Iran has yet to establish itself as a player in international gas markets and has failed so far to attract foreign investments in oil pipelines to exploit its “ideal location” for Caspian and Central Asian trade. Tehran’s efforts to become a conduit for the region’s oil and gas to the west are actually suffering from the United States policy of denying western capital to this country. In 1995 President Clinton, by executive order,

¹³⁴ TehranTimes Nov 4 2002

¹³⁵ Maureen Lorenzetti, “US warns Iran about meddling with its Caspian interests”, *Oil&Gas Journal*, March 18, 2002 & OGI Editorial, Mar. 8, 2002

placed restrictions on some Iranian products. Later that year, Congress passed the Iran-Libya Sanctions Act (ILSA), imposing proscriptions on any company—American or not—spending as much as \$20 million developing Iran's oil or gas reserves. French, Russian, and Malaysian companies defied ILSA by contracting for billions to explore Iran's huge South Pars gas field in the Persian Gulf. Despite the Act, President Clinton resisted demands that the sanctions be imposed against countries who signed new contracts with Iran because he realized that such action would land the United States in a losing battle with the World Trade Organization. In his first months in office, President Bush initially supported just a two-year extension of ILSA. Various interest groups including AIPAC (American Israel Public Affairs Committee) pulled a fast move in Congress, however, and got a five-year extension in August 2001. Despite the extension, Bush did not impose any sanctions on Russia, France and Malaysia.¹³⁶ In addition, President George W. Bush's first State of the Union speech Jan. 29, 2002 gave American oil companies the clearest indication yet that the administration is not yet prepared to allow American investment in Iran. President Bush linked Iran with North Korea and Iraq, saying "states like these, and their terrorist allies, constitute an axis of evil, arming to threaten the peace of the world."¹³⁷

Nevertheless, Iran is extremely interested in the distribution and the transportation of Caspian energy resources. As Iran's oil exports and the income derived from it have declined

¹³⁶ Andrew I. Killgore, "Kazakhstan Supports Iran Pipeline Route: Is Israel's Turkish Route Doomed?", *Washington Report on Middle East Affairs*, Jan/Feb2002, Vol. 21 Issue 1, p17, 1/2p.

¹³⁷ Keith Weissman, Deputy Director of the AIPAC said that Iran was included in President Bush's now famous "axis of evil" speech because "they did it the old-fashioned way: They 'earned it' through supplying weapons to groups seeking to destroy Israel by any means necessary. He also indicated that for the foreseeable future, the US-Iran relationship is cognizant of Iran's policies toward Israel. Ibid. & Maureen Lorenzetti, "Oil industry sees mixed signals on US Iran policy", *Oil&Gas Journal* April 1, 2002 & "US warns Iran about meddling with its Caspian interests", *Oil&Gas Journal*, March 18, 2002

over the years because of the embargo, it is agitated to see the development of new commercial rivals, though it wishes to benefit from the transportation of that oil, both materially and as a way of loosening the U.S. embargo that strangles its economy.

Such a rival to the Iranian policy is Turkey. The next section will discuss Turkey as an actor in the region and how it rivals Iran in the region. However, it should be mentioned that Turkey and Iran have other political and regional disagreements in and around the Caspian basin. Turkey expressed concern over Iran's successful test in May 2002 of a ballistic missile capable of reaching Turkey. Ankara also accused Iran of supporting PKK/KADEK¹³⁸ separatists. On the other hand, Iran has denounced Turkey's close security and military relationship with Israel and claimed that Turkey harbors an armed Iranian opposition group, the People's Mujahedeen. Despite political and regional differences, trade relations between Iran and Turkey have improved in recent years. Bilateral trade in 2001 stood at \$1.4 billion. In January 2002, Iran started to export natural gas to Turkey via a 2,577-kilometer (1,598-mile) pipeline as part of a \$30 billion deal.¹³⁹

Despite all the obstacles, taking advantage of its geographical location,¹⁴⁰ Iran, like Russia, has proceeded to develop its own oil fields and to invest in those located off the coasts of Azerbaijan and Turkmenistan. It has been upgrading its oil-processing facilities in

¹³⁸ In 1984, the Kurdistan Workers' Party (PKK), a Marxist-Leninist, separatist group, initiated an insurgency in southeast Turkey, using terrorist tactics to try to attain its goal of an independent Kurdistan. The group - whose leader, Abdullah Ocalan, was captured in Kenya in February 1999 - has observed a unilateral cease-fire since September 1999, although there have been occasional clashes between Turkish military units and some of the 4,000-5,000 armed PKK militants, most of whom currently are encamped in northern Iraq. The PKK changed its name to the Kurdistan Freedom and Democracy Congress (KADEK) in April 2002. www.cia.gov/cia/publications/factbook

¹³⁹ Turkish Daily News, Hürriyet- A Turkish daily, AP news, June 17-23, 2002.

¹⁴⁰ Iran sits astride this region and really is in the center of it. You can't get from East to West or West to East without being extremely ingenious in your transportation to avoid traveling through Iran itself.

Neka on the southeastern Caspian coast, and it is now building an oil pipeline from Neka to Tehran. At the same time, it has been constructing pipeline links and electricity grids with Turkey and the countries of Central Asia and the Caucasus. And it has pursued energy deals with the other Caspian states, including profitable "oil swaps" with Turkmenistan in which Iran exports oil from its southern fields through the Persian Gulf in exchange for imports from its northern neighbor.

Russia, interestingly enough, actually likes the U.S. policy towards Iran, because at this point, Iran is locked into Russia; Iran has few other alternative supplies of weapons. Finally, if you cannot ship oil through Iran, the first alternative would be through Russia; so Moscow is very much pleased with that geopolitical gain courtesy of American policy.¹⁴¹

The political and legal bottom line of the possibility for Iran to play an effective actor role in accordance with its potential caliber is that, until the United States and Iran have normalized relations, any proposals favoring Iran or heightening its leverage in the region are unfeasible.¹⁴² However, there is no doubt that this country will try to increase its role in some way or another in shaping the region's energy picture in the not too distant future.

3) Turkey

The Turks' interests in the region's oil and gas resources are obvious. Turkey has a general and strategic stake in the independence and well being of the new Turkic republics of the region. Former President Demirel once said "We see this rich region of oil and gas

¹⁴¹ Ariel Cohen, The New "Great Game": Oil Politics in the Caucasus and Central Asia, The Heritage Foundation, *Background* No. 1065, January 25, 1996.

¹⁴² This was also a clearly reflected argument, both by the representatives of the Bush administration and company officials, during the CERA discussions in February 2001 Houston.

reserves, not just as a source of energy, but as an element of stability. Just as the founders of the European Community saw coal and steel as a source of peace and stability for Europe, so we see oil and gas in our region serving the same role.” Stability and prosperity in the region will also mean increased trading and investment opportunities for Turkey. (Iskit 1996)

Turkey’s further specific interests include: transit revenues from export pipelines crossing her territory, securing relatively low-cost crude for her refineries and gas for her consumers as well as substantial work contracts for her companies. We should also add to this picture the Turkish governments’ safety and environmental concerns regarding increased tanker traffic through Turkish straits connecting Black Sea & Mediterranean, and their insistence in the necessity of avoiding this route for Caspian oil exports. A 2002 study by BP-AMOCO displays the fact that no matter what measures are taken by the Turkish government to ensure safer navigation, major tanker accidents, on average of every two years, in the Turkish straits are inevitable. This study has also been confirmed by the State Department.¹⁴³

Turkey, straddling the Caspian Basin and Europe, forms a natural energy bridge between the source-rich countries of the Caspian Basin and the energy-hungry world markets. Due to her physical location and being the biggest energy importer of the area, Turkey casts herself as an energy hub in her region. Besides, as one of the biggest investors in the region and her close historical, cultural and economic ties with the newly independent countries of the region, Turkey acts not only along with her commercial interests but also bears the responsibility for supporting these nations in their social and economic

¹⁴³ *The BP Magazine*, Issue One, 2002

development.¹⁴⁴ This is one of the basic foreign policy goals of Turkey, despite the country's own problems in these areas.

Clearly, her own modest economic and industrial resources limit Turkey's influence in the region. In a globalizing environment the economic health of a country cannot be separated from the characteristics of its political order. The EU candidacy provides the incentive for Turkey to attain all the standards of a liberal democratic country with a well functioning market system. To succeed in that task will place Turkey ahead of others in the game to lead the Caspian basin into the 21st Century as well. This is Turkey's real challenge.

In view of the foregoing, Turkey has embarked upon mega projects involving transportation of the hydrocarbon reserves of Caspian Basin through her territory, namely, the Baku-Tbilisi-Ceyhan (BTC) oil pipeline project and the Trans-Caspian gas pipeline project (TCGP), which are regarded as top priorities for Turkey. Shortly after the conclusion of the "Deal of the Century"¹⁴⁵ in September 1994, Turkey launched her BTC project in December that same year. It took only one month for the United States to declare her support for this pipeline through Turkey, which was announced on January 30, 1995. The realization of this project has become one of the highest priorities of the Turkish Government. Conscious of the fact that this huge undertaking requires a constant effort and the disentanglement of a complex web of problems, the Turkish authorities and Turkish

¹⁴⁴ Turkish Ministry of Foreign Affairs' official web page "www.mfa.gov.tr"

¹⁴⁵ "Deal of the Century" refers to a \$13 billion, 30-year contract which was signed by an international consortium - the Azerbaijan International Operating Company (AIOC) in September 1994 to develop three fields -- Azeri, Chirag, and the deepwater portions of Guneshli -- with total reserves estimated at 4.3 billion barrels. Project partners include: BP (34.1%, operator, UK), Unocal (10.2%, USA), Lukoil (10%, Russia), SOCAR (10%, Azerbaijan), Statoil (8.6%, Norway), ExxonMobil (8%, USA), TPAO (6.8%, Turkey), Devon Energy (5.6%, USA), Itochu (3.9%, Japan), Amerada Hess (2.7%, USA)

diplomacy have been fully engaged in the task of enhancing the prospects of the BTC pipeline.¹⁴⁶

The Turkish pipeline company BOTAS is the turnkey contractor for the construction of the pipeline within Turkish territory. Turkey's largest oil company, TPAO, maintains 6.8 % of the shares in the Deal of the Century (also known as the Mega Project) and 9% of the shares in the Shah Deniz project.

Given the fact that more than 118 million tons of oil and oil products are being shipped through the Turkish straits annually,¹⁴⁷ Turkey argues that the potential increase of tanker traffic in the straits will pose additional dangers and threats to human life, the environment, navigation safety and property. Therefore, it is of paramount importance for Turkey and the other countries concerned to find environmentally safe routes for transporting Caspian oil. This can be achieved, without risking instability, by building the BTC pipeline according to Turkey and the United States.

Likewise, considerable efforts have been made to realize the Trans-Caspian Gas Pipeline (TCGP) project. In addition to BTC and TCGP projects, Turkey has also been engaged in energy transportation projects involving Russia. Turkey has been purchasing Russian natural gas via an overland pipeline through Ukraine, Romania and Bulgaria since 1987. In 1997, Turkey and Russia signed an agreement on the transportation of Russian natural gas to Turkey via an underwater pipeline in the Black Sea, known as the "blue stream project". The construction of the pipeline was completed in late 2002.

¹⁴⁶ Temel İskit, *ibid.*

¹⁴⁷ From the presentation of Laurent Ruseckas during the CERA Week Conference in Houston, February 12, 2003.

What are Turkey's broader policy objectives regarding Caspian energy resources?

Turkey has two broad policy objectives regarding Caspian energy resources:

1) Meeting Turkey's energy requirements, medium-to-long-term

The gap in Turkey's energy supply and demand is one of the key elements, which determines its energy policy. As a country with an emerging and rapidly growing economy, Turkey is facing a rising growth in its demand for energy by 8% per annum, whereas the world average is 1.8%.¹⁴⁸

As shown in the Table 9 below, Turkey's energy consumption in 1998 was 76 million tonnes of oil equivalent (mtoe). It is expected to reach 179 mtoe by 2010, and 319 mtoe by 2020.¹⁴⁹ Turkey's demand for natural gas is estimated to rise to 52 billion cubic meters by 2010 and 80 billion cubic meters by 2020.¹⁵⁰

Table 5.1: Turkey's energy, natural gas and electricity demand

	Ministry of Energy and Natural Resources figures				State Planning Organization figures			
	1998	2001	2010	2020	1998	2001	2010	2020
Energy Demand (million mtoe)	76	78,1	179	319		78.1	153.9	282.2
Natural Gas Demand (billion m3)			52	80		16,3	55.30	87.9
Electricity Demand (billion kWh)						126.9	265	528

¹⁴⁸ The Ministry of Energy and Natural Resources of the Republic of Turkey.

¹⁴⁹ Ibid.

¹⁵⁰ Ibid.

The figures of the State Planning Organization are slightly different. The energy demand will have a slow growth until 2005 and will grow fast and hit 153.9 mtoe (million tons of oil equivalent) in 2010. The natural gas demand will be 55.3 billion cubic meters (1.9 trillion cubic feet) in 2010,¹⁵¹ and will rise to 87.9 billion cubic meters in 2020. In 2001, it was 16.3 billion m³. In the meantime, by 2010, the natural gas demand of the EU countries will rise up to 27 percent from 23 percent.¹⁵²

In the same manner, it has been communicated that Turkey's energy demand will rise from 78.1 mtoe in 2001 to 153.9 mtoe in 2010 and 282.2 mtoe in 2020. Turkey's installed power capacity is expected to become 265 billion kWh in 2010 and 528 billion kWh in 2020, which was 126.9 billion kWh in 2001."¹⁵³

Turkey has been pursuing policies in order to meet its expanding energy need based on diversified, reliable and cost-effective supply sources. Evidently, given the results of the projection studies recently conducted, Turkey has to invest no fewer than 3.5 billion dollars each year in the energy sector up to and including the year 2010 in order to secure the supply of energy. Including the additional investments required in power transmission and distribution, this figure reaches 4.5 billion dollars per year.¹⁵⁴ As a matter of fact, the growth rate of the electricity demand in Turkey has been very high compared to world and OECD averages.

¹⁵¹ *The Associated Press & Turkish Daily News, 10.21.2002*

¹⁵² Yurdakul Yigitguden's presentation during the 5th International Natural Gas and Power Conference which was held on September 24-25, 2002 in Istanbul.

¹⁵³ Ibid.

¹⁵⁴ Prime Minister Bulent Ecevit's speech at the World Economic Forum Meetings in 2000 at Davos, Switzerland.

2) Opportunity to become Europe's gateway to an additional energy-resource-area

In the long run, Turkey seeks to be the European Union's gateway for natural gas from Iran and the Caspian basin. Turkey has recently taken some specific steps to realize this goal. Apparently the goal also fits into the national interests of both Greece and Iran. It certainly makes sense for the European Union, as well. The 2001 workshop on Oil & Gas Transport from Caspian to the West, within the framework of TACIS (Technical Assistance to the Commonwealth of Independent States) & INOGATE (Interstate Oil and Gas Transports to Europe) programs of the European Union resulted in the conclusion that Turkey is the inevitable route to transport the Caspian gas to the West.¹⁵⁵

Turkey's Energy Ministry officials believe that Europe's future gas supply could be secured from the Caspian resources via Turkey. The European energy market grew in a stable manner, and its demand for natural gas far exceeded the estimates. In 2001, the demand of the European Union for natural gas was 23 percent, but it was expected that this would increase up to 27 percent by the year 2010. For this reason, the European Union has to plan for the decade ahead and at this point Turkey will be included in the agenda. Estimates emphasize that Western Europe would produce 580 MCM natural gas in 2010, with a production gap of 182 BCM. Gas supplies from U.K. are expected to fall. The European Union is slated to meet a minimum of 25 per cent of its natural gas requirement from the East-West corridor.¹⁵⁶ The Turkish government believes that the E.U.'s reliance on the East-West corridor is the correct alternative. It has been enhanced by the Turkmenistan and Shah

¹⁵⁵ Cited by Cenk Pala, Head of BOTAS's Foreign Relations Department, during the Turkey's First Natural Gas Conference which was held in July 2001

¹⁵⁶ Yurdakul Yigitguden's presentation during the 5th International Natural Gas and Power Conference which was held on September 24-25, 2002 in Istanbul.

Deniz natural gas project agreements and the Natural Gas Cooperation Agreement finalized between the European Commission and Turkey & Greece on July 7, 2000. The latter was approved by the governments of both countries on March 28, 2002.¹⁵⁷ All of this has bolstered Turkey's policy to become an energy bridge between East and West.¹⁵⁸

The Turkey and Greece natural gas connection project is a \$ 300 million deal to extend an existing Iranian natural gas pipeline from Turkey into Greece - an agreement that could eventually take Iranian gas to other European countries. The then Turkish Energy Minister Zeki Cakan and the Greek Development Minister Akis Tsochadzopoulos attended the meeting, where energy officials signed the deal to extend the pipeline from the town of Karacabey in western Turkey to the city of Komotini in northeastern Greece. The pipeline, which is expected to be completed by 2005, will initially carry 500 million cubic meters (17.5 billion cubic feet) of gas, which is slated to reach one billion cubic meters in 2007. This would be a 36-inch pipeline, and the project would cost an estimated \$200-250 million.¹⁵⁹

The project dates back to a trilateral Natural Gas Cooperation Agreement signed on July 7, 2000 in Brussels by the European Commission, Turkey and Greece. On August 8 and 9, 2001, Turkey stated that it could meet Greece's gas requirements, forecast to be 7.5 bcm in 2002. *Societe Generale* subsequently carried out a feasibility study on this. A meeting in Istanbul of BOTAŞ and Depa, the Greek gas company, in early March 2002 saw the virtual finalisation of discussions on this matter. Simultaneously, Greece and Iran signed a memorandum on March 14, 2002 pledging to explore ways to extend a gas pipeline from Iran

¹⁵⁷ The feasibility studies towards the Turkish-Greek Natural Gas Pipeline investment will be completed in 2003

¹⁵⁸ Yurdakul Yigitguden's presentation during the 5th International Natural Gas and Power Conference which was held on September 24-25, 2002 in Istanbul.

¹⁵⁹ IBS Energy Line, 03.21.2002, Issue 04/02

that now ends near Ankara. The Greek government has also secured E.U. funds to possibly extend its natural gas network to Italy.¹⁶⁰

From Turkey's viewpoint, the arrangement makes clear sense; not only in that it serves her long-term goal to become Europe's gateway to alternative sources of energy, but also, the project can address the problem of the gas surplus likely in the second half of this decade under existing contracts.

Turkey's support to the East-West energy corridor policy also overlaps with the E.U.'s strategic objective of the diversification of the energy supply. The Turkey and Greece natural gas connection project is supported by the European Commission, which wishes to see a southern European gas ring in order to improve gas supply security. The price of natural gas in the E.U. market is determined by two criteria: one is based on oil prices and the second through the spot market. In recent years, dependence on Russian gas on spot markets is rapidly increasing. This is a major source of concern among the major buyers and producers of natural gas in Europe. This also underlies the importance of the East-West energy corridor. With this motive in mind, E.U. representatives, especially French officials, are always including Turkey as their future full member and major transit hub of additional energy resources.¹⁶¹

¹⁶⁰ Turkish Daily News, 03.29.2002

¹⁶¹ Chairman of the International Energy Agency Governing Board Dominique Maillard, in his presentation during the European Energy Markets Conference which was held in Houston on September 27, 2002 stressed the importance of the East-West energy corridor and referred to Turkey as the future additional gas supply route to Europe. In 2001 CERA week in February, again the representatives from French national natural gas company Gas de France were explicitly referring to Turkish route for additional natural gas supply and naming Turkey among the 35 member EU in the year 2020. Similar points were also stressed by Laurent Ruseckas of CERA in his article in The Financial Times, July 23, 2001.

In addition, to support this general policy of energy security through diversification of the sources, the European Investment Bank (EIB) has provided TPAO with a Euro 90 million credit for development of its Silivri underground gas storage project, formerly known as Northern Marmara and Değirmenköy. The credit agreement was signed in Ankara on March 12, 2002. The project is expected to cost a total of \$150 million. This is the first EIB operation under the new "Special Action Programme", which makes available financing of similar projects for up to Euro 450m during 2001-04.¹⁶²

Developments that strengthen Turkey's long-term goal of becoming a gateway to the EU for additional and alternative sources of natural gas are not limited to these projects and developments. As he received the visiting Swiss Economy Minister Pascal Couchepin, then Prime Minister Bulent Ecevit proposed cooperation between Turkey and Switzerland on joint projects to be carried out in Central Asia, Caucasus, the Balkans and Afghanistan.¹⁶³

Turkey is also involved in discussions with Austrian customers about exporting gas to Vienna via alternate routes like Hungary and Slovakia. Gökhan Bildacı, General Manager of BOTAŞ, acknowledged this at the "Fourth Caspian Energy Retreat," an international conference held in London on March 11th, 2002.¹⁶⁴ He also emphasized BOTAŞ's interest in developing export contracts, saying that talks were continuing with Bulgaria and Romania on this.

Meanwhile, Minister of Energy and Natural Resources Zeki Cakan announced that BOTAŞ would cooperate with Bulgarian Bulgargaz and Romanian Transgaz for the

¹⁶² IBS Energy Line, 03.21.2002, Issue 04/02

¹⁶³ Turkish Daily News, 03.27.2002

¹⁶⁴ IBS Energy Line, 03.21.2002, Issue 04/02

transportation of Caspian natural gas to Europe. Cakan stated that the Austrian OMV and Hungarian MOL companies have also declared interest in participating in the Caspian gas project and added that these firms would bring the issue to the E.U.'s attention.¹⁶⁵ Eventually, on October 18, 2002, Turkey's Balkan neighbors Bulgaria and Romania agreed to build a section of an international pipeline to transport Iranian natural gas from Turkey to Central Europe.¹⁶⁶

There is, however, a disagreement between the experts over the possibility of positive outcomes from above-mentioned agreements and policies. The Greece-Turkey natural gas pipeline connection project is viewed with some scepticism by gas companies who question how gas shipped via Turkey can compete in price with gas from Russia. In addition, there is disagreement among scholars on whether the export of excess natural gas of Turkey could be winner in this competition. For example, CERA's Laurent Ruseckas thinks pushing excess gas to southern Europe may be easy, whereas oil and gas consultant Ferruh Demirmen does not. Demirmen argues that most of the gas import market in E.U. until 2020 is committed (closed) under existing contracts, and the gap that remains to be filled is heavily crowded with potential vendors holding plenty of gas, including Russia, Norway and Algeria, all of them already well entrenched in the E.U. gas market.¹⁶⁷

¹⁶⁵ Selected News on Turkey June 24-30, 2002 Compiled by the Washington Office of Turkish Industrialists' and Businessmen's Association (TUSIAD-US)

¹⁶⁶ Assozciated Press, Cumhuriyet & Dunya Daily, 10.19.2002

¹⁶⁷ The Financial Times, July 23, 2001, Turkish Daily News, August 24, 2001.

A. Political Assets of Turkey in the Caspian Region

The end of the Cold War and the demise of the Soviet Union drastically changed the international environment of Turkey's foreign and security policy. "In just a few years, Turkey has changed the style, scope and even substance of its foreign policy".¹⁶⁸ The Turkish governments undertook great efforts to adapt the country's foreign relations to the new situation. In the view of many analysts, these efforts are characterized by a greater assertiveness of Turkish foreign policy with regard to various regional political constellations.¹⁶⁹ Self-constrained and low profile no longer seems to be the hallmark of Turkey's foreign relations. Among Turkish officials, the conviction re-emerged that "Turkey has a special role to play in international affairs."¹⁷⁰

A Regional Power?

George R. Berrige describes the definition of medium powers by stating that:

"Medium powers typically have large populations, considerable national wealth and substantial armed forces. They have interests in many parts of the world and are therefore widely represented by their diplomatic services. It is also usual for them to possess influence within one or more regions of the world which is comparable to the influence which the great powers have in the world as a whole (though the extent of this will tend to be dictated by their own relationship with the great powers, and by the extent to which the great powers take an interest in the region). This is why it is often appropriate to refer to them as 'regional great powers'".¹⁷¹

¹⁶⁸ Philip Robins, "Between Sentiment and Self-Interest: Turkey's Policy Toward Azerbaijan and the Central Asian States", *Middle East Journal*, Vol.47, No.4, Autumn 1993, p.610.

¹⁶⁹ Kemal Kirisci, "The End of the Cold War and Changes in Turkish Foreign Policy Behaviour", *Foreign Policy*, Vol.17, No.3, 1993, p.10.

¹⁷⁰ Mehmet Öğütçü, "Religious 'Bias' in the West Against Islam Turkey as a Bridge in Between", *Foreign Policy*, Vol.18, p106.

¹⁷¹ George R.Berrige, *International Politics; States, Power & Conflict Since 1945*, 2nd ed., (Exeter: Harvester Wheatsheaf, 1992),p.18.

For nearly 40 years Turkey served as the southeastern bastion of the NATO alliance. Today it remains a member of the alliance. But the end of the Cold War, followed by the disintegration of the Soviet Union, whose threat NATO had countered, reduces the need for a defensive bastion. Now Turkey claims a new role, which is more likely to be as a regional power.

Formerly a peripheral bastion of NATO, Turkey now lies at the center of a new area of instability. Geographically, it is well placed to serve as a base from which a new order could radiate. At the outset of these changes, it was often concluded that Turkey had lost its former international importance, which derived from its value to the western alliance as the linch-pin of NATO defenses in the eastern Mediterranean. Before long, however, more positive reactions—even in some cases exaggerations¹⁷²—became the norm. In fact as William Hale has put it, “it soon became clear that the transformation of its international environment presented Turkey with a changed, but not diminished international role”.¹⁷³

Since the founding of the modern Turkish republic, especially in the period following the Second World War, Turkey's leaders have tried to form close political, military and economic relations with the West; Turkey's inclusion in NATO, its bilateral ties with the USA, and its membership in various European institutions were significant indicators of the

¹⁷²Among others Graham Fuller is one of the presentors of these exaggerations about the Turkey's future international importance—including, for example, the idea that it would become a kind of regional superpower, within its own sphere of influence extending from the Adriatic to western China. See for example, 'Turkey's New Eastern Orientation' in Graham E. Fuller and Ian O. Lesser with Paul B. Henze and J. F. Brown, Turkey's New Geopolitics: from the Balkans to Western China (Boulder: Westview Press, 1993), also see Graham E. Fuller, 'Central Asia and Transcaucasia after the Cold War: Conflict Unleashed' conference paper presented in 'The End of the Cold-War: Effects and Prospects for Asia and Africa' conference held at the School of Oriental and African Studies-SOAS, University of London, in 21-22 October 1994.

¹⁷³William Hale, 'Turkey, The Black Sea and Transcaucasia' in John Wright, Richard Schofield and Suzanne Goldenberg, eds., Transcaucasian Boundaries (London: UCL Press, 1995), p.54.

success of this strategy. But the issue of “Turkish national identity”—whether it was a European or a Middle Eastern state—has never been resolved. Developments within the period of 1995 and 2003 such as the emergence of strains in Turkey's relations with Europe and the growth of Islamic activism in Turkey have further complicated this question. The impact of the Turkic world on Turkey represents yet another complicating factor. The emergence of the new Transcaucasian and Central Asian republics, which share with Turkey a common linguistic, cultural, and religious heritage, confirms that Turkey possesses a broader identity that extends beyond a purely European one. This broader identity can be considered an asset rather than a weakness or disadvantage. The challenge is to acknowledge and accept this identity in the twenty-first century.”¹⁷⁴

With the downfall of the Soviet Union, what created a vacuum in the Caspian and Central Asian region, and American tendency to move into that vacuum, highly influential people within official decision-making circles did not remain immune to those pan-Turkic and pan-Islamic trends, although they clothed them in a more appealing garb. President Turgut Özal (1991-1993), some of his counselors, quite a few politicians and intellectuals, and part of the press had thus preached “an active foreign policy”, also referred to as “neo-Ottomanism.”¹⁷⁵

First as prime minister and then as president, Turgut Özal controlled the government of Turkey from the end of 1983 until the elections of October 1991. He was well aware of the role that his country could play in a rapidly changing regional scene and did much to

¹⁷⁴ Ziya Öniş, 'Turkey in the Post Cold-War Era: In search of Identity', *Middle East Journal*, Vol.49, No.1, Winter 1995, p.48.

¹⁷⁵ Ihsan Dagi, “Turkey in the 1990s: Foreign Policy, Human Rights, and Search for a new Identity,” *Mediterranean Quarterly*, Vol.4, No.3, 1993, pp.62-64, 74-75.

propagate the concept of Turkey as an island of stability in a troubled sea. Süleyman Demirel, who became prime minister in November 1991 and was elected president in May 1993, sought to spread the same message. Parliament, in May 2000, upon the termination of Demirel's term of office, replaced him by electing the former president of the Constitutional Court Ahmet Necdet Sezer, who has also made clear that he would follow the steps of his predecessors, perhaps in a less charismatic and assertive way but with the same goals in mind.

Like the late president Turgut Özal, Demirel believed that it was not enough for Turkey to enjoy stability within its own borders. Turkey will not be able to ensure, or safely enjoy, its own stability unless international order also extends to its neighbors. The Turkish authorities would find it much easier to master the problem posed by Kurdish separatist terrorism and, to a lesser extent, Islamic and revolutionary Marxist terrorism, if the regimes in Damascus, Baghdad, and Tehran abided by international law and did not seek to profit from terrorism. It is therefore in Turkey's interests to assist efforts to establish law and order outside its borders. By itself, Turkey cannot bring order to the Balkans, the neighboring republics of the former Soviet Union, and the Middle East. But it can make a significant contribution to international, especially Western, efforts in this direction. The belief that Turkey is now strong enough to be considered a regional power is widely held in Turkey, even though not all Turks see a benefit in exercising this power.¹⁷⁶

During the first half of the 1990s, Turkish foreign policy had certain strategic priorities in the Caspian. For historic, linguistic, cultural, and economic reasons, Azerbaijan was of

¹⁷⁶ Andrew Mango, *Turkey : The Challenge of a New Role* (Washington, DC.: The Centre for Strategic and International Studies, 1994), pp.110-11.

primary concern. Turkey, a country dependent on energy from neighbors, such as Iraq and Iran, with whom it has had uneasy relations, was especially interested in Azerbaijan's oil and gas reserves. Turkey also viewed Azerbaijan potentially as a bridge between itself and the CIS (Commonwealth of Independent States), especially the Central Asian republics. Indeed, Azerbaijanis, for their part, tried to portray themselves as such to the Turks. Despite talk of Turkish solidarity, Turkey was also aware of the historic cultural and religious bonds of Azerbaijan with Iran and thus it was anxious to prevent it from gravitating further toward Iran. In pursuit of this goal, Turkey was the first country to recognize Azerbaijan's independence. Turkey had established extensive ties with Azerbaijan even during the communist Muttalibov era. When the opportunity presented itself, as it did in spring 1992, for Turkey to develop a privileged relationship with that country, it seized it and supported the pro-Turkish National Front (APF) and its leader, Ebulfaz Elchibey.¹⁷⁷

A second priority of Turkish foreign policy was to make Turkey the main—and even the sole—conduit for the energy exports of Azerbaijan and those of Kazakhstan, Turkmenistan and other Turkic countries of the Caspian and Central Asian regions. Turkey was also interested in becoming involved in the exploration and exploitation of Azerbaijani oil.

A third priority was to make Turkey one of the principal—if not the principal—mediator of regional conflicts, the guarantor of regional peace and an overall power broker. The conflict that most concerned Turkey was, of course, the struggle between Armenia and Azerbaijan over Nagorno-Karabakh which we discussed earlier.

¹⁷⁷*Turkish Times*, May 15, 1992.

Lastly, perhaps the most important priority was to play a balancing role in opposition to Russian ambitions in the region, which hoped to install a *pax-Russica* in the region. Further complicating matters was Iran's ambition in the region.

B. Economic Assets

The legal and practical framework of economic relations between Turkey and Azerbaijan, Kazakhstan and Turkmenistan is largely established. The joint commissions on economics and transportation and Business Councils established with these countries make the discussion of economical and commercial relations possible on a regular basis.

The trade volume between Turkey and Azerbaijan increased from a couple of million USD in 1992 to almost one billion USD in 2002. Turkey thus plays a leading role in investments in Azerbaijan. Currently, more than 650 Turkish companies operate there. Turkish investments, including the energy sector and contracting services exceeds 1.5 billion USD. Economic relations between the two countries have been maintained through meetings of the Joint Economic Commission (JEC) and the Business Council (BC).

With a view to providing financial assistance to the economic development of Azerbaijan, two Credit Agreements worth a total amount of 250 million USD between Turkish Eximbank and International Bank of Azerbaijan were signed in April 1993 and in April 1994, respectively.

Together with Georgia, Azerbaijan constitutes an economic and commercial gateway for Turkey to the Caspian and Central Asia. Therefore, both official and private sectors attach importance to further develop economic and commercial relations with Azerbaijan.

Turkey's trade volume with Kazakhstan and Turkmenistan alone was more than 500 million US dollars in 2002, which constitutes 85% of its total trade with the Central Asian republics. The total amount of credits Turkish Eximbank has allotted to the Central Asian states, as of 2001, is around 797 million USDs, while the extended limit of credits is 903 million USDs. These credits aim to support the developing market economies of the Central Asian countries. Around 900 Turkish companies are currently involved in a wide range of investment projects and services in the republics of Central Asia.

Turkish businessmen play important roles in investments in this region. Investments by Turkish companies in Central Asia have reached a total of more than 3.5 billion US dollars. Turkish construction projects carried out in the last decade in Central Asia carry a price tag in excess of 7.8 billion USDs.¹⁷⁸

Turkey's economic policy towards the independent states in the Caspian and Central Asia were designed to overcome severe economic problems and to lead them to democracy and a market economy. In accordance with its policies, Turkey has continued, within her capacity, to support and encourage the Central Asian republics towards their goal of strengthening their economies, which has also contributed to their enduring efforts to foster democratic and pluralistic societies.

C. Social and Cultural Aspects of Relations

Knowing that every country needs well-educated experts to ensure the economic progress of their countries, Turkey has provided a large scholarship program to students from

¹⁷⁸ Figures in this section are obtained from the Undersecretariat of Foreign Trade and Ministry of Foreign Affairs of Turkey (www.mfa.gov.tr, www.foreigntrade.gov.tr).

Central Asian republics. Approximately 10,000 students have been admitted to Turkish universities and approximately 7,000 students are studying in Turkey.

Turkey is also cooperating with the Caspian and Central Asian Turkic republics in setting up vocational schools and high schools. The schools, which are supplied with equipment, training materials and teachers, envisage, along with the scholarship program, to provide qualified labor and foreign-language-speaking personnel.

In conclusion, it is debatable whether Turkey to date has been able to maximize her interests in the power game revolving around the immense riches of the Caspian region. For instance, it certainly would have been beneficial if Kazakhstan entered a formal commitment, with Russia's explicit consent, to route Tengiz oil via the Caspian-Mediterranean line. The new discovery in the Kashagan field and Chevron's and Conoco's letters of intent to participate in the BTC project, however, seem like pay-offs for the devoted and continuous efforts of the US-backed Turkish policy. Although new in the game, Turkey learned quickly that to further her interests she has to work very hard towards building a delicate balance where other parties' interests are also satisfied.

Turkey's energy politics appear to have secured significant success given the progress so far. She has not only accumulated knowledge about the rules of the game, but she has also become a player, which was able, through creating mutually beneficial policy objectives and interests, to persuade most of the other players to go her way. In a single decade, Turkey has become fully engaged in Central Asia and the Caspian. This key role has been attained despite Turkey's inability to create a coherent Central Asia policy over the years. Thus, one must wonder what might have been achieved if, earlier on, Turkey had developed a more

realistic, sober and pragmatic overall policy.¹⁷⁹ With the passage of earlier sentimentalism about ethnic brotherhood with all Central Asian republics, Turkey should reconsider its policy vis-à-vis individual countries in the region instead of treating them as a coherent whole. It is the task of diplomacy to recognize when to give priority to one's own interests and when to compromise. Turkish foreign policy was praised at the end of the Cold War for its high degree of rationality, sense of responsibility, long-term perspective and realism. Turkey, beyond exerting itself as big brother to the region by claiming indispensable ethnic and cultural ties, should employ these above-mentioned praised qualities in its Caspian policy, which has been especially lacking in 1990s.

¹⁷⁹ Turkey's multifaceted relations with the countries of the region are not of a balanced give-and-take type. In this relationship, Turkey continuously supplies aid and any other assistance that it is capable of. What it has received in return, however, has been far from satisfying: lack of international support, no appreciation, meddling with the Kurdish issue, and criticism that Ankara harbors pan-Turkic or domineering ambitions. Turkish decision-makers consistently deny the last two allegations. With an already tarnished image because of its earlier "big brother" attitude, bad business practices of some of the Turkish adventurers, and its inability to offer alternative solutions to regional economic and security problems, now might be the right time for Turkey to reconsider its relationship with Central Asian and Caspian countries. See Mustafa Aydin, "Turkish Foreign Policy towards central Asia and the Caucasus: Continuity and Change", *Private View*, Autumn 2000, No.9 pp.36-44.

PART II.

**OTHER ACTORS EFFECTIVE IN ENERGY RESOURCE DEVELOPMENT OF
THE REGION:**

4. The United States

The United States obviously is a major player in this game. Caspian energy development has significant implications for broader U.S. foreign policy goals. These goals fall into four general categories:

1. Strengthening the independence and prosperity of the new states of the Caspian region;
2. Bolstering energy security by ensuring the free flow of new sources of hydrocarbons to world markets, unfettered by regional competitors and geographic choke-points, such as the Bosphorus;
3. Re-establishing economic linkages among the new states of the Caspian region to mitigate regional conflicts; and
4. Enhancing business opportunities for companies from the United States and other countries.¹⁸⁰

Caspian reserves could replace the slowly declining production of oil and gas fields in the North Sea and other areas, which have been major factors in moderating western energy prices over the past two decades. Thus, importance of energy security is clear.

¹⁸⁰ Speech delivered by John S. Wolf, Special Adviser to the President and Secretary of State for Caspian Basin Energy Diplomacy, at the 19th Annual Conference of the American-Turkish Council on March 30, 2000 in Washington DC.

Energy development is a very important vehicle for introducing stability, market forces, and democracy into a region that continues to struggle with its communist legacy (all current rulers –including heads of states- of the region are ex-communist administrators) and regional conflicts (Azeri-Armenian Nagorno-Karabakh conflict, Georgian-Abkhaz conflict, Chechnya, etc). The presence of western energy investors in the Caspian not only provides much needed revenues to these fledgling economies and struggling governments, but also encourages the “rule of law” via the implementation of contracts and generally more efficient business practices. Whether western investors will ultimately succeed in stimulating the rule of law in the region remains to be seen.

Western governments in general and the United States itself in particular should continue an admittedly uphill fight for democracy in this region, but the wholesome prospects for that fight increase with greater resources and cooperation with democratic partners. In addition, the development of an east-west energy export corridor has the potential to foster stronger regional cooperation and to enhance the economic integration of the Caspian with the west.

In contrast to Armenia, the leaderships in Azerbaijan and Georgia were eager to cultivate closer ties with the United States and Turkey. President Shevardnadze has announced that Georgia will seek to join NATO, and officials in Baku have suggested that NATO, the U.S., or Turkey could establish a military base on the Apsheron peninsula in Azerbaijan (northwest of the country), to offset Russian-Armenian military ties.

Concerning new opportunities for U.S. investors, it is instructive to look at the value of oil contracts in the Caspian region, where western firms already are planning investments

of more than \$100 billion from 2000-2020. Granted, much of this investment is contingent upon the results of successful exploration and complex pipeline negotiations, but the sheer magnitude indicates the region's potential.¹⁸¹ Investments in Caspian energy resources will provide opportunities for foreign investors in other sectors as well. Wealth generated by energy exports is clearly able to spur economic diversification and market growth in the region. This will require sound management of the new revenues by the governments, including a real effort at reinvesting them wisely and fighting corruption.

The U.S. role in these projects can best be described as mediator and facilitator in accomplishing deals. If the United States does not serve as a facilitator in negotiations, it should encourage all parties to conclude the agreements required to ensure the commercial viability of the pipelines. While the United States is encouraging the establishment of partnerships among countries and companies, the task of negotiating commercially viable agreements is seemingly left to the responsibility of the countries and companies involved in specific projects.

Ongoing energy projects in the Caspian have demonstrated that active American leadership and commercial cooperation can reap both economic and political benefits. During the Clinton administration, the United States strongly endorsed joint investments by American and Russian companies in the development of energy resources and transportation networks both within Russia and throughout the Caspian region. This approach provided economic incentives for Russian cooperation while giving the other former Soviet republics access to unprecedented wealth that could grant them a degree of independence not

¹⁸¹ From the speech delivered by Bill Richardson, U.S. Secretary of Energy, at "The Geopolitics of Energy into the 21st Century" conference organized by CSIS in Washington DC, December 8-9 1999.

experienced since the time of Tamerlane. At the same time, it has secured a major role for American companies in the region while consolidating American relations with Turkey and the other Caspian states. Finally, it contained Iran's regional influence at a time when that country's policies were particularly anti-American.

But these accomplishments are now at risk, according to some observers, because of inadequate attention from the Bush administration and restrictive U.S. policies.¹⁸² In contrast to the Clinton administration's vigorous support of Caspian energy initiatives, the Bush team seems to have placed those issues on the back burner. It has eliminated, for example, the position of special adviser to the president and secretary of state for Caspian energy diplomacy, replacing it instead with a "senior adviser" on Caspian energy issues in the State Department. It has excused from serious Caspian energy policy development the high-level interagency groups encompassing the White House, the Commerce, Energy, and Treasury Departments, and the trade finance agencies, which contributed to this policy during the Clinton administration.

On the one hand, in the absence of such attention, coordination, and oversight, the success and leadership of American firms in the Caspian region may well be stunted by restrictive policies. The prospect of developing meaningful commercial energy dialogue with Russia, as mentioned earlier, makes these concerns more viable.

On the other hand, new geopolitics emerged after September 11th, and the need to cooperate with the Caspian and Central Asian countries in the campaign against terrorism makes continuous U.S. involvement in the region an absolute necessity. The U.S.-led efforts

¹⁸² Kalicki, *FP*, *ibid*

to combat terrorism after the September 11th attacks are creating a political earthquake in Central Asia and the Caspian region. Coalitions are shifting and new ones are being formed. In the effort to court new support, the United States should be careful not to forsake those states in the region that have supported its anti-terrorism and non-proliferation efforts during the past decade.

Long prior to the catastrophic events of 2001, states like Azerbaijan, Kazakhstan (on the issue of non-proliferation) and Uzbekistan were cooperative with Washington on a variety of issues affecting U.S. security, and, at times, endured retribution from neighbors such as Iran, China and groups in Afghanistan, due to their allegedly pro-American policies. Azerbaijan's, Uzbekistan's and to some extent Kazakhstan's generous assistance to the United States in the aftermath of the tragedy is crucial to making possible various policy and military options in the region.

The Department of State still maintains a Senior Advisor on Caspian Basin Energy Diplomacy. The incumbent Ambassador Steve Mann serves as a catalyst between governments, industry and in some cases NGOs, to achieve specific milestones to further the goal of creating an East-West energy corridor from the Caspian to the Mediterranean.

Thus, the growth of oil supplies from the Caspian can be one of the most important new contributions to stability in world oil markets -- especially in the face of non-OPEC declines elsewhere. The Caspian Basin has tremendous potential, offering the possibility of production increases from 1.6 million barrels per day (b/d) in 2001 to 5.0 million b/d in 2010. This represents the largest non-OPEC production growth in the world. Transporting the oil from this land-locked region to world markets through the development of multiple pipelines

has been (since the mid-1990s), and should continue to be, a major U.S. foreign policy priority. In addition to enhanced energy security, this policy will strengthen the sovereignty and economic viability of new nation states in the region.¹⁸³ Therefore, The United States has many reasons to pursue the enhancement and expansion of political and economic relations with the Caspian countries. By further developing those relations in general, and working with the governments in and around the region to facilitate energy development, the United States government can make one of its most important contributions to energy security.¹⁸⁴

5. Oil and Gas Companies

In all pipeline projects in the region, multinational oil and gas companies are always concerned with commercial feasibility of the projects. There are the inevitable questions of profit. Whether the oil goes to Turkey, China or to India is irrelevant. Whether the transaction is profitable makes all the difference.

Which companies are involved?

While the ranking figures, like the one below (Figure 5.1.), provide a useful indication of companies likely to succeed in the Caspian, they do not take into account the technical, financial, political, and market risks that face all companies operating there. Each project is subject to varying degrees and types of risk, and those companies best able to

¹⁸³ Testimony of the Honorable Alan Larson, Under Secretary for Economic, Business and Agricultural Affairs, U.S. Department of State, before the Senate Foreign Relations Committee Subcommittee on International Economic Policy, Export and Trade Promotion, Washington, D.C. April 8, 2003

¹⁸⁴ Daniel Yergin's testimony before the U.S. House International Relations Committee hearings on "Oil Diplomacy: Facts and Myths Behind Foreign Oil Dependency" June 20, 2002.

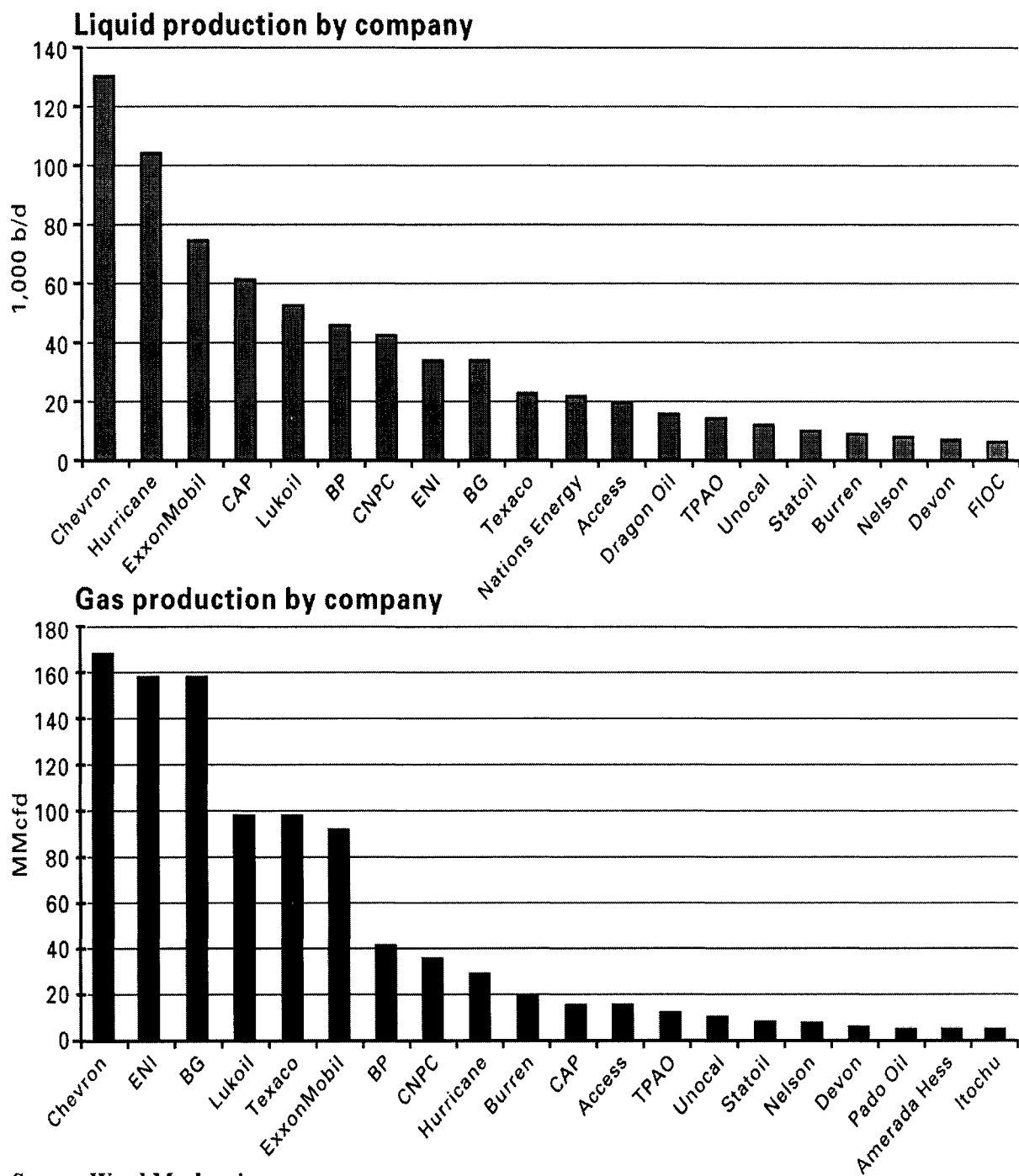
successfully manage such risks in this volatile region will ultimately succeed and become the most profitable.

Using Wood Mackenzie's PathFinder database and mapping product, in Figure 2, remaining reserves rankings have been compiled for the top 20 companies (excluding the national oil companies) operating in the Caspian region (Figure 5.2.).¹⁸⁵ Despite the discovery of the giant Kashagan oil field by the OKIOC consortium during 2000, Chevron Corp. has maintained its overall position at the head of the reserves rankings due to its 50% stake in Tengiz Chevron and Texaco Inc. reserves are displayed separately to illustrate the relative contribution, prior to their merger to form ChevronTexaco Corp. in October 2000. The top 20 companies in the region control 60% of the Caspian's oil and gas reserves. ChevronTexaco is the leading oil company in the Caspian, and is well positioned to dominate oil and gas reserves and production rankings in the Caspian for several years.

¹⁸⁵ *Oil & Gas Journal*, December 17, 2001

Figure 5.1.

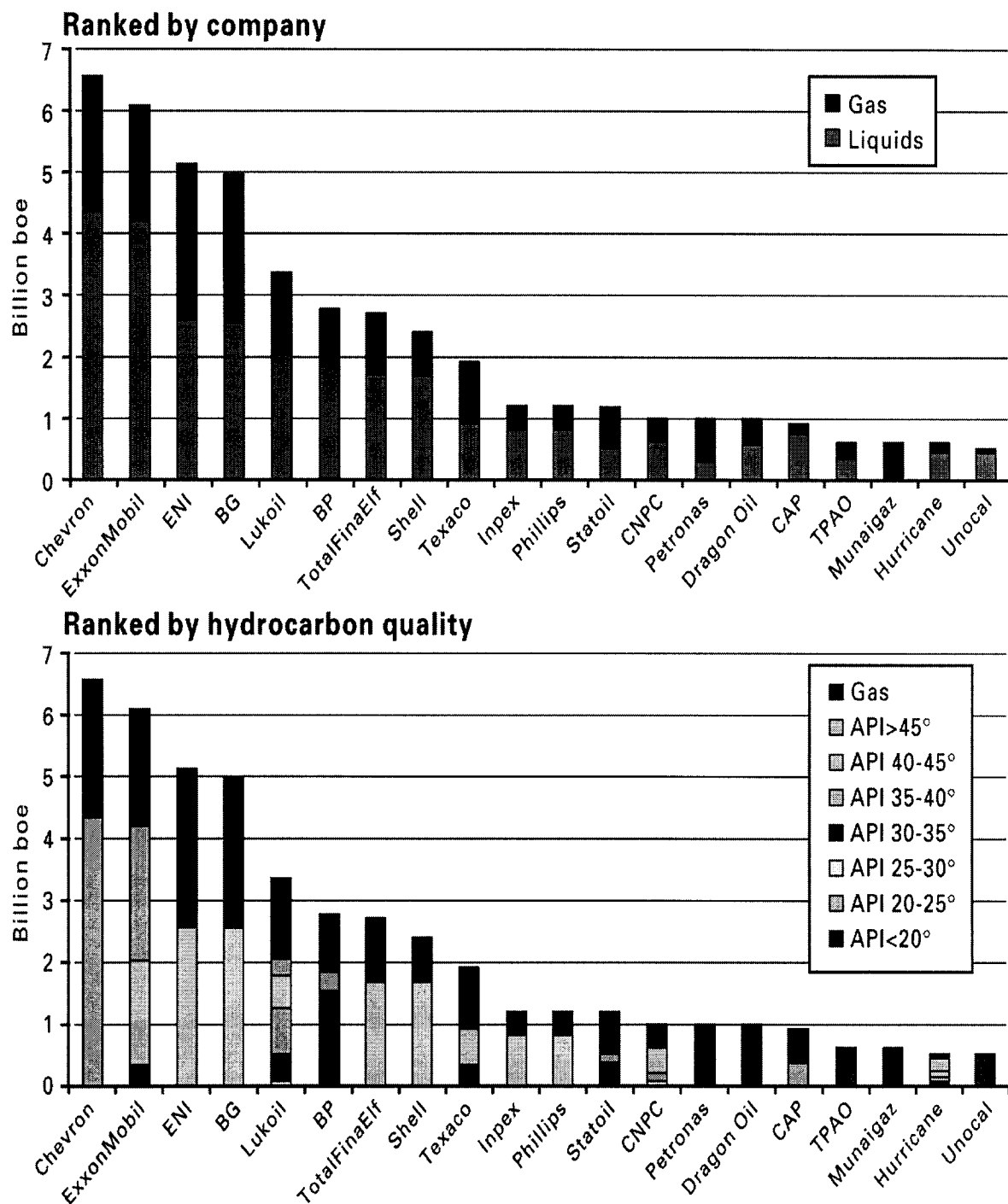
2001 CASPIAN REGION PRODUCTION



Source: Wood Mackenzie

Figure 5.2.

CASPIAN REGION'S REMAINING RESERVES*



*As of 2001.

Source: Wood Mackenzie

ExxonMobil Corp. has closed the gap significantly to within 500 million BOE, with its 16.67% stake in the Kashagan discovery. In addition to its previously stated liquids reserves estimate, Wood Mackenzie used a conservative reserve estimate of 25 tcf of gas for Kashagan, which later, although not yet confirmed, was revised up to 50 tcf following further appraisal.

Even allowing for this upward revision of Kashagan reserves, the newly consolidated ChevronTexaco should easily be able to maintain its lead position in the Caspian Basin.

Although initially part of the OKIOC consortium that made the Kashagan discovery, BP, along with Statoil, decided to sell its interests in Kashagan to the remaining partners. In doing so, BP slid down the reserve rankings from the third position to sixth, while OKIOC members ENI SPA and British Gas PLC (formerly affiliated with the BP group) have moved into the third and fourth spots, respectively. Lukoil has also moved ahead of BP following the discovery of Yuri Korchagin and Khvalynskoye oil fields in the Russian sector of the Caspian.

The Kashagan discovery has thrust several new companies into the reserves rankings, including TotalFinaElf, Royal Dutch/Shell Group, Inpex Corp., and ConocoPhillips Petroleum Co. Tengizchevroil is operated by ChevronTexaco with 50% interest. ExxonMobil holds 25%, the Kazakh state oil and gas company KazMunaiGaz holds 20%, and LukArco holds the remaining 5%.

It is clear that the region's production and reserves base is very much dominated by the majors and super-majors, for which the Caspian region provides a significant part of their overall global reserve base and is likely to remain a focus for future additions. The top 20

companies in Figure 5.2. control about 60% of the region's remaining oil and gas reserves, with the remainder largely in the hands of state organizations.

Companies have always maintained that commercial considerations will first and foremost determine the outcome in energy development projects. These massive infrastructure projects must be commercially competitive before the private sector and the international community can commit investments. Support for specific pipelines such as the BTC oil pipeline and TCGP is not driven by a desire to intervene in private, commercial decisions. Rather, it derives from the belief that it is not in the commercial interests of companies operating in the Caspian states — nor in the strategic interest of the host states — to rely on a single, major competitor for transit rights.

The need for private investment to realize the full potential of the region's oil and gas reserves is beyond dispute. One estimate puts the total investment requirements at US\$ 140-200 billion (in more or less equal amounts for oil and for gas).¹⁸⁶ Since 1995, multinational oil companies have entered into joint arrangements to explore and produce the Caspian region's resources. As of 2002, multinationals have spent anywhere from \$25 billion to \$30 billion in developing these projects.¹⁸⁷ To protect these investments, oil and gas companies must take a sensible, long-term view of the region's development, oil demand, and price trends in the oil market. With this huge investment exposure, it is only prudent to plan now

¹⁸⁶ The requirements of Turkmenistan's oil and gas industry for capital investment during 2001-10 are projected at \$25 billion. Energy Department officials say Kazakhstan will require \$50 billion to \$70 billion in investment, while Azerbaijan will need around \$60 billion. Nikola Krastev, "Multinationals Pushing Oil Projects Despite Instability, Corruption" *EurasiaNet & RFE/RL* March 31, 2002; *Oil&Gas Journal*, October 14, 2002 ; "The Future of Caspian Oil: Can a "Great Game" be Averted?", Cambridge Energy Research Associates, December 1997.

¹⁸⁷ Dirk L. Bendsdorp, "Selling natural gas in a liberalizing market," a paper presented during the European Energy Markets Conference which was held in Houston on September 27, 2002

for long-term export and domestic distribution of the region's oil and gas.¹⁸⁸

In the light of above explanation and analysis, I would like to conclude that private companies are major actors in the Caspian oil and gas scene. For their part, they add to the complexities of this grand puzzle.

6. OTHER COUNTRIES OF THE CASPIAN BASIN; AZERBAIJAN, KAZAKHSTAN & TURKMENISTAN.

First I would like to discuss the common elements, such as the assets, risk factors and problems of the other Caspian littoral countries, Azerbaijan, Kazakhstan and Turkmenistan, as a whole. Following which, I will delve into the individual and distinctive characteristics of these states.

The newly independent countries of the Caspian, as the owners of abundant energy resources, naturally represent key actors in the Caspian Basin. Although proved oil and gas resources can be considered relatively small shares compared to global supplies, recent discoveries in late 2001 and 2002 are likely to change these figures (Table 5.2.). As of Jan.1, 2002, the five Caspian states - Azerbaijan, Iran (Caspian reserves only), Kazakhstan, Russia (Caspian reserves only) and Turkmenistan – were estimated to possess remaining liquid reserves of 39.4 billion bbl (Table 5.3.; Figure 5.3.; Figure 5.4.).

¹⁸⁸ David L. Goldwyn, *Testimony before the Subcommittee on International Economic Policy, Export and Trade Promotion, Senate Committee on Foreign Relations*, April 12, 2000.

Table 5.2. Caspian Oil and Gas - Proved Reserves at the end of 2001

	Oil (billion barrels)	Share of World Total	Gas (trillion cubic feet)	Share of World Total
Iran	93.0	8.5 %	812.3	
Iran (Caspian)	0		0	
Azerbaijan	7.0	0.7 %	30.0	0.5 %
Kazakhstan	8.0	0.8 %	65.1	1.2 %
Russia	48.7	4.6 %	1,680	30.7 %
Russia (Caspian)				
Turkmenistan	0.546	0.1	102.0	1.8 %
Total World	1,050		5,476.7	

Source: BP Statistical Review of World Energy 2002.

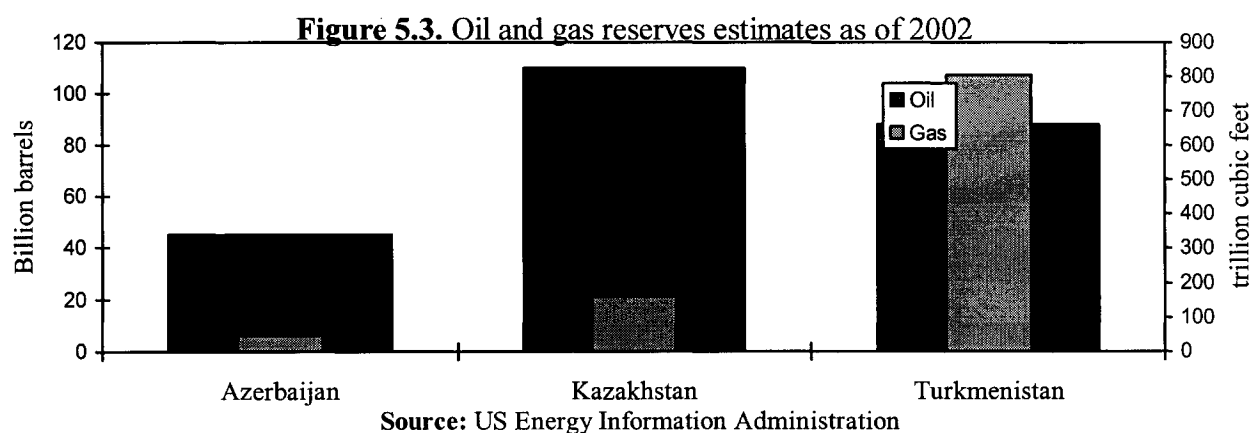
Table 5.3.

CASPIAN REGION REMAINING RESERVES SUMMARY¹

	Oil, million bbl	Gas, bcf	Million boe	Gas % of total
Azerbaijan	6,625	21,358	10,384	36.2
Kazakhstan	29,839	93,313	46,262	35.5
Iran ²	0	0	0	0
Russia ²	750	1,250	970	22.7
Turkmenistan	2,177	91,060	18,204	88.0
Total	39,391	206,981	75,820	48.0

¹ Wood Mackenzie projection for Jan. 1, 2002. ² Caspian portion only.

Source: *Oil&Gas Journal*, December 17, 2001



Future liquids production growth in Azerbaijan depends heavily on the sanction and construction of the high-profile BTC main export pipeline. Providing BTC is operational by

2005, the ACG project should be able to realize its full potential, driving Azerbaijan's liquids production up nearly fourfold to more than 1.1 million b/d in 2010 (Table 5.4.).

Table 5.4.

CASPIAN REGION LIQUIDS PRODUCTION POTENTIAL¹

	1990	1995	2000	2005	2010	2015	2020
	1,000 b/d						
Azerbaijan	251	186	282	406	1,112	954	519
Kazakhstan	516	409	736	1,629	2,246	2,484	2,144
Iran ²	0	0	0	0	0	0	0
Russia ²	0	0	0	32	100	85	63
Turkmenistan	114	100	154	272	318	333	251
Total	881	695	1,172	2,339	3,786	3,856	2,977

¹ Based on existing discoveries only. ² Caspian portion only.

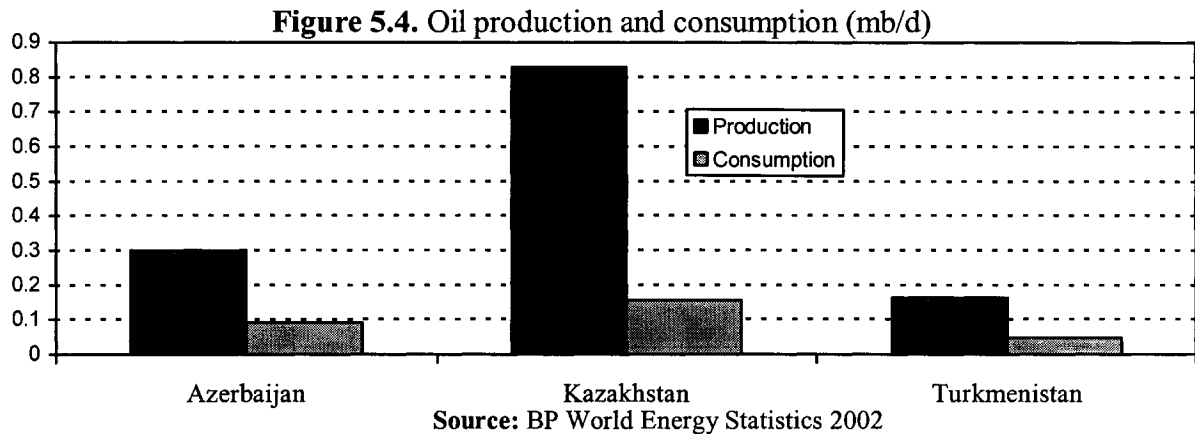
Source: *Oil&Gas Journal*, December 17, 2001

While future exploration is likely to add to the region's proven liquids reserves and hence production potential post-2010, disappointments in the promising Azeri sector in 2001 and 2002¹⁸⁹ have cast significant doubt over the prospects of the southern Caspian. Conversely, large discoveries in the Russian and Kazakh sectors in the north have provided increased optimism that future production growth may come from discoveries made in that region.

¹⁸⁹ In February 2002, ExxonMobil abandoned its Nakhchivan-1 exploratory oil well in Azerbaijan's sector of the Caspian Sea after failing to find commercial reserves. Nakhchivan-1 is the second dry well sunk by Exxon in the Azeri sector of the Caspian. In 2001 it failed to find commercial oil reserves on the Oguz prospective block and later abandoned exploration there. Other companies have not had much more success. Italy's Eni Agip, France's TotalFinaElf and U.S. group ChevronTexaco have all failed to find commercial reserves in other Azeri offshore fields. The massive Azeri-Chirag-Guneshli oil field and the Shah Deniz gas field, both operated by BP, remain the only major reserves discovered to date in the Azeri sector of the Caspian. "ExxonMobil to Abandon Azerbaijan Well," 02/25/2002, http://www.rigzone.com/news/article.asp?a_id=2698

In Turkmenistan, liquids production is influenced primarily by progress at the Cheleken and Livanov contract areas. Production is expected to rise to 318,000 b/d by 2010 before declining after 2015 (Table 5.4.).

Figure 5.4. below, depicts the production and consumption of oil and gas in the Caspian region. Again, Russia is excluded so as not to distort the scale. Russia produces more than 7 mb/d of oil but only consumes 2.5 mb/d, leaving approximately 5 mb/d for exports. Russia also produces 56.3 bcf/d of natural gas and consumes 35.2 bcf/d domestically, exporting more than 21 bcf/d.



Although oil currently remains more important to Azerbaijan, it contributes about 10% of the region's remaining gas reserves, primarily due to the giant Shah Deniz gas field. Despite its smaller gas volumes, Azerbaijan has a geographical advantage that has enabled it to secure a significant gas sales contract with Turkey at an international gas price. Unlike some of the other Caspian states, Azerbaijan remains relatively well positioned to gain additional gas market share and to capitalize on its gas assets in the longer term.

Based on existing discoveries alone, the Caspian region has the potential to produce about 16-17 bcf/d of natural gas by 2010, with the main contributors being Turkmenistan (49%) and Kazakhstan (38%) (Table 5.5.). The key projects driving gas production over the short-to-medium term in Kazakhstan are the Karachaganak, Tengiz, and Kashagan developments. In Turkmenistan, gas production will be driven largely by the production capacity of existing fields and market demand, rather than by development of new reserves. Such long-term deals would also benefit Kazakhstan, and it has already invested in modernizing its domestic gas pipelines.

With estimated associated gas reserves of about 25 tcf, the Kashagan oil discovery has enhanced Kazakhstan's position as a regional gas player, bringing it in line with the vast remaining gas reserves held by Turkmenistan.

Table 5.5.

CASPIAN REGION GAS PRODUCTION POTENTIAL¹

	1990	1995	2000	2005	2010	2015	2020
	MMcfd						
Azerbaijan	1,070	643	584	965	2,040	2,262	1,713
Kazakhstan	769	701	807	3,302	6,345	7,420	6,736
Iran ²	0	0	0	0	0	0	0
Russia ²	0	0	0	52	167	142	106
Turkmenistan	8,491	3,154	4,484	8,356	8,172	6,621	4,828
Total	10,330	4,498	5,875	12,675	16,724	16,445	13,383

¹ Based on existing discoveries only. ² Caspian portion only.

Source: *Oil&Gas Journal*, December 17, 2001

These abundant energy resources are good enough to make these countries conspicuous actors in the Caspian energy geopolitics. There are, however, some other factors that need to be considered as regards the development of these abundant energy resources.

After the collapse of the Soviet Union, the energy industry in these countries and especially the oil and gas sector shrank along with the rest of the economy. This contraction was related to inefficiencies inflicted upon these economies during the command-and-control system of the Soviet Union, the subservience of Caspian economies to that of Russia and the reluctance of post-Soviet governments to implement policies that would remedy these inefficiencies in an era of otherwise open market conditions. These new countries have begun to learn the energy business from scratch. Lack of modern institutions and companies to deal with the challenges of the energy industry plus the lack of know-how, technology and capital to develop these resources have hindered the potential role to be played by these countries. With the accumulation of wealth from the export of oil and gas, however, they should learn to be real actors soon.

Risk factors in Azerbaijan, Kazakhstan and Turkmenistan

In the case of the Caspian states, the governments' ability to allocate newly acquired oil and gas export revenues transparently to high-priority policy objectives such as diversification of the economy, education and health, is often rather weak. In other words, governments and other state institutions lacking accountability, and with few staff trained in expenditure analysis or auditing, are prone to considerable corruption and waste. Large swings in oil revenues undermine already-rudimentary fiscal discipline.¹⁹⁰ Weak parliamentary oversight of the executive, and the lack of an impartial and competent judiciary, mean there are few checks and balances against such behavior. Highly

¹⁹⁰ Jonathan Walters, "Caspian Oil and Gas," A World Bank Study, June, 2000.

personalized and centralized political authority, combined with uncertainty over succession to high office and widespread patronage in public appointments, reinforce these tendencies.

This can give rise to a widespread popular perception that most of the benefits of oil are being captured by local elites in collusion with foreign investors, and that there is little impact on increasing the living standards of the majority of the population. Even worse, the growth of the oil sector may crowd out investment in the rest of the economy, leading to a decline in average incomes outside the oil sector. This phenomenon, known as “Dutch Disease,”¹⁹¹ may already be afflicting some Caspian oil producers, and is almost certain to be manifested once hydrocarbon revenues increase substantially, unless governments make a concerted action to prevent this.¹⁹²

Even where there is little or no Dutch Disease, non-oil sectors in the oil producing countries of the Caspian seem to be growing only as slowly as the economies of other CIS countries. The oil producers are thus becoming highly dualistic economies, with increasing inequality between those who participate directly in oil growth based primarily on exports, and those who are excluded. Over time, this can be expected to create political tensions.

It is questionable whether Caspian Basin governments will try to seize the opportunity to address the dangers posed by Dutch disease. So far, the governments have

¹⁹¹ Dutch disease is an economic malady in which the large influx of foreign currency from oil and gas exports creates distortions in the domestic market and exchange rates that ultimately hinder the development of non-energy sectors. Energy profits tend to inflate the value of a nation's currency. This, in turn, reduces international demand for the particular country's durable goods, possibly resulting in a withering of agricultural and non-energy manufacturing. Oil and gas development also tends to monopolize foreign investment, frustrating the potential development of other sectors.

¹⁹² Just as the fiscal effects of oil revenues are asymmetric between upswings and downswings, so are the exchange rate effects. Non-oil sectors wiped out during an exchange rate appreciation induced by an oil boom, are not easily restored when a downswing in the oil cycle causes a depreciation of the exchange rate. Ibid.

done little to address the potential economic and social consequences. Because it has the largest and most diversified economy, Russia is less likely to feel the full effects of Dutch disease. Azerbaijan and Kazakhstan, however, appear headed for an economic shock. The risks are perhaps greatest for Azerbaijan, where oil already comprises more than 90 percent of exports and where non-energy industry has virtually ground to a halt. The Turkmen economy, too, depends on the revenues from natural gas and oil, which constitute major portion of the GNP. According to data of January 1999-January 2003 period, natural gas constituted approximately 70 per cent of Turkmenistan's total export and crude oil and oil products 9 per cent.¹⁹³

Even if regional leaders push to implement changes, however, the window of opportunity for the oil-and-gas revenue bonanza might prove too fleeting for Caspian Basin states to avoid a bout of Dutch disease. Indeed, many analysts say the possible spike in energy prices in the near future may be followed by an even more drastic decline.¹⁹⁴ If that scenario turns out to be true, Azerbaijan, Kazakhstan and even Russia could find themselves struggling to cover ever-widening budget gaps created by diminished oil and gas export revenue.

All three Caspian littoral states are landlocked. Some of the pipelines proposed involve numerable transit countries. The number in fact is exceptionally high, or even unprecedented, by comparison to countries elsewhere in the world.¹⁹⁵ Transit is always

¹⁹³ Electronic version of *Turkmenistan News Weekly*, economy section.

¹⁹⁴ Ariel Cohen "Caspian Basin Confronts Boom and Bust Energy Cycle," March 24, 2003 A EurasiaNet Commentary, www.eurasianet.org

¹⁹⁵ Perhaps the most extreme example is the proposed Trans-Caspian Gas Pipeline, which involves four countries (Turkmenistan, Azerbaijan, Georgia, and Turkey) and transit across a territory with controversial

risky, and Caspian transit countries are riskier than most (please refer to the ethnic problems mentioned in the previous chapter).

The strongest incentive for cooperative behavior between investors and the transit countries is the availability of alternative pipelines for producers. In several cases of proposed pipelines in the Caspian region, alternatives either already exist or could be created at relatively low cost by connecting to existing systems.¹⁹⁶ The propensity of some governments in the region to heavily subsidize pipeline construction, although wasteful on the whole, does serve to enhance discipline on competing transit countries.¹⁹⁷ In general, the high degree of transit competition in the Caspian region should help to induce good cooperative behavior. On the other hand, some of the alternative transit options involve crossing competing producer countries.¹⁹⁸ This competition reduces the attractiveness of such transit, since a competing producer may disrupt transit to enhance its own market prospects.¹⁹⁹

Legal and Regulatory Environment

Different countries are at various stages of developing a legal framework for the oil and gas sector (Table 5.6.). The same can be said about the privatization of the oil sector in

property or use rights (the Caspian Sea itself). There are few, if any, examples of such transit complexity elsewhere in the world.

¹⁹⁶ For example, the Russian and Iranian pipeline networks (both oil and gas).

¹⁹⁷ There appears to be a growing tendency for governments in the region to build or plan to build pipelines with subsidized financing, substantial tax breaks, or government guarantees. Examples include Yuzhne-Brody (Ukraine), Chechnya bypass through Dagestan, Blue Stream, Baku-Tbilisi-Ceyhan, and the pipeline from Neka on Iran's Caspian coast.

¹⁹⁸ For example, Russia, Iran, and Azerbaijan (for Turkmen gas).

¹⁹⁹ Jonathan Walters, *ibid.*

these countries. Though all of them have inherited similar centralized non-market-oriented economic systems, their privatization efforts are very different.

Azerbaijan and Kazakhstan desperately need additional export route capacity for their oil. Currently, pipeline capacity allowed by Russia to the “Caspian Three” (Kazakhstan, Turkmenistan and Azerbaijan), other than the CPC pipeline operated by ChevronTexaco, is limited mainly to 160,000 b/d of Tengiz oil sent to the Baltic Sea through the Druzba (Friendship) pipeline and 20,000 b/d of Azeri oil sent to Novorossiisk. Alternative transportation via trains and barges or swaps with Iran are cumbersome but provide a short-run, albeit costly, solution to the problem. About 140,000 b/d of oil is exported through non-pipeline options. These alternatives, however, cannot handle the 4-5 mb/d of crude oil the region is projected to export by 2010. Although Turkmenistan’s exports will remain a fraction of those by Azerbaijan and Kazakhstan (Figure 5.6.), the country will still need to find an export route for its oil. Currently, the country uses swaps with Iran for about 20,000 b/d, but this option is not practical for the 540,000 b/d the country is expected to have available for export by 2010. In terms of access to markets, Turkmenistan is probably in the worst shape. Most pipeline routes will have to go through several potential competitors’ territory. The most direct route through Iran, as earlier noted, is politically untenable. Besides elaboration on common problems that the Caspian Three face, it is also useful to look at individual characteristics of the three countries.

Table 5.6. Availability of the energy related legal and environmental legislation

	Azerbaijan	Kazakhstan	Turkmenistan
Petroleum Law	No	Partial	Yes
Regulations	No	No	Yes
Production Sharing Agreements-PSAs	Yes	Yes	Yes
Environmental Law		Yes	
One-stop Shop	No	Partial	Yes
Pipeline Law	No	No	No
Pipeline/gas tariff regimes	No	Yes	No

Kazakhstan

Kazakhstan, with a population of 16 million people and with a landmass of more than one million square miles, is one of the most sparsely populated countries in the world. GNP per capita increased from \$304.75 in 1993 to \$1,664 in 2002. Kazakhstan has a vast area of arable land, but the agricultural sector's share of GDP is only about 10% while the industrial sector, which is largely geared towards developing Kazakhstan's natural resource base, accounts for about 30%. The economy is still closely linked with the other economies of the Former Soviet Union (FSU), and especially with Russia. However, since independence in 1991, trade has been redirected toward markets outside the FSU. Export share to Russia fell from 52% in 1987 to 26% in 1999. About 40% of Kazakhstan's imports come from Russia.²⁰⁰

In terms of the energy sector, refineries in Kazakhstan are the biggest problem for the industry. Refineries are struggling to overcome their legacy of outdated technology from the Soviet era. Prior to the break-up of the Soviet Union, these refineries were part of a broader regional network. They were designed to function as part of a monolithic, centrally

²⁰⁰ www.kazakhinfo.com, www.president.kz

controlled Soviet oil industry. The justification for the initial construction of these refineries was based on the needs of the Soviet era and the requirements of the Soviet economy, rather than on the particular domestic or industrial needs of each country. As an example, Kazakhstan's refining configuration is not suited to its internal needs. The 104,000 b/d Atyrau refinery is the only refinery that can process domestic oil produced in the region. The Pavlodar and Shymkent refineries do not have connections to the most prolific producing region of the country and depend on Russian oil. In 1999, 74% of refinery throughput was Russian oil delivered from Siberia.

Turkmenistan

With combined hydrocarbon resources, estimated at 22.8 trillion cu m (805 tcf) of gas and 12 billion tons (88 billion bbl) of oil, Turkmenistan could be viewed as a serious player in the Caspian region and the world. For comparison, according to U.S. Energy Information Administration data for February 2002, Azerbaijan's resources were estimated as follows: gas, 46 tcf; oil, 36-45 billion bbl; Kazakhstan's resources: gas, 153-158 tcf; oil, 102-110 billion bbl.²⁰¹

With 101 tcf of proved gas reserves (roughly two percent of total world reserves) Turkmenistan appears to be well positioned to benefit from increasing demand for natural gas. However, as compared to its competitors, Turkmenistan has certain disadvantages. Since the country is landlocked, LNG is not a viable alternative, and the country is farther away from hard-currency markets. After the collapse of the Soviet Union, natural gas resources in Turkmenistan have become too distant for major consumers, especially since

²⁰¹ *Oil & Gas Journal*, October 14, 2002

Gazprom allows limited access to its pipeline system. Ukraine, the largest consumer of Turkmen gas in the 1990s, has not been able to pay its bills. After cutting off supplies to Ukraine at the end of the first quarter of 1997, Turkmenistan resumed its supply to Ukraine at the end of December 1998. Although only part of the payments was to be made in cash, Turkmenistan had to cut supplies again in mid-1999 because of Ukraine's inability to pay. The result of these developments can be seen in production figures: Turkmen gas production fell to 413 bcf a year in 1998 from almost 3 tcf in the late 1980s. Accordingly, exports fell to 77 bcf in 1998 from 2.4 tcf in 1987.

In order to revive the Turkmen gas exports, alternative markets have been considered. American companies Bidas and Unocal developed a potential pipeline route through Afghanistan. However, Pakistan does not have an immediate need to import gas in the next five to seven years. Pakistan has been increasingly successful in finding and developing more of its own gas resources. Also, gas demand has stagnated as a result of recent delays in power plant development. In addition, the possibility of supplying gas to India through Pakistan seems to be more remote than ever, as the relationship between these two countries continues to deteriorate. The Chinese market also has been considered. The distance to be covered for Turkmen gas to reach the potentially large markets in southeast China is such that estimates for the cost of building this pipeline reach upwards of \$10 billion. As a result of all these constraints, European markets, beginning with that of Turkey, appear to be the best alternatives.

Trans-Caspian plans

The Trans-Caspian Natural Gas Pipeline project (TCGP) calls for transporting gas from eastern Turkmenistan through a pipeline laid on the Caspian seabed to Azerbaijan and via Georgia to Turkey. The projected capacity of the \$3 billion pipeline is 30 billion cu m/year (2.9 bcf/d). March 1999 saw the establishment of the Transcaspian Pipeline Consortium led by a U.S. company, the Pipeline Solutions Group (a joint venture between Bechtel and GE Capital) – PSG, which was later joined by Shell. Shell took the lead after PSG pulled out. The project has remained dormant since 2000, after Azerbaijan and Turkmenistan failed to agree on the share of gas that Azerbaijan would be able to ship through the line. Another major hurdle for the TCGP is: Turkmen President Niyazov's uncompromising position on the legal status of the Caspian Sea and his insistence on a view that the fields that are under development by Azerbaijan belong to Turkmenistan. As long as the Turkmen government maintains this position, no pipeline can be built.

Despite the deadlock, a long-term purchase and sale agreement between Turkmenistan and Turkey that envisages the delivery of 16 billion cu m/year (1.5 bcf/d) of gas remains on the table. The existence of this agreement gives hope that the project will be implemented, and, for that reason, Shell remains committed to it. The final decision that will determine its fate rests with the governments of the participating countries.

Although both the United States and Turkey have strongly encouraged Turkmenistan to support this project, President Niyazov has disregarded the chance to diversify his country's energy transportation, continuing to propose instead a Russian or Iranian route, something Ankara has rejected.

In addition to TCGP, Iran already expressed its support for the gas pipeline project to export Turkmen gas through its territory. In terms of total investment, the Iranian pipeline would probably be cheaper than the TCGP pipeline, and would also avoid the potential legal problems surrounding the status of the Caspian Sea. But, the biggest drawback of the Iranian pipeline for Turkmenistan is the possible interruption or restriction of gas flow by Iran in the future. Russia, the largest natural gas reserves holder in the world, by owning the single export pipeline system for Turkmenistan's gas exports has been restraining Turkmenistan's access to the world markets for almost a decade now and it is very likely that Iran, owner of the second largest gas reserves in the world, may follow a similar strategy in the future.²⁰²

Turkmenistan, like Russia and Iran, is not concerned about the urgency of developing its Caspian oil reserves. Its Caspian coast is the least explored, and it has large natural gas reserves elsewhere in the country. Therefore, in order to attain more energy export security, Turkmenistan's short- to mid-term objective is to develop an independent natural gas export infrastructure that does not have to pass through Russian territory. Nevertheless, in 2000, Turkmenistan, in the words of Ambassador Mann, senior U.S. adviser for Caspian Energy Diplomacy, "made herself a non-player in this game." Ultimately, by refusing to participate in any proposed pipeline coming out of their territory, the Turkmen made themselves solely dependent on the Russian transport system.

Historically, Russia's natural gas transmission grid, built to serve the Soviet Union, has been Turkmenistan's only option for exporting this gas. During the past several years, Moscow's control over natural gas export routes has allowed it to employ tough bargaining

²⁰² "Turkmenistan faces challenges in export transportation options" *Oil&Gas Journal* October 28, 2002

tactics, pressing Turkmenistan to accept prices for its natural gas that are far lower than those for which the Russian Gazprom resells that natural gas to European customers. According to Ambassador Steve Mann, Turkmenistan had to accept the price of \$ 21 per tcm, far lower than was officially announced by Gazprom as \$ 39. In contrast, Gazprom resells it for an average of \$ 100 to European customers.²⁰³

Turkmenistan continues to depend on Russian and to a lesser extent Iranian demand for its gas sales, thereby solidifying its political alignment with those two countries. The Turkmen gas is transmitted only through these two countries own pipeline networks. Ironically, this flies in the face of President Niyazov's declared stance on independence.

Azerbaijan

Azerbaijan covers an area of 86,600 square km on the southeastern flanks of the Caucasus Mountains, with its eastern portion bordering the Caspian Sea. About 25% of its population of 8 million people lives in the capital, Baku. GNP per capita is \$770.15 for 2002. Azerbaijan is the site of the world's oldest oil discoveries and one of its oldest oil exporters. This country is also endowed with fertile agricultural land and a well-educated labor force.

Azerbaijan was beset with political instability from independence in August 1991 until its October 1993 presidential elections. This was aggravated by a three-year war over Nagorno-Karabakh, which resulted in the Armenian invasion of almost 20% of Azerbaijani territory. About 900,000 people (11% of the population) are refugees. A cease-fire has been

²⁰³ From the Ambassador Stephen Mann's presentation at the special Caspian Energy session of the CERA week conferences held on February 12, 2003.

enforced since May 1994, and peace negotiations continue. Nonetheless, a breakthrough does not appear imminent.

Following independence, trade among the CIS collapsed. In Azerbaijan, this was exacerbated by the conflict with Armenia and fighting in Chechnya that restricted oil exports, leading to a persistent output decline and high inflation. As a result, GDP declined every year between 1988 and 1994, when it reached about 37% of its 1988 value. This decline does not, however, reflect the country's underground economy; the World Bank has estimated that "unofficial" economic activity accounts for over half of the overall economy. Virtually all sectors of the economy were hard hit, with output in agriculture falling by about 43% and in industry about 60% during the period from 1989 to 1994. The oil and gas sectors were particularly affected; production fell from 13.8 to 9.3 million tons from 1987 to 1995, as a result of growing problems with poor infrastructure, production practices, and depletion of oil fields. Fueled by foreign investment in oil and gas, however, real GDP rose by almost 10% annually between 1997 and 2002.²⁰⁴ Also, with the gradually stabilizing political situation and the cease-fire in the Armenian conflict, the government began to implement an economic program supported by the World Bank and the IMF. Inflation fell from 1,664% in 1994 to less than 1% at the end of 1997 and became negative throughout 1998 and 1999. It remained at 1.8% in 2000 and 1.5% and 2.40% in 2001 and 2002, respectively.²⁰⁵ The consolidated budget deficit has steadily declined since 1997.

Azerbaijan was minimally affected by the 1998 Russian ruble crisis, but falling world oil prices in the second half of 1998 severely curtailed investment in the petroleum industry.

²⁰⁴ www.worldbank.org/data/countrydata/aag/aze_aag.pdf

²⁰⁵ www.macrohedge.com/global/aaz.xls

Foreign direct investment fell significantly, from \$1 billion in 1998 to \$355 million in 1999, following completion of the initial round of investments in offshore oil and gas exploration, and due in part to slow progress in reaching agreement over the main oil export pipeline. Foreign direct investment recovered again, and with the addition of Baku-Tbilisi-Erzurum gas pipeline and some other projects, total investment amounts between 1999 and 2003 reached almost \$ 4 billion, bringing total investment since the 1994 Deal of the Century to \$ 8 billion.²⁰⁶

7. European Union and China; Are They Major or Secondary Actors?

Responding to the ever-growing energy demand and energy security on the global policy agenda, since 9/11, policy makers from the U.S., E.U., Russia and China have begun to look at the Caspian and Black Sea region differently. Regional development, the war against terrorism, a quest for diversification of energy supplies and stabilizing global energy pricing all play a major role in this change of perceptions about the region. All the above mentioned parties and countries of the region now face the challenge of balancing their relative strategic orientations and preferred modalities for unlocking Caspian energy. In this section, I would like to delve into the policies and motives of the European Union and China toward the Caspian Basin hydrocarbon resources.

European Union

As its demand for oil is set to increase significantly (especially with the E.U. enlargement), Europe will become more dependent on oil and gas imports. The potential of

²⁰⁶ Jonathan Walters, *ibid.*

the Caspian as a major energy exporter will certainly play an important role in meeting this increasing demand.²⁰⁷

In this respect, policy objectives of the E.U. and the United States are very much alike. They both recognize the importance of Caspian Basin oil and gas resources in contributing to the economic prosperity, energy security, and stability of the region. They also share the same views and criteria, including:

- The resources will be an important addition to world oil and gas supplies and require secure access routes to world markets.
- Essential to this development will be the early availability of multiple pipelines. Major export pipelines from the Caspian will accordingly contribute to the secure delivery of an important new source of world energy supplies.²⁰⁸

The European Union further supports the same view as Turkey and the United States that export of Caspian oil and gas to the E.U. and other western markets requires creation of new complementary transport-transit export systems that could combine onshore and offshore oil and gas pipelines, marine loading and unloading terminals, and associated sea transport by tanker as the primary goal together with the rehabilitation and expansion of the existing transport systems.

²⁰⁷ "Caspian Energy: Contrasts & Synergy between E.U., Russian and U.S. Strategies" International conference organized by the East-West Institute 24 June 2002 Brussels, Belgium.

²⁰⁸ U.S.-E.U. statement on Caspian Energy, May 18, 1998

In order to meet these needs, the European Union strongly endorses commercially and environmentally sound projects to develop Caspian energy resources and their transport to international markets such as the United States initiative of the East-West energy corridor.

The E.U. has implemented several technical assistance and training programs to help many of the Caspian states improve their legal regimes to encourage private investment in energy development and transport. The most important of these programs are; INOGATE (Interstate Oil and Gas Transports to Europe), TACIS (Technical Assistance to the Commonwealth of Independent States), CEP (The Caspian Environment Program) and TRACECA (Transport Corridor Europe, Caucasus, Asia).

The European Union's INOGATE program is designed to promote the security of energy supplies. It includes work on: revitalization of the existing transmission network and on new oil and gas pipelines across the Caspian, the Black Sea region and westwards to Europe; urgent renovation of hazardous infrastructure; strengthening regional cooperation; compliance with international standards; reform of the region's energy sectors; and protection of foreign investments.

The European Union's TRACECA project supports the development of an east-west transport and trade corridor from Central Asia, across the Caspian Sea, the Transcaucasia, and the Black Sea, to Europe. The Program was launched at a conference in Brussels, in May 1993, which brought together trade and transport ministers from the original eight TRACECA countries (five Central Asian republics: Kazakhstan, Turkmenistan, Uzbekistan, Kyrgyzstan and Tajikistan; and the three Transcaucasian republics: Azerbaijan, Armenia and Georgia), where it was agreed to implement a program of the E.U. funded technical

assistance (TA) to develop a transport corridor on a west - east axis from Europe, across the Black Sea, across Transcaucasia and the Caspian Sea to Central Asia.

The program retains the following objectives:

- To support the political and economic independence of the republics by enhancing their capacity to access European and World markets through alternative transport routes
- To encourage further regional co-operation among the partner states
- To increasingly use TRACECA as a catalyst to attract the support of International Financial Institutions (IFIs) and private investors
- To link the TRACECA route with the Trans-European Networks (TENs)

The CEP program works closely with a number of organizations in protecting the Caspian marine and coastal environments. The CEP was established in 1998 on the basis of intergovernmental agreements between the riparian Caspian countries and financial support of the various organizations.²⁰⁹

In order to identify the right options to import hydrocarbon resources of the Caspian Basin to Europe, under the auspices of the European Union, two studies conducted under the TACIS program, regarding pipeline transportation out of Caspian Sea-producing areas, have concluded that such systems are technically, economically, and environmentally feasible but

²⁰⁹ The European Union commenced support to the CEP in January 1998 through its TACIS program of technical assistance. The project is operated by the consortium ERM-Lahmeyer international, GOPA, and DHI Water Environment. The E.U. assistance established the Program Coordinating Unit and 4 thematic Centers, dealing with Management of Bioresources, Combating Desertification, Water Level Fluctuations and Pollution Control. The technical investigations culminated in a Preliminary Trans-boundary Diagnostic Analysis in early 2000. Support continues in these technical themes, together with assistance to the overall Convention structures and the identification of investment potential.

depend critically on route selection.²¹⁰ The first TACIS study focused on the technical, economic, and environmental feasibility of transporting significant oil and gas volumes from the Caspian-producing countries of Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan to European markets through new pipelines crossing the Caspian Sea. The second one dealt with the technical, economic, and environmental feasibility of creating new complementary interconnecting export systems or routes (pipelines) from the Caspian oil-and-gas-producing areas to European markets. These systems include a combination of onshore and offshore pipelines, marine-loading terminals, and associated transportation by tanker.

These studies found that only 22 million tons/year (tpy) of crude would be available for the trans-Caspian oil pipeline originating from Kazakhstan, Uzbekistan, and Turkmenistan by 2010. The addition of Azerbaijan's projected or potential crude oil exports to the European market yields an oil transport quantity of 50 million tpy available by 2010 for the pipeline section westward as a continuation of the oil pipeline system crossing the Caspian Sea. The total potential oil exports of the Caspian region dedicated for Europe will increase to 100 million tpy by 2020.²¹¹

Considering the planned Turkmenistan-Iran-Turkey Natural Gas Pipeline (TCGP), as well as the different gas development and production scenarios for the Caspian region, there is enough gas available to launch the TCGP to export 14 billion cu m/year immediately and 47 billion cu m/year by 2010. The addition of Azerbaijan's projected or potential natural gas exports to European markets indicates the availability of a natural gas transport quantity of

²¹⁰ Orhan Degirmenci "E.U. study of Caspian area oil, gas pipelines compares routes, costs" *Oil&Gas Journal*, November 5, 2001

²¹¹ Orhan Degirmenci, *ibid.*

50 billion cu m/year by 2010 for the pipeline section westward as a continuation link of the gas pipeline crossing the Caspian Sea. The total potential gas exports of the Caspian region allocated for Europe will increase to 100 billion cu m/year by 2020.²¹²

In all of these projects, Turkey as a key transit country plays a central role in pipelines aimed at meeting the E.U.'s forecasted demand. In recognition of this key role, the E.U. is supporting oil-and-gas projects transiting Turkey. From the E.U.'s perspective, Turkey is the inevitable route to transport Caspian gas to the West and the BTC pipeline is the best route for transporting its crude oil.²¹³

More significantly, as discussed in the section devoted to Turkey, to support E.U.'s general policy of energy security through diversification of the sources, the European Investment Bank (EIB) has provided TPAO with a Euro 90 million credit in 2002 for the development of its underground gas storage facilities in the European section of Turkey as the first EIB operation under the new "Special Action Programme", which makes available financing of similar projects for up to Euro 450m during 2001-04.²¹⁴

This assistance aims at the realization of a southern gas route to Europe originating from Turkmenistan and possibly Iran. With this motive in mind, E.U. representatives, and especially France, are always including Turkey as their future full member and major transit hub of additional energy resources. As one of the examples of this policy, the Undersecretary of State for Economy- French Ministry of Economy, Finance and Industry

²¹² Ibid.

²¹³ Emre Engur "Turkey determined to remain at the center of East-West energy corridor," *Oil&Gas Journal* January 14, 2002.

²¹⁴ IBS Energy Line 21 March 2002 Issue 04/02.

and Chairman of the International Energy Agency Governing Board Dominique Maillard, in his presentation during the “European Energy Markets Conference” held in Houston on September 27, 2002, stressed the importance of the East-West energy corridor and referred to Turkey as a preferred additional gas supply route to Europe. Earlier during the CERA week conferences in February 2001, again the representatives from the French national natural gas company *Gas de France* explicitly referred to a Turkish route for additional natural gas supply and included Turkey among the 35- member EU in the year 2020. Similar points were also stressed by CERA’s Caspian Director Laurent Ruseckas.²¹⁵

Another motive for Europe to assist in the realization of projects using the Turkish route is the European conviction that Caspian energy and the issue of alternative export routes from the Caspian to Europe can also play a conciliatory role between Greece and Turkey. As indicated earlier, European policymakers actively promoted the viability of a Greek-Turkish pipeline to deliver Caspian gas to Europe.

In conclusion, it can be said that Europe, while keeping Russia as one of its main oil and gas suppliers, in the future for obvious reasons of diversification and supply security, certainly prefers to stress the so-called ‘southern option’ which passes through Turkey. Accordingly, Europe is supportive of the overall initiatives in the region by the United States and its candidate member country, Turkey.

²¹⁵ The Financial Times, July 23, 2001.

China

In some energy circles, there are some concerns as to whether Europe is the right destination for Caspian oil and natural gas. Oil demand over the next 10 to 15 years in Europe is expected to grow by little more than 1 million b/d. Oil exports eastward, on the other hand, could serve Asian markets, where demand for oil is expected to grow by 10 million b/d over the next 10 to 15 years. Chinese oil consumption, in particular, is projected to soar.²¹⁶

China, the second largest energy user in the world, is looking to the oil fields of the Caspian and Central Asia as well as Russian sources in Siberia, to help meet its predicted tripling in demand for fuel in the next few decades. Beijing also regards the new oil fields being developed around the Caspian Basin as a means of avoiding excessive reliance on the Middle East, South Asia and West Africa.

China's energy consumption has more than doubled since 1980, and the potential growth of demand is "enormous." Per capita use of energy by the 1.2 billion Chinese population is still very low, equivalent to about one-fifth of Japan and one-tenth of the United States. But rapid industrialization and a growing residential demand suggests that energy consumption will grow by 3 to 5 percent per year until 2020.

World Bank forecasts based on GDP growth averaging eight percent over the period (6.5 percent after 2010) predict that the growth of energy consumption will average about four percent a year. To supply this demand, though, would necessitate building some of the

²¹⁶ <http://www.eia.doe.gov/cabs/caspian.html>

world's longest pipelines. Geographical considerations would force any pipelines to head north of the impassable mountains of Kyrgyzstan and Tajikistan across the vast, desolate Kazakh steppe, thereby adding even more length (and cost) to any eastward pipelines.

China has already signed a \$9.5 billion contract with Kazakhstan to develop three oil fields in the country and to build a pipeline from there to China. An examination of China's energy resources, and its projected future consumption, makes it clear why Beijing is so interested in the huge gas-and-oil fields being developed in the Caspian region. China is no longer self-sufficient in energy production and consumption, as it was until 1993. It possesses extensive reserves of coal, and its hydropower potential ranks first in the world. Its petroleum and natural gas reserves, however, are relatively modest (although China ranks fifth in the world in crude oil output.)²¹⁷

China has also been conducting several studies of oil-and-gas transportation from Western Siberia, Eastern Siberia and the Russian Far East to its home market. Among these are the following gas pipelines, which require \$20 billion investment over the next decade:

- Siberia-Shanghai, 3,370 miles (5,390 km) in length;
- Irkutsk-Rezhao (Shangdong), 2,100 miles (3,364 km); and
- Sakhalin-Shenyang, 1,500 miles (2,404 km).

These plans to link oil- and gas-rich Russia with the Chinese market are still being negotiated. Russia and China have been studying the possibility of building two pipelines:

²¹⁷ Stuart Parrott, "China Beijing Determined To Tap In On Caspian Region Oil", (RFE/RL) London, 21 November 1997

- an oil line from Russia's Irkutsk region (the Kuvykta field) via Mongolia to China's Shandong province on the Yellow Sea, with a possible extension to South Korea; and
- a gas line from Western Siberia to Shanghai via the Xinjiang autonomous region.²¹⁸

Despite these very advanced stage plans and projects, because of the huge distances, Caspian basin hydrocarbon resources still remain relatively easier and cheaper way to get the oil for Chinese market. Kazakhstan, also is covets the Chinese market. Kazakhstan exported 50,000 b/d and 70,000 b/d to China by rail in 1999 and 2000, respectively. In June 1997, the China National Petroleum Corporation - CNPC signed an agreement with Kazakhstan for a proposed \$3.5 billion, 1,800-mile pipeline to China that would be financed by China. The pipeline would start from Aqtöbe (Aktyubinsk) Kazakhstan to Xinjiang (the Turkic Uighur people-populated area of China). The proposed capacity would be 800,000 b/d at its peak. A feasibility study for the pipeline was undertaken, but the research was terminated in September 1999, very close to completion. In order to make the project economically feasible, Kazakhstan would have to guarantee 500,000 b/d per year for the next 10 years through the pipeline, a level to which Kazakhstan said it could not commit.

The CNPC, purchased two oil fields in 1997 in west-central Kazakhstan, 250 miles northeast of the Caspian Sea.²¹⁹ But the reserves in those fields later proved too small to make it economical to build what would be one of the world's longest and costliest pipelines.

²¹⁸ Xiaojie Xu "The Oil And Gas Links Between Central Asia And China: A Geopolitical Perspective" *OPEC Review: Energy Economics & Related Issues*, Mar99, Vol. 23 Issue 1, p33, 22p.

These failed attempts however, did not halt Chinese efforts to get involved in the Caspian oil development. For China, energy supply security is vital. "If oil security is at stake, it will restrict China's rapid economic development," Xinhua Chinese News Agency quoted An Qiyuan, a government adviser involved in oil exploration. "Without enough energy," An said, "modernization would become an empty word."²²⁰

Kazakh and Chinese companies finished building a pipeline in January 2003 that is supposed to carry oil from the Chinese-operated fields and other oil fields in west-central Kazakhstan to Atyrau, on the North Caspian Sea. Another pipeline is scheduled to go even farther into central Kazakhstan.²²¹ These achievements may be considered as incremental steps in the direction of realizing a pipeline stretching directly to China.

Additionally, to these efforts, to diversify its energy supplies and guarantee oil security, the Chinese offshore oil-and-gas producer CNOOC Ltd. announced a strategic decision on March 8, 2003 that it would pay \$615 million cash for an 8.33 percent interest in the Kashagan field of Kazakhstan. The deal covers 5,600 square kilometers and includes the Kashagan field, the Kalamkas discovery and prospective exploration sites.²²² Taking part in development of the Kashagan field would help justify a planned oil pipeline from the Caspian Basin across the empty western part of China to the densely developed east.²²³

²¹⁹ Xiaojie Xu (June 1997), "*Asian Oil and Gas: Megatrends, Balance and Geopolitics*" Energy Institute, University of Houston. Reprinted by *Geopolitics of Energy*, December 1997.

²²⁰ China builds up reserves diversifies suppliers bracing for Gulf War AP News, March 9, 2003

²²¹ Keith Bradsher, Chinese Company to Buy Stake in Big Caspian Oil Field, *The New York Times* March 8, 2003

²²² Financial Times, March 9, 2003.

²²³ Christopher Pala & Keith Bradsher, "Beijing and Caspian Oil Fields", *The New York Times*, April 1, 2003.

However, the existing shareholders,²²⁴ according to their contracts, had the right to pre-empt CNOOC's agreement to buy the proposed stake within 60 days of the agreement, on the same terms. On May 12, 2003, the existing partners in the development exercised their right to pre-empt CNOOC's bid for a share being sold by BG (formerly British Gas).

As a sign of the Chinese government's determination to be involved in this super giant project, just four days following CNOOC's offer, the Sinopec Group, another oil company controlled by the Chinese government, announced that it was prepared to buy the other half for the same amount. The Sinopec bid was also pre-empted by the existing partners of the North Caspian Sea production-sharing agreement.

Upon completion of the preemption transactions, Agip Caspian Sea BV, ExxonMobil Kazakhstan Inc., Shell Kazakhstan Development BV, and Total E&P Kazakhstan each will own 20.37%. ConocoPhillips Petroleum Kazakhstan Ltd. will own 10.19%. Japan's Inpex Corp. will maintain its 8.33% interest. Agip Caspian will remain as the operator.²²⁵

Whenever oil is mentioned, politics are not far behind in the Caspian and Central Asia. This is especially true for the emerging Chinese-Kazakh relations. There are two important issues which may very well transform the nature of the relations between China and Kazakhstan in the near future.

1. With the growing separatist sentiment in Xinjiang -- which found expression in the Uighur unrest earlier in 1990s -- Beijing's "central geopolitical concern is to

²²⁴ Britain's BG International, Royal Dutch Shell, ExxonMobil, Italy's ENI-Agip and TotalFinaElf of France each has a 16.67 per cent stake in the project. United States-based Conoco Phillips and Japan's Inpex have 8.33 per cent each.

²²⁵ *OGJ*, May 16, 2003.

work with Kazakhstan to manage the relationship among these ethnic people." Unrest bubbling amongst ethnic Uighurs in its Xinjiang province, through which the proposed Kazakhstan and China pipeline would go, could disrupt supplies. Uighur separatists have already attacked oil installations and convoys in the region in late 1990s. Long-distance pipelines, easily sabotaged, will prove attractive targets to Uighur guerillas. Further Chinese attempts to put down rebellion are likely to draw howls of protest from Kazakhstan's Uighur émigrés. If Kazakhstan's government does not handle such feelings with care, it might find itself the focus of pan-Turkic wrath, or even facing its own problem with domestic terrorism.²²⁶

2. The geopolitical situation has changed dramatically in Central Asia since the September 11th events. Especially China consider deployment of the U.S. warplanes and troops in Kazakhstan, Kyrgyzstan and Uzbekistan in the wake of the operation against Taliban regime in Afghanistan, as a threat to its' political and economic interests in the region. Despite the comforting statements from the U.S. Administration, a threat is well identified by the Chinese authorities. An unidentified Chinese diplomat in Kazakhstan said that "the USA had asked to use a base in eastern Kazakhstan for operations against China, and that the USA had installed intelligence equipment in Kyrgyzstan, also for use against China. This is a major security concern for China."²²⁷

²²⁶ Economist, 08/16/97, Vol. 344 Issue 8030, p32, 2p. The Game Gets Serious; China jumps into the scramble for the *Caspian* region's oil treasures, *Newsweek* 11/24/97, Vol. 130 Issue 21, p48.

²²⁷ Russia, China Upset by U.S. Presence, Uzreport, Uzbekistan News Agency, 25.02.2002

Whatever the prospects in the future, China cannot ignore, as some prefer to call it, the new "Great Game" played in Central Asia and the Caspian Basin. All the major powers involved thus far have varying motivations and advantages to gain from their influence on the landlocked region. China, advantageously positioned on the border of Central Asia, sees an opportunity to broaden its geo-economic role in the region and beyond, so as to become a more important geopolitical force.

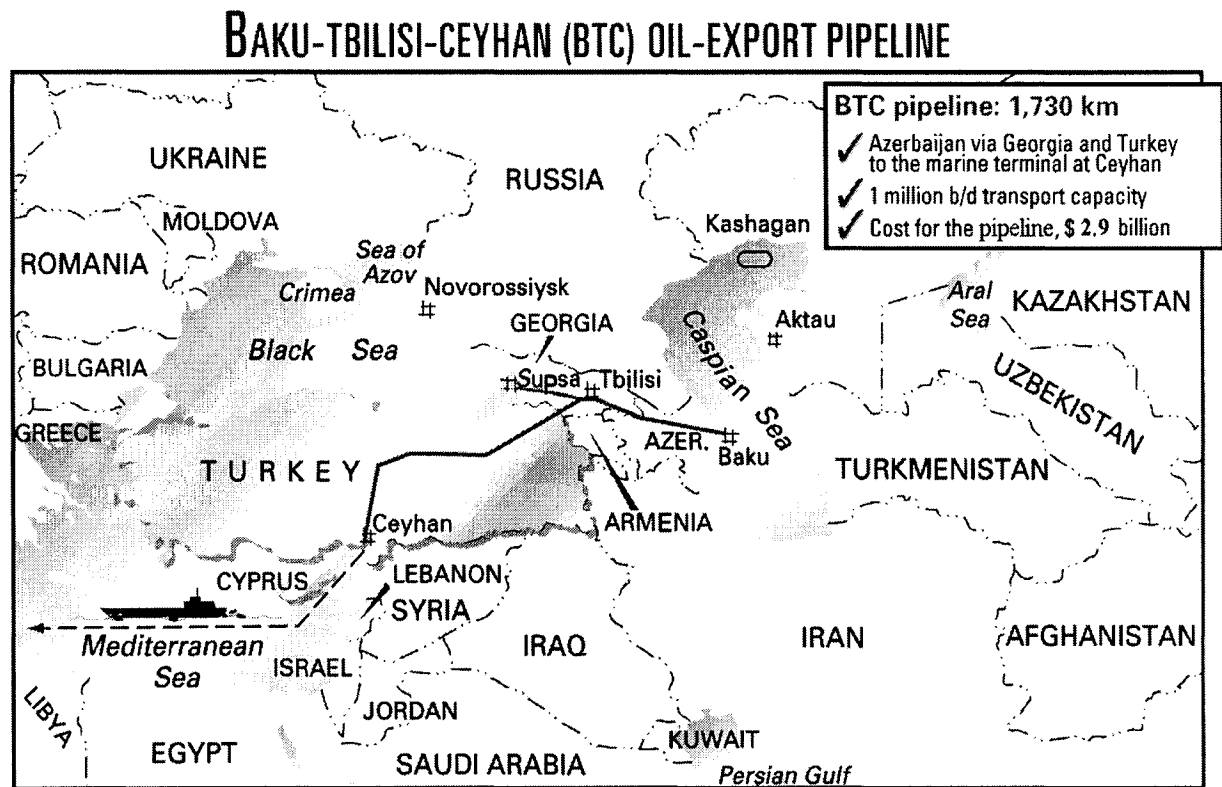
CHAPTER SIX

In this chapter, I will try to define and explain the course of events that led to the realization of the BTC pipeline. What is important about this project is that the political objectives and resolve of the United States and Turkey were the main driving force behind this project. By explaining the stages of the project, I intend to bring more definitive substance to one of my main hypotheses in this dissertation: political factors are dominant in the region and at least as important as economics in determining which pipeline is to be built.

BAKU-TBILISI-CEYHAN (BTC) MAIN OIL PIPELINE PROJECT

This project aims at the transportation of crude oil produced in the Caspian Basin, in places such as Azerbaijan and Kazakhstan, by a pipeline to a marine terminal on the Mediterranean coast of Turkey in Ceyhan and then to the world markets by tankers. Using World Bank Credit, the Feasibility Study, Environmental Impact Assessment Study and Detailed Route Study for this project were completed in 1998. The pipeline will have an approximate length of 1,100 miles (1,730 km) and will cost an estimated \$ 2.9 billion (See Figure 6.1). Seventy percent of the project-about \$2 billion- will be funded by credit. It is to be completed in 2005, and the first oil is expected to flow through it the same year. The pipeline will have a capacity of one million barrels per day.

Figure 6.1.



What brought this project to fruition?

On 20 September 1994, in Baku, a consortium of oil companies led by the British Petroleum Company (BP) signed an \$8 billion production-sharing deal with the Azerbaijani state oil company, SOCAR (State Oil Company of the Azerbaijan Republic). The 30-year contract called for production of 80,000 barrels per day (b/d) by 1997; output was expected to reach an eventual peak of 700,000 b/d. The contract provided for the development of the Azeri, Chirag and Guneshli offshore oil fields in the Caspian Sea, which are estimated to contain reserves of 3.8 billion barrels. Other investors in the 'contract of the century' - as it is commonly known – originally included American Amoco (17%), Pennzoil (4.8%), Unocal (9.5%) and Exxon (5%), Russia's Lukoil (10%), Norway's Statoil (8.5%), Japanese Itochu

(7.45%), the British Ramco (2%), Turkey's TPAO (6.75%), Saudi Arabia's Delta (1.6%) and Azerbaijan's SOCAR (10%).²²⁸

Conflicting perceptions and interests on the way of the realization process

The negotiations between Azerbaijani authorities and Western oil companies date back to 1990, when Azerbaijan was still a Soviet republic.²²⁹ These negotiations finally seemed to bear fruit in 1993, and SOCAR was expected to sign a contract with the international consortium, which did not then include the Russian or Iranian oil companies, in September 1993. It is widely believed that, the anti-Russian policies of the pro-Turkish president of Azerbaijan, Abulfaz Elchibey, were the cause of a coup, which overthrew him in June 1993. Heidar Aliev, former Soviet Politburo member and head of the Azeri KGB, grabbed power during the post-coup weeks from the decidedly pro-Russian leader of the coup, Suret Huseinov. Aliev then, renegotiated the contract with the Azerbaijan International Operating Company (AIOC) and allocated the Russian oil company Lukoil 10% of the AIOC; thus hoping that Moscow would be more favorably disposed to the idea of Azerbaijan's independently exploiting and marketing its Caspian Sea oil resources.

The early response of the Russian government to the project was a reflection of the conflicting goals that the Russians have in the region. One major goal is for Russia to maintain its sphere of influence in the region, and the then Foreign Minister, Andrei Kozyrev, and the future foreign minister, Evgenii Primakov, convinced Yeltsin on July 21, 1994 to sign a secret memorandum regarding the protection of Russian interests in the

²²⁸ Sabit Bagirov, 'Azerbaijani Oil: Glimpses of A Long History', *Perceptions* (Ankara), 1, 2, June-August 1996; *Middle East Economic Digest* (hereafter MEED), 30 September 1994,, p42.

²²⁹ Bagirov, p. 35.

Caspian.²³⁰ Accordingly, this aim views the development and export of oil as a *zero-sum game*, and is staunchly against the involvement of 'outsiders' like Turkey, the United States and others in Russia's backyard.

Iran, for its part, pursued a policy that could be characterized as ambiguous. Although Tehran had adopted a hostile stance toward Azerbaijan's pro-Turkish President Elchibey, it became more accommodating toward Aliev, who replaced Elchibey after the June 1993 coup d'état. Interested in currying favor with Tehran, Aliev repeatedly stated that Baku intended to have mutually beneficial relations with Tehran based on cooperation in the fields of oil production and marketing. True to his word, on 12 November 1994 Aliev transferred 5% out of SOCAR's 20% share in the AIOC to Iran.²³¹ Yet, facing objections from the U.S. administration, the AIOC turned down this transfer; thus sabotaging Aliev's effort to buy Tehran's support against Russian projection of a big-power role in Caspian issues.²³²

In many instances, during these early days of the project, Turkish statesmen repeatedly and openly accused Russia of acting as a neo-colonialist power. On 29 August 1995 then-President Demirel stated, "For the sake of good relations [with Russia], these [Turkic] countries should not give away concessions from their independence. ... Our brother countries must have direct access to the world markets without obstacles ... It is to their strategic, political and economic benefit to get rid of any dependency ... Turkey's approach

²³⁰Robert V. Barylski, 'Russia, The West, and the Caspian Energy Hub', *The Middle East Journal*, 49, 2, Spring 1995.

²³¹MEED, 25 November 1994, p. 28

²³²MEED, 17 February 1995, p. 30.

on the oil and natural gas pipelines should be evaluated in this context.”²³³

The 'contract of the century' reinforced antagonisms between Ankara and Moscow, because, since then, two basic routes have been in competition, promoted respectively by these two states. Both parties have presented their pipeline option as the *panacea*, which would enable Azerbaijan as well as Kazakhstan to export their oil.

The Russian route would consist of two legs. One requires construction of a 1500-kilometer \$1.8 billion pipeline from the Kazakh Tengiz fields through Tihoretsk (120 km east of Novorossiysk) to the Russian Black Sea port of Novorossiysk. This pipeline, which would have a 600,000 b/d capacity, would join the existing 1400-kilometer Baku-Tihoretsk pipeline which could carry the Azeri oil from the Caspian Sea.

The Turks, believing that a single Russian pipeline to carry Azeri and Kazakh crude would solidify Moscow's stranglehold over the region, campaigned actively against it. The idea that the Turkish pipeline would earn Turkey hard currency in royalties was, perhaps, secondary to its geopolitical calculation that, if the Azeris and Kazakhs had to rely solely on the Russian pipeline, Ankara's hopes for improved ties with the newly-independent Turkic states in the region would be drastically disturbed.

The 'early oil' controversy

Notwithstanding the Turco-Russian rivalry over the oil pipelines, the AIOC postponed its decision on the major export route until the second half of 1998. Yet in 1995, it had to determine how the so-called 'early oil' from the Caspian - up to 80,000 b/d expected to

²³³*Turkish Probe*, 1 September 1995, p. 5.

flow by late 1996 - would be transported. The output would gradually rise to 700.000 b/d by 2010, but until the early 2000s the 'early' oil would continue to be in much smaller quantities.

Since September 1994, Ankara has campaigned vigorously to convince the AIOC and the Azerbaijani government that the Baku-Ceyhan line is the most economically and politically sound option. It would be less costly for the AIOC to transfer crude oil to the Mediterranean, and the Azeris would also have significantly reduced their dependency on Russia. Yet to be successfully completed, the pipeline has to pass through Iranian, Armenian or Georgian territory.

The U.S. administration's objection to Iranian involvement based on political reasons automatically eliminated the Iranian option.²³⁴ The ongoing ethnic hostilities around Nagorno-Karabakh at that time, between the Azeris and the Armenians, made Armenian participation anathema to the Azeris. For historical reasons, such as the so-called Armenian genocide allegations and lack of diplomatic relations with Turkey, mainly because of the genocide allegations and failure to recognize Turkey's eastern borders, to date, Armenia has been left out of BTC project, when it might otherwise have been included.²³⁵

As a result of these political controversies, Turkey was left with Georgia to serve as a transit route for the Baku-Ceyhan pipeline. When the AIOC began its deliberations regarding the route for the early oil, Ankara began a dedicated lobbying effort to convince the AIOC to

²³⁴ BP has 17.2% of the shares. Turkey's share of 1.75% was increased to 6.75% in April 1995 when Azerbaijan transferred 5% of its shares. The Japanese Itochu bought American McDermott's 2.45% and Pennzoil's 5%. Sabit Bagirov, 'Azerbaijani Oil: Glimpses of A Long History', *Perceptions* (Ankara), 1, 2, June-August 1996, p.42

²³⁵ Because of the same political reasons, Armenia has also been excluded from the Baku-Tbilisi-Erzurum gas pipeline project, which was born after the discovery of huge gas reserves in Azeri field of Shah Deniz in May 1999.

accept the 926-kilometer Baku-Supsa route. There already was a Soviet-era pipeline in place which needed another 140 kilometers of pipe to become operational. The Turks expected that if the Georgian route were accepted for early oil, in the long run Turkey could construct a pipeline from Georgia to Ceyhan to serve as the major pipeline to export a significant portion of Azeri crude oil.²³⁶

Russia, for its part, tried to promote another Soviet-era pipeline running from Baku to Novorossiysk by suggesting that, of the 1400-kilometer route, only 27 kilometers required construction of a new pipeline.²³⁷ Although neither pipeline presented a meaningful advantage over the other for the limited amounts of early oil (4-5 million tons annually), Moscow may also have counted on its increasingly high-profile role as one of the three co-chairmen of the OSCE Minsk group mediating the Nagorno-Karabakh dispute between Armenians and Azeris.²³⁸ Russia's military presence in Armenia and Georgia, its reservations concerning the legality of the AIOC contract, and in general, the heavy-handed Russian diplomacy in the "near abroad" influenced the AIOC and the Azeris to take into account not only economic but also political factors. As Ilham Aliev, vice-president of SOCAR (and son of President Aliev), pointed out, *'the question of selecting an oil transport route was a political and not an economic decision for Azerbaijan'*.²³⁹ It would be wrong to exclude economic factors entirely, nonetheless, for all parties, the BTC project was always a

²³⁶ Interfax, 24 October 1994; FBIS-CEU, 25 October 1994, p. 65. The Georgians claimed that the existing pipeline from Baku to Supsa could be upgraded to carry 80,000-140,000 b/d from the current 20 000-40 000 b/d. MEED, 28 April 1995, p. 3; MEED, 20 October 1995, p. 31; *Turkish Probe*, 17 May 1996, pp. 19, 20.

²³⁷ Middle East Economic Digest (hereafter MEED), MEED, 20 October 1997, p. 31. MEED, 17 February 1995, p. 30; Middle East Economic Survey (hereafter MEES), 13 February 1995, p. A11.

²³⁸ *Azeri Turan News Agency*, 6 December 1994, in FBIS-CEU, 7 December 1994, p. 55.

²³⁹ *Gunay* (Baku, in Russian), 3 June 1995, p. 2, in FBIS-CEU, 9 June 1995, p. 86.

politically motivated project. The economic viability of the pipeline, as will be discussed later, was an issue that has been addressed in the very late stages of the project.

Eventually, on October 9, 1995, the AIOC opted for a compromise scheme, under conflicting pressures from Russia and Turkey, by announcing that the early oil would be exported through two pipelines, via Georgia and Russia.²⁴⁰ Many who took part in the AIOC decision-making process admitted that the choice of two pipelines was aimed at preventing a Russian stranglehold over Azeri oil exports. The United States, for its part, actively lobbied the AIOC and the Azerbaijani leadership to agree to the two-pipeline formula. In early October 1995 President Clinton held a long telephone conversation with Azeri President Aliiev in order to assure him that the United States believed that the two-pipeline option was best for Azerbaijan.²⁴¹ The idea appealed to the Azeris, who did not want to be dependent on Russia for access to world markets and yet, at the same time, did not want to antagonize Moscow by refusing to approve any role of Russia in the contract of the century.

In addition, the inability of both the Russian state and pipeline authorities to resolve the Chechen issue vindicated the AIOC's decision to pursue a dual pipeline strategy for its early oil exports. The only factor which could throw this prospect into doubt would be a return to major political conflict in Georgia or in Azerbaijan's Armenian-populated region of Nagorno-Karabakh, which is close to the route of the Georgian line.

The AIOC's decision led the Turks to think that they had scored a victory against Russia's attempts to shut off others, like Iran from the oil export process and to dominate the

²⁴⁰MEED, 20 October 1995, p. 31.

²⁴¹Ibid.; *The Washington Post*, 10 October 1995; MEED, 20 October 1995, p. 19; *Turkish Probe*, 17 May 1996, pp. 19-20.

region economically and politically. Yet Turkish euphoria proved to be premature. When lobbying for the Georgian route, Ankara had promised to finance the upgrade and extension of the Baku-Supsa pipeline by offering preferential credit with an eight-and-a-half year term and two-and-a-half year grace period at an annual interest rate of around 7.25%. This very advantageous offer would have been backed by the Turkish Treasury guarantee against possible delays due to any political reasons. Ankara also offered to buy all of the early oil, estimated to be 4 to 5 million tons annually.²⁴² The Turkish offer came, however, with a number of conditions attached. Ankara insisted that:

- the pipeline consortium should be dominated by Turkey (51% of shares belonging to the country);
- the long-term route should be recognized by the AIOC as Baku-Ceyhan;
- there should be an upper limit of 6 million tons on the pipeline's annual capacity.

This last condition indicated that the Turks were worried that if the Georgian pipeline had a larger capacity it could be recognized as the main export pipeline in the long run, and the Baku-Ceyhan route could become obsolete while yet in the planning stage.

On February 27, 1996, the AIOC refused the Turkish conditions for financing the pipeline, mainly because it did not want to make a commitment for the main export route earlier than it desired. Instead, the AIOC announced that it was inviting fresh bids from all interested parties for the financing of the Baku-Supsa project.²⁴³ Faced with the rejection of its offer, Turkey abandoned its support for the Baku-Supsa route. One other factor

²⁴²*MEED*, 20 October 1995, p. 31; *Turkish Probe*, 17 May 1996, pp. 19, 20.

²⁴³*Turkish Probe*, 17 May 1996, pp. 19, 20; *MEED*, 24 May 1996, p. 23.

influencing the Turkish decision was the signing of an agreement by Russia and Kazakhstan in April 1996 for the construction of an oil pipeline from the Tengiz field to Novorossiysk, which was later to be known as CPC pipeline. This pipeline with huge investments from American energy conglomerates such as Chevron would increase Novorossiysk's capacity tremendously, hence possibly swaying Baku to think that it could also accommodate Azerbaijan's long-term export needs.²⁴⁴ Announcing Ankara's cancellation of its support for the Baku-Supsa route, the Turkish Foreign Ministry spokesman stated that Ankara would henceforth strive to reach an agreement with Georgia and Azerbaijan for a whole new pipeline, Baku-Tbilisi-Ceyhan -BTC, to serve as the only main export route for Caspian oil. The Turks hoped that this would accommodate both Azeri and Kazakh export needs.²⁴⁵ According to the official Turkish position, the BTC pipeline could also incorporate an eastern extension running to Kazakhstan, thus drawing in the oil and gas supplies from the lucrative fields in that nation. Apart from geopolitical reasons, discussed above, the Baku-Ceyhan route offers several commercial advantages against Baku-Supsa route. These advantages further clarify as to why BTC was better for Turkey and for the region than Baku-Supsa route. First of all, the BTC pipeline would avoid expansion of tanker traffic through the overcrowded Turkish Straits. The Novorossiysk and Supsa routes require that tankers transport Azerbaijani oil exports through the Straits in order to access the Mediterranean and, hence, the Western markets. But the BTC option would avoid the Black Sea and the Turkish Straits altogether. Secondly, the BTC route would offer greater political stability, although the possibility of a threat of Kurdish terrorism as it was during the 1990s, does not make

²⁴⁴*Turkish Probe*, 17 May 1996, pp. 19-20.

²⁴⁵ *Ibid.*; 'The Politics of Oil in the Caucasus and Central Asia', *Adelphi Paper*, No. 300, 1996, p. 37.

Turkey an automatic safe-haven. Nevertheless, oil companies have been lukewarm towards the BTC route because due to its enormous cost. Traversing roughly 1,040 miles through mountainous territory, construction of this pipeline would incur a price tag of \$2.9 billion, exceeding substantially the cost of any likely alternatives. Eventually, all construction work on the Baku-Supsa pipeline itself has been completed in May 1999 and the new Baku-Supsa pipeline was pumping oil at its full capacity of 115,000 barrels per day in early June of the same year.

Breakthrough

One of the most decisive steps to boost the project was taken in 1998, when a feasibility study and an environmental audit for transporting crude oil from Caspian Region to the Mediterranean Sea was carried out by an international German-based engineering company, Pipeline Engineering GmbH - PLE, through a loan provided by the World Bank. The results of the study manifested were the first evidence to persuade the AIOC members producing the oil from the Azeri-Chirag-Gunashli fields of Azerbaijan to think seriously about the Azerbaijan-Georgia-Turkey route as a way to the Western markets. Later, negotiations were held between the working groups of Turkey and Azerbaijan, representatives of the Azeri government, and various oil companies, at which time important project agreements were reached, including the Intergovernmental Agreement (IGA), the Host Government Agreement (HGA), the Turnkey Agreement (TA) and the Governmental Guarantee Agreement (GG). The Host Government Agreement, the Governmental Guarantee Agreement and the Turnkey Agreement were initialed and amended as annexes to the

IGA.²⁴⁶ While the ‘Government Guarantee’ was given by the Turkish Treasury, the ‘Turnkey Agreement’ was signed with BOTAŞ for the construction of the Turkish section of the BTC pipeline.

Although the United States declared its support for the BTC pipeline, immediately after the Turkish government’s announcement of the proposed project, it was not until 1998 that this support had a direct impact on all sides involved in the decision-making process. It was U.S. Ambassador Richard Morningstar, Special Advisor to the President and Secretary of State for Caspian Basin Energy Diplomacy, who expressed this support in a very clear tone in almost every platform related to the project. During the 17th Congress of the World Energy Council in Houston on September 15, 1998, he stated that the U.S. Government had “a duty and an obligation” to play a major role in Caspian oil and natural gas pipelines. He reiterated the Administration’s, “firm commitment to developing a network of east-west pipelines that will enhance U.S. national security interests and business opportunities for U.S. companies in the strategically critical Caspian region.” In the same meeting and on number of subsequent occasions, Ambassador Morningstar further argued that, “building a Baku-Ceyhan oil pipeline and a trans-Caspian gas pipeline (TCGP) makes absolute sense for both national security and commercial reasons...Both pipelines will increase energy security by avoiding the concentration of a vast new source of oil and gas in the Persian Gulf region. Finally, both pipelines enjoy great potential to become lucrative investment opportunities for

²⁴⁶ From the presentation given by Dr. Yurdakul Yigitguden, Undersecretary of the Ministry of Energy and Natural Resources of the Republic of Turkey, on the occasion of Wilton Park Conference on the subject of Political and Economic Prospects in the Caspian Sea Region on March 6-10, 2000 in London.

U.S. companies.”²⁴⁷

With regard to Russia and Iran, the Ambassador summarized the U.S. Administration’s position,

“We believe Russia can play an even greater role in the east-west energy transit corridor by helping Turkey to meet its energy needs by shipping gas via the Caucasus and into a Turkmenistan-Turkey pipeline (TCGP)... We believe it makes no sense to undermine the independence of the Caspian NIS (Newly Independent States) by tying their hydrocarbon exports into the pipeline system of Iran, one of their primary competitors. It makes equally little sense from an energy security standpoint to concentrate oil and gas from the Caspian into the Persian Gulf region... In the meantime, we will press ahead as vigorously as possible on east-west energy corridors.”²⁴⁸

In large part due to the countless similar announcements and statements from the U.S. and Turkish governments on BTC, negative public and private views about the project ultimately began to change.

During the Organization for Security and Cooperation in Europe -OSCE Summit on November 17-19, 1999 in Istanbul, Turkey, Georgia and Azerbaijan signed the Intergovernmental Agreement of the Baku-Tbilisi-Ceyhan Crude Oil Pipeline Project. Then U.S. Energy Secretary Bill Richardson stressed the importance of this project by saying that, “This is not just another oil and gas deal and this is not just another pipeline. It has the potential to change whole geopolitics in the region”²⁴⁹

Despite some difficulties, the Georgian HGA was finalized shortly after the OSCE Summit. The IGA, accompanied by annexes, was submitted to the three parliaments for ratification. The parliaments of all three countries completed this process in June 2000.

²⁴⁷ *Pulse of Turkey*, No: 57 October 2nd 1998.

²⁴⁸ *Pulse of Turkey*, *ibid.*

²⁴⁹ Nancy Mathis “Ex-Soviet republics, Turkey sign accord for oil, gas pipeline”, *Houston Chronicle*, November 19.1999.

Finally on October 19, 2000 in Ankara, the Main Export Pipeline (MEP) participants as the sponsor group (the Project Sponsor Group, consisting of AIOC shareholders) formed by the producers, signed the HGA with the Ministry of Energy and Natural Resources of Turkey, marking the completion of the legal framework of the project and making it possible for all other activity, including engineering, to begin. The First Phase for the Turkish Section of the Project, the Basic Engineering Phase began on November 15, 2000. Through harmonious work with the representatives of the MEP, the Basic Engineering Phase was completed on time within 6 months. After the successful completion of the Basic Engineering Phase was the Detailed Engineering Phase for the Turkish section of BTC line was initiated on June 19, 2001. *Ingenieurgesellschaft Lässer-Feizlmayr* - ILF, a German-based company, was selected as the engineering company for this stage, which was completed in 12 months.

Behind the scenes, there were other crucial efforts of multilateral diplomacy that have affected the outcome of this project. During the OSCE Summit of 1999, Turkey, Kazakhstan, Georgia and Azerbaijan signed the Istanbul Declaration, wherein Kazakhstan announced its intention to deliver Kazakh oil to the Baku-Tbilisi-Ceyhan Crude Oil Pipeline. Following the discovery of a massive oil field at the enormous Kashagan structure off Kazakhstan's coast,²⁵⁰ which according to U.S. officials and industry sources may well be the largest oil

²⁵⁰ Exxon-Mobil's announcement of a "world-class" discovery at the Kashagan oil field in Kazakhstan has reopened speculation about the size of the resources of the Caspian Basin, leading once again to wild pronouncements about soaring export rates, plush government revenues and multiple oil pipelines. Kazakh President Nursultan Nazarbaev added fuel to the fire by telling an international forum that the field was so promising that he expected Kazakhstan to export as much oil as Saudi Arabia — 8 million b/d-by 2015. But, the ExxonMobil consortium's find, combined with BP's prior find of natural gas and condensate field at Shah Deniz in Azerbaijan, are encouraging developments. See Amy Jaffe Myers (Senior Energy Advisor, James A. Baker III Institute for Public Policy in Houston), "Truths and Untruths about Caspian Energy", *Private View* (The Quarterly International Review of the Turkish Industrialists' and Businessmen's Association-TUSIAD- In its kind, the most effective organization in Turkey), Autumn 2000, No.9 pp.46-52.

discovery in the past 20 years,²⁵¹ Ambassador John Wolf, the Clinton administration's chief Caspian oil negotiator said, "If the discovery is confirmed [it was later confirmed] it will be a tremendously important boost to the Baku-Ceyhan pipeline."²⁵² Kashagan's planned flow date is 2005, the same as BTC operation date and *Ente Nazionale Idrocarburi*-ENI (an Italian oil company and the operator of the Kashagan field in Kazakhstan), which also a participant in the BTC Sponsor Group.

While the contribution of Kazakh oil would be advantageous for the BTC, its absence would not adversely affect the commerciality of the project. This was made amply clear by Lord (John) Browne, CEO of BP, during the "Tale of Three Seas" conference organized by the Cambridge Energy Associates in Istanbul. On June 20, 2001, Lord Browne declared that the BTC is commercially viable even without Kazakh oil.²⁵³ Lord Browne stated that the project is commercial, based on the Azeri-Chirag-Gunasli and Sah-Deniz (condensate) reserves alone, and reiterated BP's determination to go ahead with the project. If there is no contribution from other Azeri, Turkmen or even Kazakh (Kashagan) fields, the pipeline may not have the projected 1m b/d (50mta) capacity, but it will be commercial nonetheless. The new cost figures came out of detailed engineering work did not affect the project's commercial viability significantly, because the cost parameters have been largely established from the basic engineering work. David Woodward, President of BP Azerbaijan, said in December 2001 that oil companies investing their own funds in the BTC could expect 20-30

²⁵¹ The last oil find of comparable size was in 1979, also in Kazakhstan, when it was part of the Soviet Union. That field, located onshore at Tengiz, is now being exploited by an international consortium led by the American oil company, ChevronTexaco Corp.

²⁵² *Washington Post*, 5.16.2000.

²⁵³ From the "Conference 2001 Highlights", www.cera.com.

percent profit -- an attractive return by oil industry standards. Lukoil's own analysis reportedly indicates 24 percent profitability.²⁵⁴

In addition to these developments, as a joint venture investment with the Russian government, ChevronTexaco, the biggest shareholder (50%) in the Tengiz oil field of Kazakhstan, completed the construction of the Caspian Pipeline Consortium -CPC pipeline in October 2001, to carry oil from Tengiz to the Russian Black Sea port of Novorossiysk. On February 8, 2001, ChevronTexaco informed the Turkish Foreign Ministry of its intention to participate in the BTC project because it believed the CPC line would never be enough to transport the whole capacity of the Tengiz field. In March 2002, ChevronTexaco applied for a 10 % share. Negotiations aimed at the sale of those excessive shares held by SOCAR are not yet concluded, partly due to SOCAR's ever-changing and exaggerated demands such as \$250 million cash, from ChevronTexaco.²⁵⁵ As of February 2003, ChevronTexaco still hoped to reach some kind of agreement on this issue.²⁵⁶

Not surprisingly Russia, under the Putin administration has launched a campaign against the BTC project. The Russian government offered lower tariffs for the re-opened Baku-Novorossiysk line (after the completion of the Chechen by-pass) and exerted pressure on Georgia by both cutting that country's gas supply and reacting to the alleged support of the Georgian government to the Chechen guerillas in 2001 and 2002. Russian efforts to pressure Georgia were not without evidence. It was a strategic decision. Georgia is the most vulnerable point not only in the BTC project, but also in the whole theme of the U.S. backed

²⁵⁴ Ferruh Demirmen, "Analysis of Caspian Oil Scene," *Turkish Daily News*, 26 Feb., 2002

²⁵⁵ TEBA Newsletter No: 1047/March 26, 2002

²⁵⁶ During the CERAWeek meetings in February 2003 ChevronTexaco officials reiterated their intention to join to the project.

east-west energy corridor initiative (see footnote 76 on page 106).

Following the November 2000 U.S. Presidential elections, there was a certain degree of anxiety in Turkey regarding the future of this project and unwavering American support for it. However, in addition to some earlier signs, during Houston's Cambridge Energy Research Associates – CERA conference in February 2001, representatives from the State Department reiterated the United States' full support for this project.

The final stage

In concurrence with the developments after September 11th attacks, Azerbaijan, Turkey and Georgia signed the trilateral agreement on combating terrorism and organized crime in June 2002. The agreement carries special importance regarding the security of the Baku-Tbilisi-Ceyhan oil and parallel Baku-Tbilisi-Erzurum natural gas pipelines.²⁵⁷

The agreement regarding the establishment of the Baku-Tbilisi-Ceyhan Pipeline Company (BTC Co.) was signed in London on August 2, 2002. The Turkish oil company *Türkiye Petrolleri Anonim Ortaklığı* - TPAO signed the agreement as well as BP, SOCAR, UNOCAL, STATOIL, ENI, ITOCHU and DELTA HESS at the ceremony in London.²⁵⁸ Shares of the participants in this newly formed company were agreed on as follows: Pipeline operator BP holds a 38.21% interest in BTC Pipeline Co., with other interests held by State Oil Co. of the Azerbaijan Republic (SOCAR) 25%, Statoil ASA 9.58%, Unocal Corp. 8.9%, Turkish state oil company TPAO 7.55%, ENI SPA 5%, Japan's Itochu Corp. 3.4%, and

²⁵⁷ *Selected News On Turkey* June 24-30, 2002 compiled by the Washington Office of Turkish Industrialists' and Businessmen's Association (TUSIAD-US)

²⁵⁸ Turkish Daily News August 3, 2002

Amerada Hess Corp. 2.36%.²⁵⁹

After the completion of the detailed engineering study, a groundbreaking ceremony marking the start of the actual construction phase was held in Baku on September 18, 2002. Turkish President Ahmet Necdet Sezer, Azerbaijani President Haidar Aliev and Georgian President Eduard Shevardnadze, and U.S. Energy Secretary Spencer Abraham participated in the festivities. Representatives of the operating AIOC consortium partners were also present at the ceremonies.

At the ceremony, Sezer mentioned that Kazakhstan, by establishing a connection between Aktau, a Caspian port city in Kazakhstan, and Baku, would be added to the project, and BTC would become the Aktau-Baku-Tbilisi-Ceyhan pipeline. Sezer stated that the necessary measures will be taken to add Kazakhstan to BTC, and bring Turkmen and possibly Uzbek natural gas to Baku-Tbilisi-Erzurum natural gas pipeline.

Georgian President Shevardnadze, declared the project to be "Georgia's main achievement in the past 10 years since it declared independence. Georgia is particularly eager for new energy sources, given the troubled nature of its relations with Russia.

Despite the excitement expressed by the participants, not surprisingly the Kremlin has refused to support the project out of fear that it will exclude Russia from the Western markets. Oil from Azerbaijan currently is shipped through Russian and Georgian lines (mainly through Baku-Novorossiysk and Baku-Supsa lines). Russia's biggest oil company, Lukoil, despite earlier contrary announcements, declared that it would not join the project.

U.S. Energy Secretary Spencer Abraham said the project, "contributes to regional

²⁵⁹ *OGJ*, Dec. 13 2002

strength and to international energy security and that helps us both." Reading a letter from U.S. President George W. Bush, Abraham said that the project would increase the world's energy security and that it would strengthen the sovereignty and independence of the nations involved.²⁶⁰

Turkey will earn \$200-300 million for oil passage per year. Georgia on the other hand expects that BTC will increase her gross domestic product by almost 10 percent. In his weekly radio address, Shevardnadze said that oil transit fees from the pipeline alone would net Georgia \$63 million annually.²⁶¹

Implications of the project

Increased interest from the companies

The biggest impact of this project came immediately after the groundbreaking ceremony. As soon as the BTC Co. was established and the groundbreaking ceremony was concluded, several other oil and gas companies, fearing exclusion, rushed to join the project. Shortly after BP's announcement that reserves in AIOC operation area were actually more than previously believed, and that it was rich enough to fill BTC without the commitment of additional reserves from somewhere else, French TotalFinaElf joined the project. Japan's INPEX also decided to team up with the consortium in September when construction works began. The consortium now comprises, BP with 32.6 percent, Azeri state oil firm SOCAR with 25 percent, U.S. group Unocal with 8.9 percent, Norway's Statoil with 8.71 percent, Turkish TPAO with 6.53 percent, ENI and TotalFinaElf each with 5.0 percent, Japan's Itochu

²⁶⁰ *Turkish Daily News* 19 September.2002

²⁶¹ The Associated Press 25 September 2002

with 3.4 percent, INPEX with 2.5 percent and Saudi Arabia's Delta Hess 2.36 percent. In addition, on October 30, 2002, BP announced it would sell a 2.5 percent stake to U.S. energy company ConocoPhillips. It would not be surprising to see more investors in the project in the future.²⁶²

The Kazakh commitment

There was a truth in the Turkish president's words when he referred to the future Kazakh connection to the project. Immediately following the groundbreaking ceremony in Baku, Kazakh officials made it clear that the Kazakh government desired to export major volumes of oil through the BTC pipeline. Since November, Kazakhstan's state petroleum company KazMunaiGaz has engaged in intensive talks with the BTC consortium, led by BP. KazMunaiGaz transport manager Kairgeldy Kabyldin said, "We are now considering an agreement between Azerbaijan and Kazakhstan which would guarantee Kazakh firms' participation in the Baku-Ceyhan pipeline," Reuters reported. Kabyldin said Kazakhstan could commit up to 400,000 barrels of oil per day.²⁶³

On December 3, 2002, Kazakhstan's Ambassador to Azerbaijan, Andar Shukputov, told President Heidar Aliiev, "Finally, the BTC pipeline is becoming a reality," London based financial news agency, the AFX reported. Shukputov added, "Kazakhstan wants to be involved in this project." Later, Azerbaijani officials made it public that Kazakhstan had made an official request not only to ship oil through the pipeline but also to sponsor the \$2.9 billion project. Natiq Aliiev, president of the Azerbaijani state oil company SOCAR, told the

²⁶² Reuters, October 30, 2002; OGI Dec 13, 2002

²⁶³ Michael Lelyveld "Kazakhstan: Astana Plans to Boost Energy Exports to West," *RFE/RL*, December 08, 2002

Russian Interfax news agency that BTC officials had met with U.S. sponsors in London on Kazakhstan's last-minute bid for shares.²⁶⁴

BP has said it would welcome a role for Kazakhstan. The consortium has long insisted that it has enough oil in Azerbaijan to fill the one million-barrels-per-day pipeline, but it has not turned Kazakhstan away. An intergovernmental agreement is expected to be signed in late 2003.

With Kazakhstan's interest, BTC's viability seems to have solidified. The Kazakh government's pledge of oil also ends three years of uncertainty about its support. President Nursultan Nazarbaev previously promised the same amount of oil, in November 1999, at an OSCE summit in Istanbul, but later backed away, saying he was pressured into signing the deal.

This time, Kazakhstan is eager to join the project, citing future flows from its giant Kashagan oil field in the Caspian Sea. Five members of the BTC group also have stakes in Kashagan (BP through BG, ENI through Agip KCO, TotalFinaElf, Inpex and ConocoPhillips), although the formal decision on shipping the oil across the Caucasus to Turkey's Mediterranean port of Ceyhan seems to belong to the Kazakh government through its monopoly over exports. With the addition of TPAO's and SOCAR's shares, companies representing 74.13 percent of the shares in BTC project have direct control of 66.67 percent of the shares in Kashagan field; BP-operator company in BTC project, ENI-operator company in Kashagan, TotalFinaElf, ConocoPhillips and Inpex. The only companies left out are ExxonMobil and Shell.

²⁶⁴ Ibid., *OGJ*, Aug. 14 & Dec. 13 2002.

A boost for the Baku-Tbilisi-Erzurum Gas pipeline

After a massive 700-billion cubic meter natural gas discovery in May 1999 in the Azeri offshore Shah Deniz region by BP PLC (BP), the consortium operator, negotiations to export this gas to the region's biggest and fastest growing market, Turkey, immediately began.²⁶⁵ Since the Baku-Tbilisi-Ceyhan main oil pipeline project was in an advanced stage, reaching an agreement was not difficult. Azerbaijan, Georgia and Turkey have agreed to build a second pipeline parallel to the BTC line (the route would be exactly the same up to the eastern Turkish city of Erzurum, where the gas pipeline would connect to the Turkish gas pipeline system), which would reduce costs.

Partners²⁶⁶ in the Azeri offshore Shah Deniz gas field, on March 14, 2002, cleared the way for construction of an export pipeline to Turkey by signing a Host Government Agreement with Georgia at a ceremony in the capital of Tbilisi. This was the last governmental agreement necessary for the launch of the first phase of the BP-led project in September 2002.²⁶⁷

Speaking in Tbilisi, Ambassador Steven Mann, Senior Advisor to the Secretary of State on Caspian Energy Diplomacy, said, "The United States will keep working with the government of Georgia to find ways to solve (the energy security) problem in the years ahead as well. We know that it has by no means been an easy issue for Georgia even in this winter. However, we believe that we have made good progress and we want to keep it going even as

²⁶⁵ *OGJ*, July 15, 1999

²⁶⁶ BP, which holds a 25.5% interest in the project, confirmed that it will be technical operator for both the pipeline and the field development. Other Shah Deniz consortium shareholders are Statoil, also with 25.5%, and State Oil Co. of the Azerbaijan Republic (Socar), TotalFinaElf SA, Naftiran Intertrade Co. Ltd., and LukAgip NV—each with 10%—and Turkey's TPAO 9%.

²⁶⁷ IBS Energy Line 21 March 2002 Issue 04/02

we look ahead to next winter.”²⁶⁸

The \$2.6 billion first phase includes the construction of a production platform at the Caspian field and a pipeline through Georgia to link up with a new Turkish-built line. In 2001, Azerbaijan signed an agreement to supply Turkey with two billion cubic meters (bcm) of gas from 2005, rising to 6.6 bcm by around 2007. The pipeline will also feed the Georgian market, lessening Georgia's dependence on Russian gas supplies, which are intermittently cut off. David Woodward, President of BP in Azerbaijan also announced that Shah Deniz had a full production potential of 16 bcm a year.²⁶⁹

The construction project of the Baku-Tbilisi-Erzurum export gas pipeline was officially ratified on April 16, 2002, with the heads of the project signing the final agreement in London.²⁷⁰ Despite these smooth developments towards the realization of the project, plans to export gas from the Shah Deniz offshore field from the outset faced delays and cost overruns in the early autumn of 2002.²⁷¹ Estimated costs of the project have jumped more than \$600 million, irritating Azerbaijan's state oil company SOCAR. David Woodward, BP's head in Azerbaijan, said the consortium would "review the project concept."²⁷² Negotiations to overcome this difficulty were finalized in early 2003. Now Shah Deniz gas is expected to arrive in Turkey in late 2005.

On the other hand, Azerbaijan's Shah Deniz field has implications beyond gas export:

²⁶⁸ IBS Energy Line 21 March 2002 Issue 04/02

²⁶⁹ *Rigzone Energy News*, "Oil Majors Sign Caspian Pipeline Deal with Georgia" March 14, 2002, http://www.rigzone.com/news/article.asp?a_id=2843

²⁷⁰ *AZERBAIJAN* No: 16 (318), April 18 2002, <http://www.andf-az.org/> Azerbaijan National Democracy Foundation

²⁷¹ *The Financial Times*, September 30, 2002

²⁷² *Dow Jones Newswires*, October 4, 2002

Its condensate will help alleviate the alleged oil-reserve shortfall for the Baku-Ceyhan oil pipeline. If in addition to gas, an oil layer is found beneath the gas in the Shah Deniz field, or independently in a separate reservoir its impact on Baku-Ceyhan. The Shah Deniz discovery, pointing to an alluring gas export potential from Azerbaijan to Turkey, was probably the main reason for BP's warming up to the BTC project in October 1999, after long opposition to it.²⁷³ Since then, beside its effort to search for the necessary volumes for this pipeline, BP has assisted in the development and negotiation of innovative model agreements between Turkey, Azerbaijan and Georgia. As stated earlier, after the completion of the ratification process of the intergovernmental agreement for the BTC oil pipeline in the parliaments of all three countries, the argument of oil companies that investment in offshore field development and pipelines will not go forward until agreements are finalized²⁷⁴ is no longer valid.

One step closer in realization of TCGP project

With the realization of the BTC pipeline, Turkey and the United States came closer to their dream project; Turkmenistan-Turkey-Europe Trans Caspian Gas Pipeline project (TCGP). The BTC pipeline was, as President Bush called it, "an essential component of an East-West energy corridor."²⁷⁵ The second major component is the Baku-Tbilisi-Erzurum gas pipeline; the third component is the Kazakh addition to the BTC and transformation of the project into Aktau-Baku-Tbilisi-Ceyhan pipeline. The last essential part would include TCGP.

²⁷³ *Oil and Gas Journal*, Nov. 15, 1999, p. 23.

²⁷⁴ Ralph Alexander, BP Amoco's Group Vice President, *Testimony before the Subcommittee on International Economic Policy, Export and Trade Promotion, Senate Committee on Foreign Relations*, April 12, 2000.

²⁷⁵ From the letter he has sent to the groundbreaking ceremony of the project. Richard Allen Greene "Hopes and risks in Caspian project," *The New York Times*, September 23, 2002.

In fact BTC, TCGP and the development projects of Kashagan field are very much complementary in nature. Experts say Kazakhstan and Turkmenistan can fill the pipeline when the Azerbaijani fields begin to show declines in output early in the next decade.²⁷⁶

Given the promising developments in line with the resolution of the legal status of the Caspian Sea and the increasing demand of Europe and Turkey for natural gas, realization of this project makes perfect sense. Despite the Turkmen government's decision to commit high volumes of natural gas to the Russian transportation system on April 10, 2003 for the next 25 years²⁷⁷, the proven gas reserves of the Turkmenistan still can make TCGP project viable. It is totally up to the Turkmen government to decide on the future of this project.

Environmental concerns are better addressed with BTC

Environmentally, BTC is the safest way to transport oil out of the Caspian Basin. If the chosen export route did not terminate at Ceyhan, new oil exports shipped from Black Sea ports would certainly add to the environmental risks of shipping oil through the Turkish Straits. Each 10-million-ton increment of Caspian oil shipped out to the Mediterranean would require eight-hundred trips through the Bosphorus by medium-sized oil tankers, or two hundred trips by large tankers, each year. Such increases in traffic density would directly increase risk of accident and impose additional delays on other vessels, including tankers, because the strait is intermittently closed to regulate traffic.²⁷⁸ This, on the other hand, would increase the cost of transportation of oil and gas significantly, a development that would

²⁷⁶ Ariel Cohen, "New Great Games in the Caspian will Involve Complex Stakes" A *EurasiaNet* commentary October 11, 2002.

²⁷⁷ Amy Jaffe Myers presentation at the panel on Caspian energy organized during the Offshore Technology Conference, May 5, 2003; "Turkmenistan, Gazprom to build gas pipeline by 2007" *Interfax*, 29 May 2003.

²⁷⁸ <http://www.wws.princeton.edu/~wws401c/1998/baku-ceyhan.html>

certainly irritate the oil companies.

Impact on oil prices and OPEC production policies

Even relatively modest amounts of new oil reaching world markets from the Caspian could affect how the OPEC sets its production levels. As Akbar Noman, the head of the World Bank office in Baku, stated "simply because, new oil from the Caspian might make OPEC countries feel that their bargaining position has been weakened."²⁷⁹ If there are further major new discoveries in the Caspian, which might very well be the case given the huge number of unexplored fields around the sea,²⁸⁰ it could have an even more significant affect.

Conclusion

The BTC pipeline has been more popular with statesmen rather than businessmen, as its appeal is much more geopolitical than commercial. As stated repeatedly, the political allure of the BTC project for the whole region is self-evident: On the one hand, the BTC pipeline could deny Iran a significant role as a Caspian energy exporter, reduce the dependence of Caspian states on Russian pipelines, and bolster fledgling regional economies; especially those of Azerbaijan, Georgia and Turkey.

On the other hand, however, the combined diplomatic weight of the United States and Turkey has ultimately overcome the commercial hesitation and cost-conscious reluctance of the Western oil companies to support the \$ 2.9 billion BTC project and has turned it from "a pipeline pipedream" into a "one million barrel fact" as the senior U.S. adviser on Caspian

²⁷⁹ Richard Allen Greene, *ibid.*

²⁸⁰ Just to give an example; Managing Director of the Kazakh national oil company KazMunaiGas Mr. Nurlybek Imanbaev has stated that, only in the Kazakh section of the Caspian Sea there are more than 180 offshore sites waiting for exploration drilling. From an interview made during the 2003 Offshore Technology Conference in Houston, May 5, 2003.

Basin Energy Diplomacy, Ambassador Stephen Mann likes to call it.²⁸¹

Accordingly, the BTC project has always been considered a politically motivated project. This was so, long before it was declared a commercially viable option to export oil out of the region. And indeed political decisions, such as Iran's and Armenia's exclusion from the project, and the clear-cut objective of bypassing the Russian northern route were shaped by political motives. That brings me to the essence of what I want to convey: It is axiomatic in the Caspian Basin that energy projects involving all, or a group of, riparian countries can only take place if a political climate conducive to political dialog is in place.

The BTC project is the first comprehensive project aimed at changing the *status quo* in the region; the *status quo* being the only alternative route to export oil out of the region, the Russian route to Novorossiysk. For the first time, Russia's monopoly over oil export routes from the Caspian region has been broken, and with additional pipelines entering the scene in near future, this trend is likely to accelerate.

Given the fact that the BTC line will be in place in 2005, Kazakhstan and Turkmenistan are holding hope to link up with this rapidly engineered pipeline in order to diversify their chances to export their oil and gas. This pipeline will also decrease the cost of additional pipelines that would run parallel to the BTC line, such as the Baku-Tbilisi-Erzurum gas pipeline. Together with the CPC pipeline, the BTC is the likely candidate to export the region's greatest oil reserves, such as Kazakhstan's Kashagan field. In the chapter eight we will see how this may eventuality unfold. To aid in our forecast, we shall employ a predictive model as applied to potential policy making by the major actors involved.

²⁸¹ From the speech delivered by Ambassador Mann during the CERA week conferences in Houston on February 12, 2003.

CHAPTER SEVEN

This chapter is the heart of the dissertation. By discussing the results of 116 interviews that were conducted in the period between December 2001 and May 2003, this chapter helps to find definitive answers to the questions and issues that have been raised in contextual chapters four and five. Based on answers from the experts, it ranks not only the importance of the new rules of the “game,” but also the actors involved in the region and major problems of the Caspian Basin. These results, together with discussions presented in earlier chapters and those that will be added in the next chapter will present us enough to render our conclusions and overall observations in this dissertation.

RESULTS OF THE INTERVIEWS

This chapter deals primarily with the results of 116 interviews that were conducted in the period between December 2001 and May 2003. Respondents were identified based on their expertise in energy matters and knowledge in Caspian energy issues. They were selected from various major oil and gas companies, research institutes, relevant interest groups and government offices. The experts who were interviewed were asked to suggest others who would be relevant to the subject of this dissertation (as it was explained in chapter three, a “snowballing” technique was used). Among more than 250 people approached, 116 agreed to answer the interview questions either in writing or out loud.

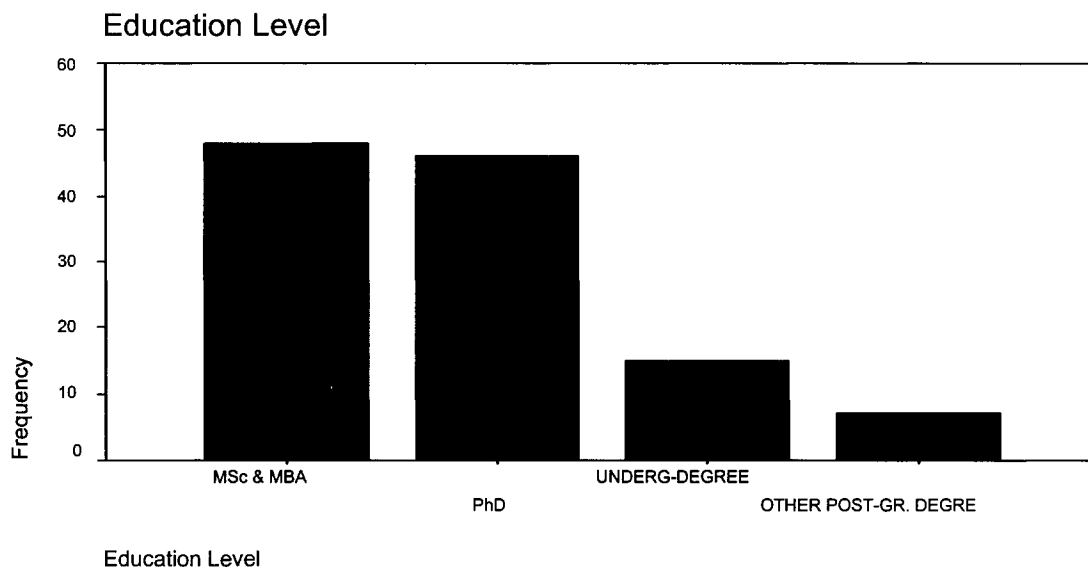
Firstly, I would like to discuss the demographic composition of the group, and then I would like to present the answers to the questions asked in the interviews. The questions that

were posed in the interviews can be found in Appendix 1. In all of the analysis presented below, I used the statistical software product SPSS (version 10) for data analysis.

Demographic and some other characteristics of the respondents

Of the 116 experts, 46 of them hold PhD degrees, 48 of them have MSc or MBA degrees, 7 of them have other Masters degrees, and 14 of them hold various undergraduate degrees. (Figure 7.1.)

Figure 7.1.

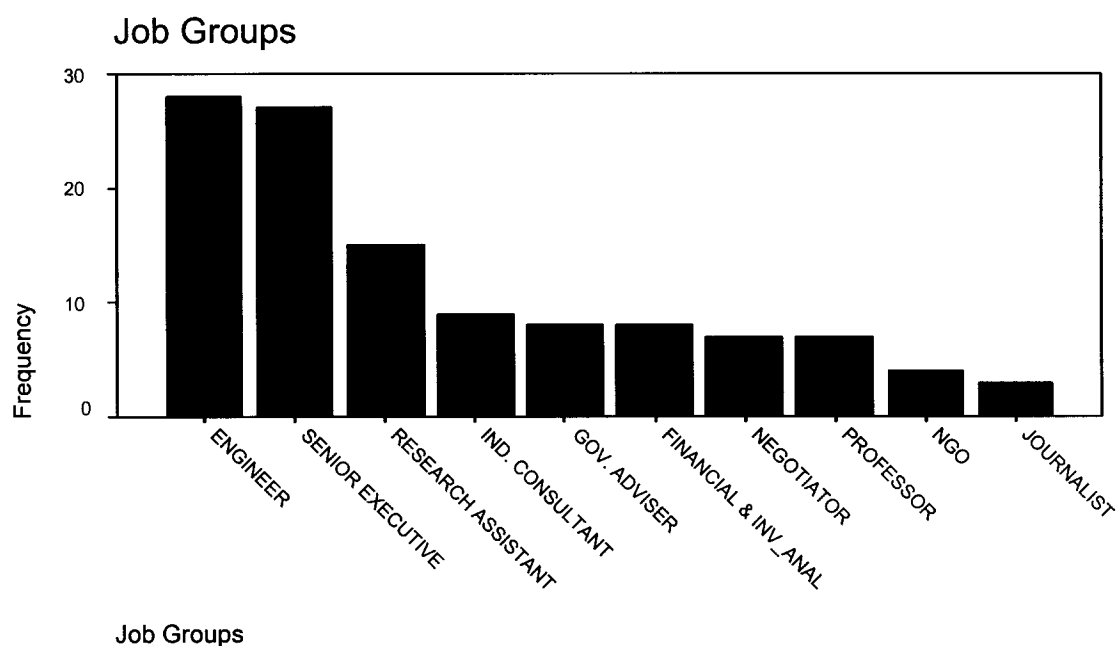


76 of the respondents were working in the private sector, 24 of them in academia and 16 of the experts were government employees. Twenty-eight were engineers, 27 were senior Executives in either government or private companies, 15 were researchers in academia, nine were independent consultants, and eight were advisers for various governments.²⁸² Seven

²⁸² The senior US adviser on Caspian Basin Energy Diplomacy, Ambassador Stephen Mann and Russian President's Special Envoy for Caspian affairs and former Minister of Energy and Minerals, Deputy Minister of

more were financial or investment analysts, seven were professors, seven identified themselves as private and public company negotiators, seven represented various NGOs and three were journalists (Figure 7.2.).

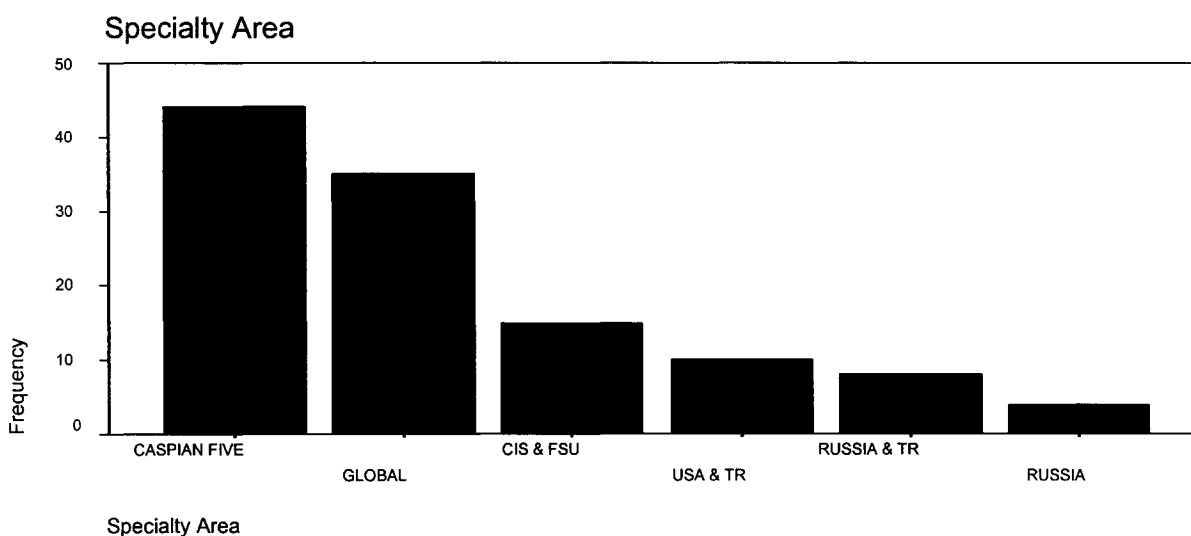
Figure 7.2.



In terms of specialty area and their affiliation, 44 of the respondents were experts on Caspian energy issues, including all of the five Caspian riparian countries, 35 were experts on global energy matters, 15 were experts on CIS and FSU energy matters, 10 were experts on Russian and Turkish energy markets, 8 were specialists on Russian and Turkish energy sectors, including 4 on the Russian energy sector alone (Figure 7.3.).

Foreign Affairs Victor Kalyuzhnyi are included in this category.

Figure 7.3.



In terms of nationality, 57 of the respondents identified themselves as Turks, 23 either chose not to identify themselves as Russian, Turkish, American, Kazakh, Turkmen, Azeri and Iranian, or they belonged to other nationalities in the region such as Georgian or Uzbek. Twenty two of the experts were Americans, seven of them were Azeris, three of them were Russians, and three were Kazakhs. Approximately two-thirds of the Turks had previously, or currently, worked in at least one of the Caspian countries such as Azerbaijan, Kazakhstan, Turkmenistan, Iran or Russia. Most of them are American citizens and have spent their entire careers working for international oil companies and have no direct knowledge or experience about Turkey's energy sector and official policies toward the region. Only 14 of them actually lived and worked in Turkey. In order to allay concerns of bias on the part of the respondents, following the presentation of the results, in Appendix 2, I compared the outcomes compiled from the data including and excluding Turks. The changes I discerned were minor. This is not surprising: The majority of the questions asked had nothing to do with nationalities, and were basically expertise questions.

Interest toward the Caspian

68 of the experts stated that they were interested in the region “most of the time,” 36 said “some of the time” and 12 experts responded “only now and then.” 111 experts said that they had discussed the Caspian energy development issues with a friend, 62 of the experts said that they had conducted research or a study regarding the Caspian region, 47 experts said they had participated in a policy planning meeting with regard to Caspian energy resource development in their respective firms, governments or institutions.

Do you agree or disagree?

When presented the following statements, experts were asked whether they would agree or disagree with these statements. The reactions were as follows (Figure 7.4.):

To the statement: “In today’s volatile energy geopolitics, issues of transportation and delivery of hydrocarbon resources to the markets are much more important for the development of these resources than the actual production problems and proven resource assessments.” 92 of the experts stated that they either completely agree (37) or generally agree (55). Only 18 said they generally disagree and only four said they completely disagree.

When presented with the statement “The Caspian energy resource development will eventually create interdependence among major actors (great powers, countries and companies) in the region and will expedite westernization, democratization and secularization of the countries of the region,” 85 of the experts either generally agreed (60) or completely agreed (25). Twenty-eight generally disagreed and only one completely disagreed.

A scout few of the experts (3) expressed concern about the wording of the question. Their well-taken complaint was that westernization, democratization and secularization are

three different concepts that should be addressed separately.

In response to the statement “Political Islam and terrorism are major threats to the security of the countries of the region, as well as economic development in the Caspian area,” 68 of the respondents either completely agreed (30) or generally agreed (38), 34 generally disagreed, and 12 completely disagreed.

This question also troubled some of the experts. Most of the respondents (more than half) expressed the view that political Islam and terrorism are two different problems in the region. Most of the experts stated that political Islam is a consequence, not a cause, of difficulties in the region. They said it is a response to authoritarian governments and governments that ignore the traditions and cultural ties of the countries in the region. Therefore, although it is a concern for the region’s governments, political Islam is not seen as a major threat to security and economic development as is international terrorism. In accordance with the explanations in the fourth chapter, political Islam, or simply Islam, is seen more as folklore rather than a political force in the region. The way Islam is interpreted in these countries is much closer to the moderate interpretation in Turkey.

“For the time being, the most suitable regime for the Caspian region is authoritarian rule.” Forty of the experts completely disagreed, 36 generally disagreed, 27 respondents generally agreed, and 9 completely agreed. Most of the experts who responded favorably to this statement stressed the “for the time being” part.

105 of the experts agreed with the statement “In the long run, the best regime for the countries of the region is democracy.” (75 completely agree, 30 generally agree). Only six said they generally disagree and two completely disagreed.

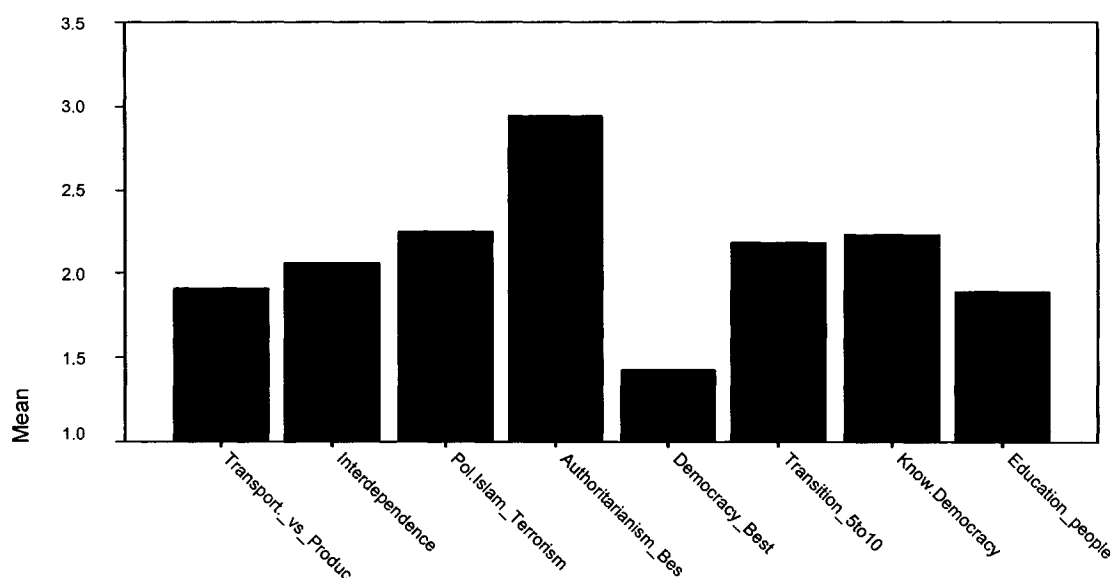
53 experts said they generally agreed with the statement “Transition to democracy will require a period of 5 to 10 years with willing people and political leaders.” Twenty-four completely agreed. 29 generally disagreed and 7 completely disagreed. Many of those who agreed and disagreed with the statement expressed caution, stressing that it will take longer than 5 to 10 years to make the transition. Almost one third of the experts expressed the view that following the independence in 1991, despite the golden opportunity, the United States, especially, and Western governments, more generally, did not place enough pressure on the governments of the region to move quickly on transition reforms. Those experts argued that, as in Africa and Latin America (i.e. Nigeria, Venezuela), the United States and other Western powers are reluctant to press too hard for political and economic reform for fear that their access to the region’s valuable natural resources will be restricted. They think that the Western governments could be tougher on pressuring the regional governments to not just endorse, but also to implement political and economic reforms that would make these countries more pluralistic.

Seventy-one experts agreed (21 completely 50 generally) that “The average person in the region does not know much about democracy.” 36 expressed they generally disagree and only 6 said they completely disagree. One important note regarding the replies to this statement is that people from the countries of the region almost without exception generally or completely disagreed with this statement. They claimed that people actually have some notion and idea about democracy.

Ninety-two of the respondents agreed (38 completely, 54 generally) that “With regard to countries with regimes other than democracy, first priority should be to educate the people about democracy.” Sixteen generally disagreed and five completely disagreed.

Figure 7.4. Summary of the results for the “do you agree or disagree” section.

(1) Completely Agree, (2) Generally Agree, (3) Generally Disagree, (4) Completely Disagree



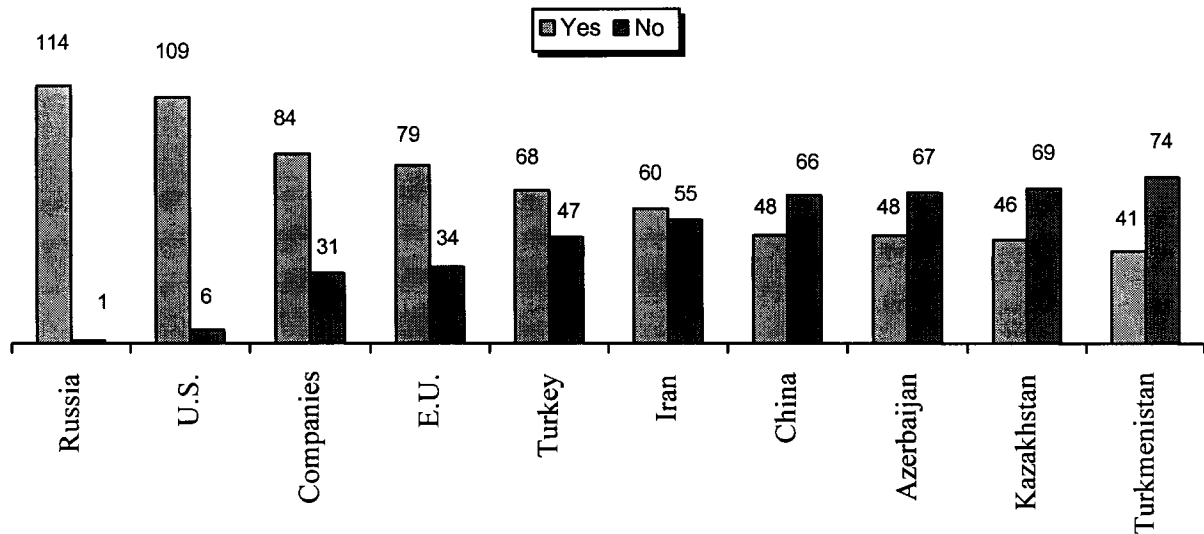
“Great Game”, Major and Secondary Actors, New Rules of the Game

Although a majority of the experts (61) answered the question “Are we witnessing a contemporary version of the old “Great Game” with new players and new rules in the Caspian basin?” as yes, and 54 said no, it can be said that the respondents were split on this issue. Almost everyone said this is not the same kind of game that was played in late 19th Century. Some made a distinction between the governments’ and companies’ attitudes on the whole issue of energy development in the region. This group of experts claimed that governments involved in the region still think of this development issue as a geopolitical game, and act like they are in the game; however, companies do not show signs of such perception, and their motives are driven by competition and economic incentives.

When asked about the actors in the energy development of the region, the experts’ answers were as follows: 114 respondents said Russia was a major actor and 109 experts said the United States is a major actor, too. The other actors with majority support from the

experts are as follows: International Oil Companies (84), European Union (79), Turkey (68) and Iran (60). The other actors named as actors but who failed to receive majority support to be considered as “majors” are as follows: China (48), Azerbaijan (48), Kazakhstan (46), Turkmenistan (41). (Figure 7.5.)

Figure 7.5. Who are the major actors ?

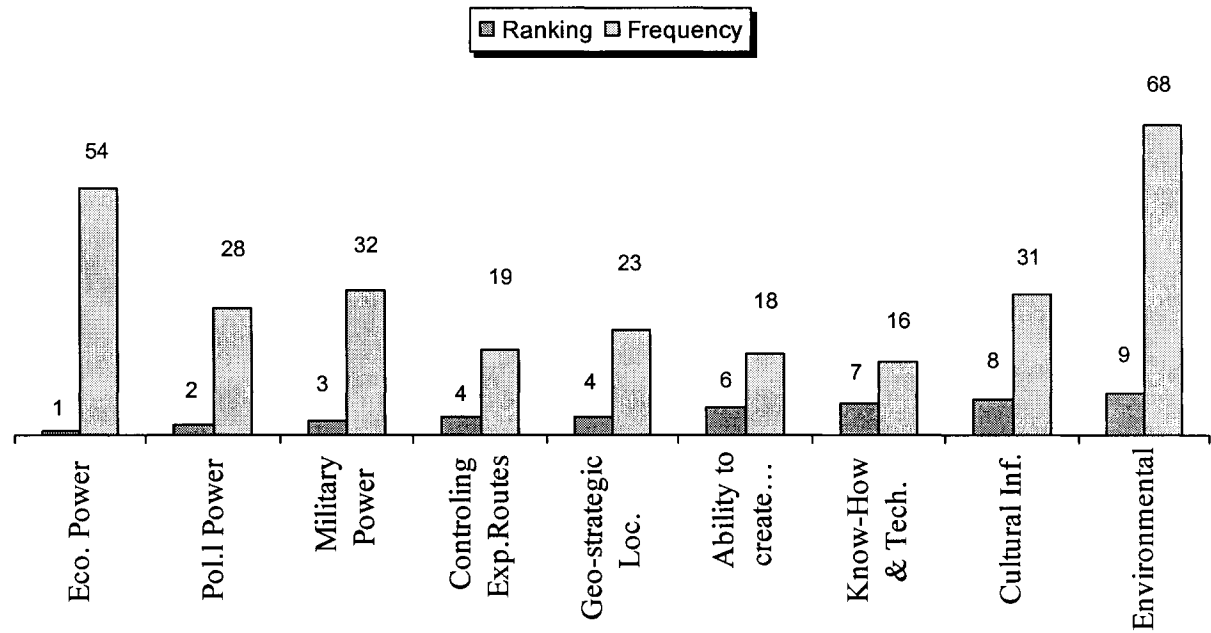


As for the “new rules of the game,” the experts were asked to rank the precipitating factors in order of their perceived importance in the energy development in the region, “1” being the most important and “9” being the least. The positions of each factor, as assigned by the individual experts, were then compiled to determine overall ranking. Experts also noted that whoever masters these factors will become major actor in the Caspian Basin.

Fifty-four of the experts identified economic power as the number one factor. 28 experts stated that political power is the number two factor. 27 of the respondents also said that political power is the number one rule, making it the second most important factor overall. 32 of the experts said military power is the third important rule of the game. Controlling export routes is the fourth important factor with 19 of the experts in agreement.

23 respondents said that geo-strategic location of the actor determines the extent of his role. With 18 votes from the experts, the “ability to create spheres of influence and or launch coalitions and alliances around the shared goals and interests” was ranked as the sixth important factor. Know-how and technology ranked seventh with 16 votes. Cultural influence, with 31 expert views, becomes the eighth important rule, and ranking last is environmental factors. (Figure 7.6.)

Figure 7.6. Rules of the Game-The Most Important Factors



Saliency of the actors

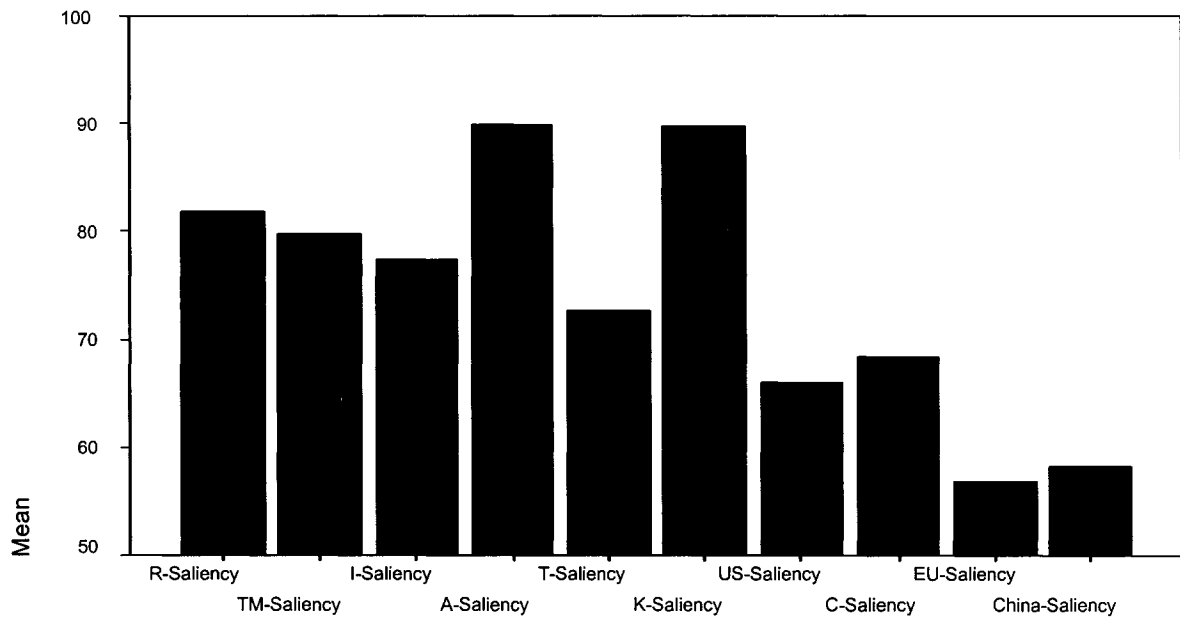
As far as saliency²⁸³ scores of the actors are concerned, 75 experts identified Russia's saliency score as 80, Turkmenistan's saliency score was stated as 80 by 52 experts. Iran's saliency score was identified as 80, too (by 67 experts). The saliency score for Azerbaijan is 95 (supported by 66 experts). Turkey's saliency score is 80 identified by 59 experts. Kazakh saliency is 95 (stated by 60 experts). United States' saliency score is 60 (indicated by 78 experts). Companies' saliency score is 60 (identified by 61 experts). European Union's saliency score is 60, too (stated by 71 experts). China's saliency score is 60 (stated by 60 experts). Based on these results, Azerbaijan has the highest saliency score (considering the mean values of saliency scores), Kazakhstan has the second highest and they are followed (in order) by Russia, Turkmenistan, Iran, Turkey, Companies, United States, China and European Union.

Table 7.1. Saliency Scores for the Actors

Statistics											
		R-Saliency	TM-Saliency	I-Saliency	A-Saliency	T-Saliency	K-Saliency	US-Saliency	C-Saliency	EU-Saliency	China-Saliency
N	Valid	114	104	104	104	104	104	113	104	102	88
	Missing	2	12	12	12	12	12	3	12	14	28
Mean		82.32	79.76	77.26	89.33	74.18	88.65	65.27	68.75	56.86	58.18
Mode		80	80	80	95	80	95	60	60	60	60

²⁸³ Saliency as explained before (Chapter Three) means here, actors' commitment to pursuing an issue over all others or the preparedness of each to focus on the issue when it comes up, even if it means putting aside some other issue. (The issue being overall Caspian energy development.)

Figure 7.7. Saliency Scores for the Actors



As far as resource scores²⁸⁴ are concerned, 44 experts identified Russia's resource score as 90, Turkmenistan's resource score was stated as 20 by 52 experts. Iran's resource score was identified as 40 (by 33 experts). Azeri resource score is 30 (stated by 42 experts). Turkey's resource score is 40 identified by 37 experts. Kazakh resource score is 30 (stated by 41 experts). The United States' resource score is 90 (indicated by 48 experts). Companies' resource score is 60 (identified by 37 experts). European Union's resource score is 50 (stated by 35 experts). China's resource score is 30 (stated by 35 experts).

When mean values of each actor's resource scores are considered, the United States with a resource score of 88 is the number one actor in this category. Russia with a resource score of 82 is perceived to be the second most powerful actor. After Russia, ranking goes as follows: The third actor is companies (62), the fourth resourceful actor is the E.U. (48), the

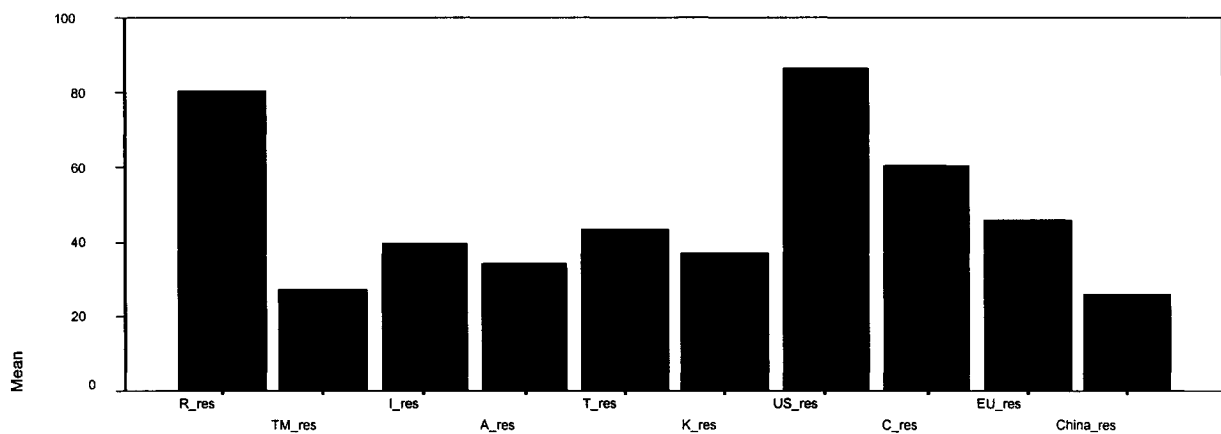
²⁸⁴ Resource scores, as explained in the Chapter Three, are judgemental numerical values attributed to an actor's potential influence or power, whatever relevant in terms of shaping energy resource development in the region. 100 being the most powerful and 10 being the least

fifth is Turkey (45), the sixth most powerful actor is Iran, the seventh is Kazakhstan, the eighth is Azerbaijan, the ninth actor is Turkmenistan, and the least resourceful one is China.

Table 7.2. Resource Scores Based on Whole Data Set

		Statistics									
		R_res	TM_res	I_res	A_res	T_res	K_res	US_res	C_res	EU_res	China_res
N	Valid	106	91	86	81	93	88	99	84	84	81
	Missing	10	25	30	35	23	28	17	32	32	35
Mean		81.65	27.47	41.16	36.17	45.16	37.27	87.98	62.38	47.86	26.54
Mode		90	20	40	30	40	30	90	60	50	30

Figure 7.8. Resource scores for the Actors



Conflict or cooperation, zero-sum game or win-win solutions

81 of the experts stated that they expect that cooperation instead of conflict will prevail in the Caspian Basin. Only 21 said conflict will prevail, and 12 experts said that, for the foreseeable future, it is going to be both. Those who said that cooperation would prevail expressed the view that this must be the case in order for the development of the region's resources to be feasible both economically and practically. The development of resources requires a stable and secure stage of operation. They believe the cooperation will be "orchestrated;" the conductor of this orchestration will be the actor who has best mastered the "rules of the game" as listed above.

Similarly, 66 respondents said “win-win solutions” would be more likely to characterize the near future of the region. 38 said “zero-sum game” will characterize the future and 8 experts insisted that it would be both. Those who said the zero-sum game will prevail in the region asserted that in the near term, negotiation of zero-sum game agreements will be easier and more expedient by nature. They think win-win solutions require a more stable environment. They also stressed that democracy provides the best environment for win-win solutions.

Is there a particular solution or a project for the energy development of the region?

65 of the respondents said they do not believe that there is a particular solution, blueprint (scheme) or proposition that is relevant to the development of the energy resources of the Caspian about which they felt strongly. 49 said yes they believed in such a scheme. Most of the respondents emphasized that, although there are some similarities between the countries of the region (most are Turkic and were all part of the Soviet Union, except Iran), each one has its own particular set of conditions (population mix, religious mix, level of industrial and economic development, degree of democratization, transparency etc.) and problems. They do not think that one cookbook solution or scheme would apply to all.

Approach to History

In talking about the history of the region, we often find that many nations in the region seem to be confronted with enmities inherited from the past. When asked about which of the given statements best describe their attitude toward this issue, 77 experts said, “I think cooperation should be seen as a means to overcome prejudice stemming from history.” 16 held the view that “history dictates the extent of cooperation in the region.” 11 of them said, “I do not think that history should matter in today’s contemporary world.” Eight respondents

suggested that “history school books used in the countries of the region should be re-written in such a way that they should not rationalize and perpetuate historical enmities.”

Major problems of the region

Experts identified and ranked the following problems as major problems of the region. Although experts were extended the opportunity to add to the list, none of the experts mentioned any additional issues as major problems of the region.

64 experts said authoritarianism, bureaucracy and corruption is the number one problem of the region. 54 respondents identified economic inequality and poverty as the second important problem of the region. With 41 yes votes, ethnic conflicts and problems are the third most significant problem of the region. Legal status of the Caspian was ranked as the fourth most important problem in the region and “religious differences and rise of political Islam” was ranked fifth most important problem with 27 votes (26 votes identified legal status of the Caspian as the fourth and 28 votes indicated it as the fifth most important problem, since “religious differences and rise of political Islam” with 27 votes was identified as the fifth and with 29 votes as the sixth most important problem, it was safe to declare the legal status of the Caspian Sea as the fourth major problem.) The least important problem (by perception) of the region was environmental issues (with 59 votes). (Figure 7.9., Figure 7.10.)

Figure 7.9. Ranking of the major problems of the region (by mean values)

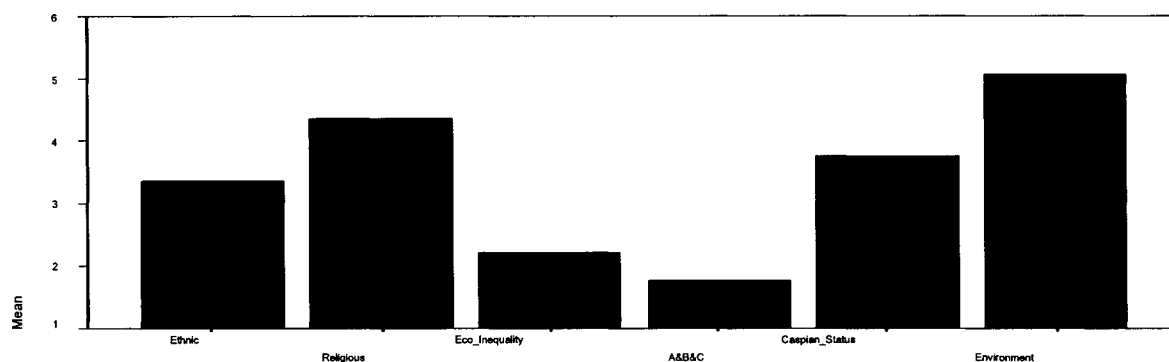
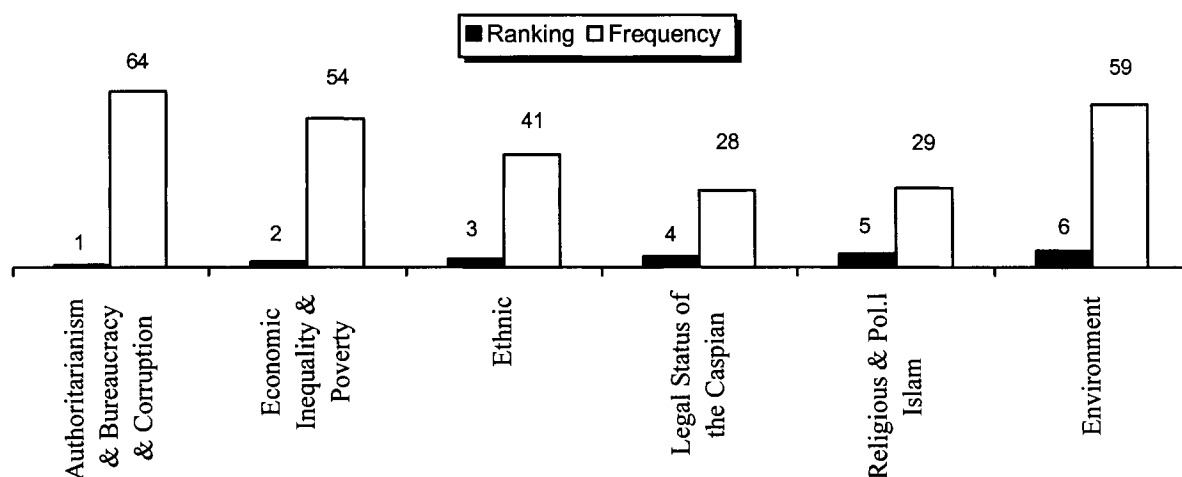


Figure 7.10. Major Problems of the region



In addition to the above-mentioned major problems, experts repeatedly commented on and added the following issues as big problems for the region:

- remoteness from major consumer markets, lack of infrastructure for oil and gas transportation and heavy dependence on the Russian network for export purposes,
- monopolistic market structures and frequent amendment of the underdeveloped legal and regulatory framework for investment; lack of established rules,

- weak allegiance to the principle of “rule of law,”
- Russia’s political influence and clear intentions to dominate and interfere in domestic affairs of the riparian countries & Iranian intrigues,
- political uncertainty. Oil companies want to be able to get their money out somehow. There was a rush among the western companies to get there first, but they soon realized that, without the political risk taken out of the equation and some sort of established political stability, they would have to move cautiously.

Viable options to export energy resources of the region to the market

Among the six different routes (through Russia, through Iran, through Turkey, through Pakistan & India, through Bulgaria & Ukraine, through China) 114 experts, given all political and economic reasons discussed in Chapters Four and Five, identified the Turkish route as a viable option. 92 respondents chose Russia as another viable option. The third is Iran (chosen by 66 experts). Pakistan & India came in as the fourth frequently mentioned viable option (20) and China is the least mentioned viable option, with only 16 experts’ preference. (Figure 7.11. and Figure 7.12)

Figure 7.11. What are the viable export routes ?

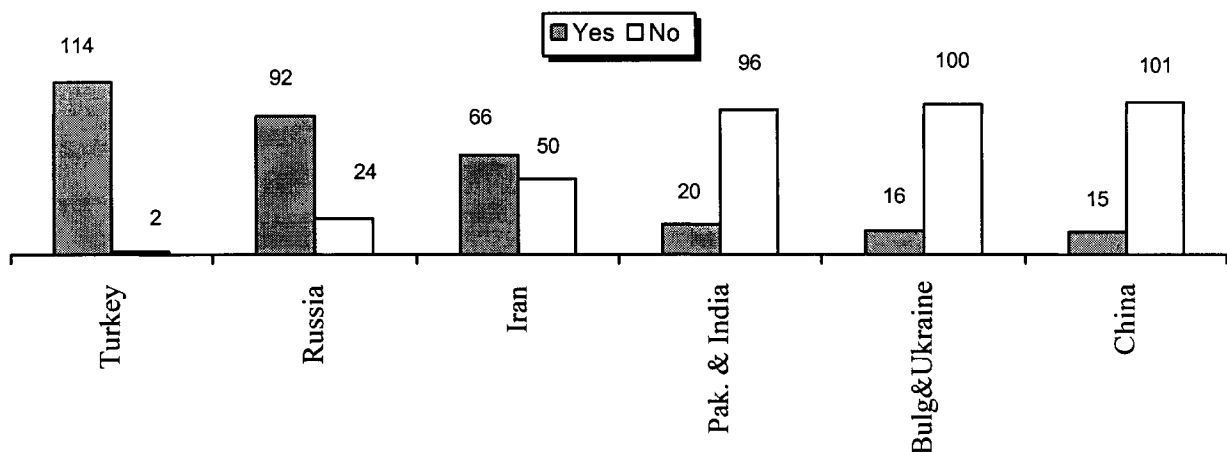
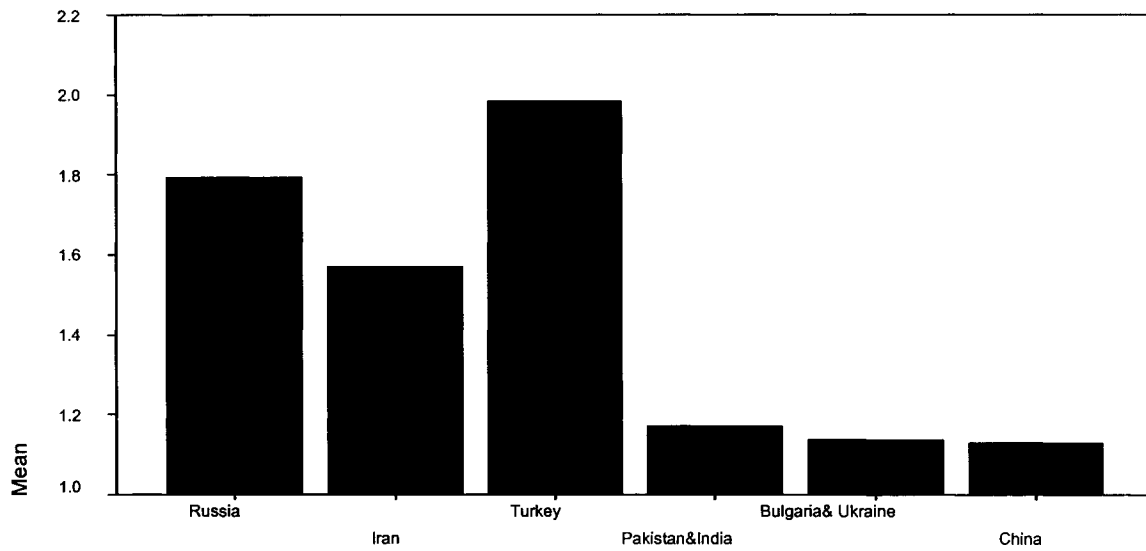


Figure 7.12. Viable export routes



I would like to draw the attention of the readers to the point that this is not the ranking of “the most viable options.” In other words, I did not use the word “most” because it could give the wrong impression that even some of the Russian respondents voted for Turkey as their number one choice. I simply asked the experts to identify only, viable export route(s) (They were free to mark as many routes as they thought were relevant viable export routes). So the numbers that are presented in the above figure and table reflect only the cumulative number on how many experts considered these individual alternative routes as viable options. Therefore, 114 experts did not name Turkey as the most viable option or their number one choice; instead that number of experts considers Turkey as merely “one of the viable options.” Russia was considered to be a viable option by 92 experts, Iran by only 66.

Since Turks constitute a sizable part of the respondents (57 out of 116) in this survey, it is a methodological necessity to re-run all the statistical analyses excluding them to ensure that any suspected bias on their part has not caused a distortion of the results. For results based on the data set excluding Turks, please refer to Appendix 2. Results are compared in

graphs and charts. Based on these results, there are two rather minor differences and those are:

- On the question, “Are we witnessing a contemporary version of the 19th century Great Game in the Caspian?” based on the data set excluding Turks, a majority of the experts do not think that the new geopolitics in the region is similar to the original “Great Game” played in the late 19th century between Russia and Great Britain (30 to 29). Considering that there is one missing value in this data base, this result does not change much from the whole data set result.
- On the question, “Who are the major actors?” the first six rankings do not change: 1-Russia, 2-United States, 3-Companies, 4-European Union, 5-Turkey, 6-Iran. Then, based on the whole data set ranking: 7-China, 8-Azerbaijan, 9-Kazakhstan, 10-Turkmenistan, the new ranking based on the data set excluding Turks is as follows: 7- Azerbaijan, 8-Kazakhstan, 9-China and 10-Turkmenistan.

CHAPTER EIGHT

This chapter examines the promising oil and gas developments in Kazakhstan, and more specifically, it seeks to answer the question of how the Kashagan oil field will be developed. What might be the geopolitical consequences of this project for the Caspian Basin? What is interesting in this chapter is that the pipeline issue has arisen regarding the giant Kashagan field in Kazakhstan with the same issues that emerged in the BTC project. By discussing possible alternative routes available to the Kazakh government other than the Russian oil pipeline network, and applying the BDM's predictive model, I will put forward the most likely scenario in terms of which pipeline to be used in bringing that oil to market. In doing so, the applicability of the BDM model will be tested in the context of energy development, which is different from the original and traditional fields of application for this model. Therefore, this chapter will constitute a partial answer to the central question of this dissertation: Can we develop a model based on certain factors to predict which export route will be chosen for the energy resources of the Caspian Basin?

KASHAGAN and BEYOND

Significance of Kashagan

Kazakhstan has emerged as the main focus of upstream²⁸⁵ oil and gas investment in the Caspian region, especially since the discovery of a world-class super giant at the offshore

²⁸⁵ Upstream refers to oil & gas exploration and production up to the sales and distribution stage.

Kashagan field. The field known as Kashagan lies in the north-west Caspian off the coast of Kazakhstan and is reported to cover an area 47 miles (75 kilometres) long by 22 miles (35 kilometres) wide.

Kashagan oil field, believed to be the fifth largest ever found in the world, has estimated total reserves of 50 billion barrels of oil (up to 15-20 billion of which are thought to be recoverable)²⁸⁶ and 25 tcf of natural gas.²⁸⁷ Kashagan alone represents more than 70 percent of the proved oil reserves of Kazakhstan²⁸⁸ and it is by far the largest offshore field in the Caspian basin. The 480-square mile deposit is reportedly so large that it is believed to even surpass the size of the North Sea oil reserves.²⁸⁹

Drilling began in 2000 under the auspices of its concessionaire, the Offshore Kazakhstan International Operating Company (OKIOC). The OKIOC later changed its name to Agip Kazakhstan North Caspian Operating Company (Agip KCO). The contracting companies involved in the North Caspian Sea Production Sharing Agreement operated by Agip KCO are: ENI-Agip (Italy) 16.67%; BG (formerly subsidiary of BP, U.K.) 16.67%; ExxonMobil (U.S.) 16.67%; TotalFinaElf (France/Belgium) 16.67%; Royal Dutch/Shell (U.K./Netherlands) 16.67%; Inpex 8.33%; ConocoPhillips (U.S.) 8.33%.²⁹⁰ The North Caspian PSA covers 5,600 sq km.

²⁸⁶ *The New York Times* May 13, 2003

²⁸⁷ www.eia.doe.gov – 2003 figures; *OGJ*, Dec. 17, 2001, p. 18.

²⁸⁸ Based on figures indicated by EIA with regard to Kazakh onshore and offshore oil projects in Kazakhstan.

²⁸⁹ Nikola Krastev, “Multinationals Pushing Oil Projects Despite Instability, Corruption,” *EurasiaNet RFE/RL*, March 31, 2002

²⁹⁰ www.eia.doe.gov

In May 2003, upon the BG group's decision to sell its share to two Chinese companies, the existing partners exercised their contract based right to preempt this selling decision. Upon completion of the preemption transactions, Agip Caspian Sea BV, ExxonMobil Kazakhstan Inc., Shell Kazakhstan Development BV, and Total E&P Kazakhstan each will own 20.37%. ConocoPhillips Petroleum Kazakhstan Ltd. will own 10.19%. Japan's Inpex Corp. will maintain its 8.33% interest.²⁹¹

The two-year appraisal program to evaluate the value and size of the Kashagan field undertaken by the contracting companies indicates a preliminary estimate of the ready to produce reserves from the field in the range of seven to ten billion barrels of oil. Based on this program the field was declared a commercial discovery in June 2002, opening the way for preparation of a development plan.²⁹² Further exploratory drilling activities are still in progress (In 2003 5 wells have been drilled at Kashagan and until 2006 three more wells will be drilled for exploratory purposes).

The discovery well, Kashagan East, was a single vertical well, drilled to a total depth of 4,500m.²⁹³ The contracting companies continued to explore other structures in the North Caspian Sea contract area and they found considerable reserves in 2002 at the Kalamkas field.²⁹⁴ The Aktote, Kashagan South West and Kairan areas will be explored by the end of 2003. So far, over \$600 million have been spent since 1993, and it is expected that many

²⁹¹ *OGJ*, May 16, 2003.

²⁹² *OGJ*, June 28 and October 22, 2002.

²⁹³ <http://www.offshore-technology.com/projects/kashagan/>

²⁹⁴ *OGJ*, October 22, 2002.

more billions of dollars will be spent during the development and production phases that will begin in 2005 and beyond.

Implications of the Discovery

The discovery of Kashagan and subsequent discoveries in and around the same Agip KCO operating area (such as Kalamkas) have had a significant impact on the regional reserve estimates.

As of 2002, the four Caspian states - Azerbaijan, Kazakhstan, Russia (Caspian reserves only) and Turkmenistan - are projected to have remaining liquids reserves of 39.4 billion bbl (Figure 8.1.).

The Caspian is dominated by six key projects (Kazakh-Kashagan, Tengiz, Karachaganak, Azeri-Chirag-Guneshli [ACG], Shah-Daniz, and the Severnyi block in Russia), which contain a combined 26.9 billion bbl, or 68% of the region's total liquids reserves.²⁹⁵ For the purposes of this analysis, even if we estimate immediate producible oil reserves of Kashagan at a conservative 10 billion bbl, it still represents more than 25% of the regional total. The giant discovery has strengthened Kazakhstan's regional reserve position, and it now controls about 75% of the Caspian's oil.²⁹⁶

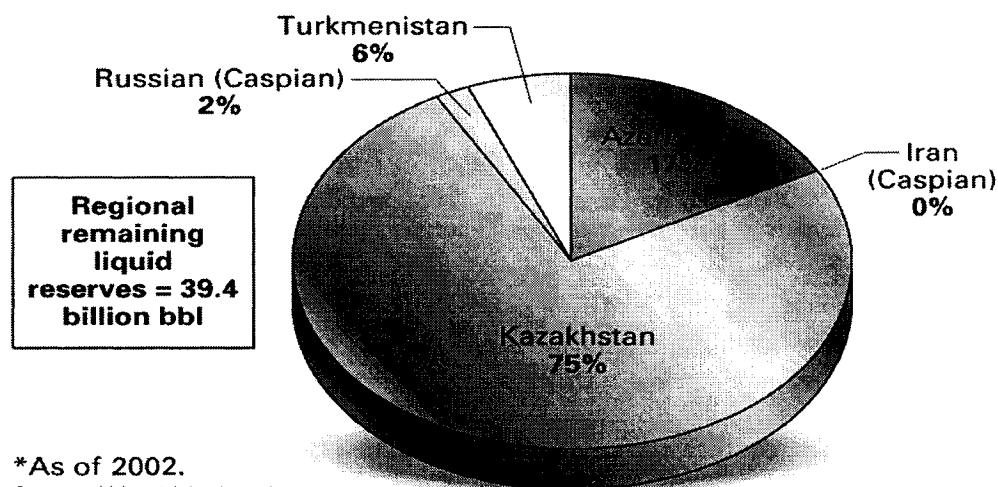
²⁹⁵ The largest onshore oil fields are Tengiz, one of the world's 10 largest oil fields with 6-9 billion barrels of reserves. Seismic studies in 2002 suggest that Tengiz may have between 9 and 13.5 billion barrels of oil. The field is operated by TengizChevroil (TCO). Major share holders in this company include: ChevronTexaco (U.S.) 50%; ExxonMobil (U.S.) 25%; Kazmunaigaz 20%; LukArco (Russia) 5%. Total cost of the development is expected to be \$20 billion over 40 years. Peak production will be 750,000 bbl/d by 2010.

Karachaganak field is operated by a consortium called: Karachaganak Integrated Organization (KIO): Agip (Italy) 32.5%; BG (U.K.) 32.5%; ChevronTexaco (U.S.) 20%; Lukoil (Russia) 15%. Estimated reserves: 2.3 billion recoverable barrels of oil & gas condensate reserves; 16 Tcf of recoverable natural gas reserves. Total cost of two phase development is expected to be \$4 billion.

²⁹⁶ Hilary McCutcheon & Richard Osbon, "Discoveries alter Caspian region energy potential" *Oil&Gas Journal* December 17, 2001

Figure 8.1.

CASPIAN REGION REMAINING LIQUIDS RESERVES*



Further appraisal work at Kashagan and the surrounding Agip KCO acreage will certainly lead to an upward revision of the reserves in the near future, strengthening Kazakhstan's position in the region still further.

Despite the addition of 750 million bbl of reserves from the Korchagin and Khvalynskoye oil fields in the Russian sector of the Caspian, Azerbaijan remains firmly in the second spot with 17% (6.6 billion bbl) of the Caspian total (Figure 8.1.). Exploration drilling in Azerbaijan during 2000 and 2001 has largely been disappointing, casting serious doubt over the ultimate potential of the southern Caspian. Turkmenistan's liquid reserves have more or less remained unchanged at 6% (2.2 billion bbl), while Iran has yet to contribute to the regional total, with exploration drilling unlikely to commence before 2004.

With estimated associated gas reserves of about 25 tcf, the Kashagan oil discovery has enhanced Kazakhstan's position as a regional gas player, bringing it in line with the vast

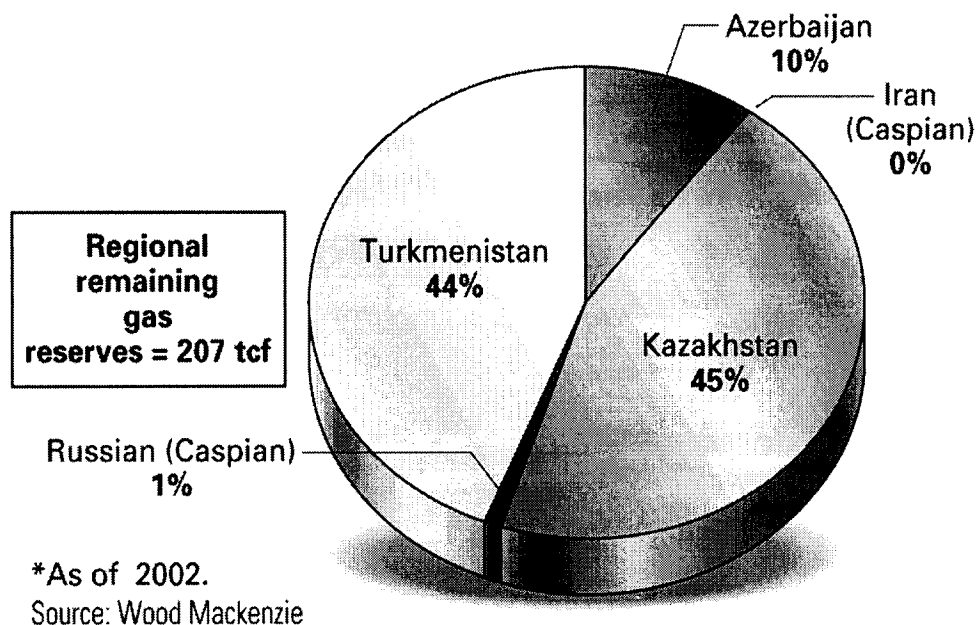
remaining gas reserves held by Turkmenistan. Kazakhstan and Turkmenistan contribute 45% and 44%, respectively, of the Caspian's 207 tcf total remaining gas reserves (Figure 8.2.).²⁹⁷

Although oil currently remains more important to Azerbaijan, it contributes about 10% of the region's remaining gas reserves, primarily due to the giant Shah Daniz gas field. Despite its smaller gas volumes, Azerbaijan has a geographical advantage that has enabled it to secure a significant gas sales contract with Turkey at an international market price. Unlike some of the other Caspian states, Azerbaijan remains relatively well positioned to gain additional gas market share and capitalize on its gas assets in the longer term.

Iran, which has yet to commence exploration in its sector of the Caspian, is not expected to contribute to the region's liquids production before 2010.

Figure 8.2.

CASPIAN REGION REMAINING GAS RESERVES*



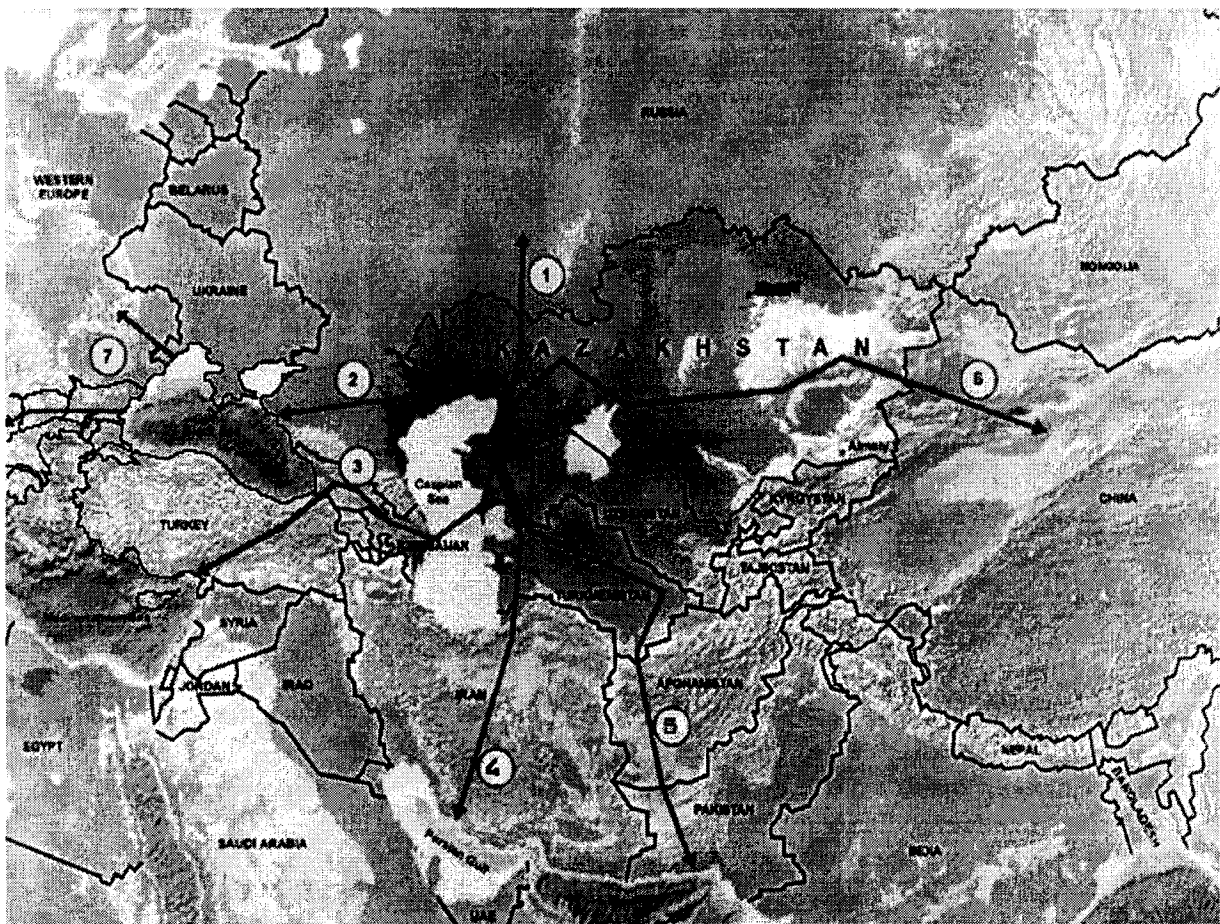
²⁹⁷ Ibid.

Possible Routes to transport Kashagan Oil and Gas

Successful exploitation of the Kashagan will depend on the construction of new transport pipelines, capable of handling large volumes of oil produced in a landlocked sea. The direction of such a pipeline remains in question, and thus holds the potential for fierce competition among regional and global powers.²⁹⁸

Alternative routes that are being considered (Figure 8.3.) and some concerns associated with each project are as follows:

Figure 8.3. Map of the alternative routes for Kashagan (and Kazakh) hydrocarbon resources²⁹⁹



²⁹⁸ Maureen Lorenzetti Watching Government: Caspian finish line, OGI Aug 19 2002

²⁹⁹ Adopted and partially redrawn from a map shown at http://www.uskba.net/about_energy.htm

Atyrau-Saransk-Samara: (Route 1 on the map) This 691 km route is part of the interconnected Kazakh-Russian pipeline system. Expansion work that started in 1999 is now under way at a cost of \$37.5 million, and once completed will enable Kazakhstan to increase oil exports via the Russian route to 310,000 b/d, from a present capacity of 210,000 b/d.

Caspian Pipeline Consortium (CPC) (Route 2 on map) The CPC was formed to build a pipeline system to transport oil from Tengiz, western Kazakhstan, to the Black Sea at Novorossiysk, Russia, and began to bring oil to world markets in the fall of 2001. The CPC Project upgraded the existing line from Tengiz via Atyrau and runs along the Caspian coast to join in the north with the Russian end of the line. The system also consists of port facilities and a newly built line from the northwest Caspian coast in Russia to Novorossiysk. The total cost of the project is estimated at \$2.4 billion. The completion of both the CPC pipeline and ongoing Tengiz operations should add more than \$150 billion in combined GDP to the Russian and Kazakh economies. The CPC pipeline will also be used for transporting natural gas liquids from a production plant to be constructed at Karachaganak by the KIO consortium.

The above-mentioned two projects represent the Russian route for Kazakhstan. Russia controls nearly all of Kazakhstan's current export routes. Recently, the industry newsletter "Petroleum Argus" reported friction with Russian energy officials over Kazakhstan's demands that it should be able to control the volume and destination of its oil shipments through the Russian pipeline system. In other words, the country's influence has grown to the point where it wants to play the oil market, as Russia does. A Russian official reportedly responded, "If they want equal treatment, they should start supplying oil to the

Russian domestic market as our producers do." (Russian companies must sell to the home market at a cheap subsidized price.)³⁰⁰

On the surface, relations with Russia have been free of such complaints. On December 7, 2002, Nazarbayev met in Astana with Aleksei Miller, chief executive of the Russian gas monopoly Gazprom, about boosting sales of Kazakh gas abroad. The two countries are also working on plans to raise Kazakh oil transit by 50 percent with a pipeline expansion project starting in late 2003.³⁰¹ However, problems beneath the surface seem to be driving Kazakhstan to look elsewhere for its future, including to projects like BTC.

Many experts suspect that modifications of existing routes, like the established Druzhba system, may satisfy investors and importers, not only in Russia, but also in Kazakhstan. The Russian pipeline monopoly, Transneft, has announced plans to begin merging the Druzhba system, which runs from Russia to Slovakia, with a pipeline called Adria that terminates in Croatia. Russian media quote Transneft as promising to begin this project in the near future. In the meantime, Kazakhstani oil may only access the Druzhba system to facilities on the Baltic Sea, if those terminals do not handle Siberian oil.³⁰²

Among potential north-south routes, it remains difficult to foresee where feasible routes might emerge. John Roberts, an editor with *Platt's Global Energy Information Services*, says that as long as the United States opposes France's TotalFinaElf North-South pipeline from Kazakhstan via Turkmenistan to Iran, Kazakhstani oil can flow either North, to

³⁰⁰ Ibid.

³⁰¹ Michael Lelyveld "Kazakhstan: Astana Plans to Boost Energy Exports to West," *RFE/RL*, December 08, 2002

³⁰² Richard Allen Greene "Hopes and Risks in Caspian Project," *The New York Times*, September 23, 2002; Ariel Cohen, "New Great Games in the Caspian will Involve Complex Stakes" A *EurasiaNet* commentary October 11, 2002; Maureen Lorenzetti, *ibid*.

Russia, or West, to the Black Sea and the Mediterranean. Washington is not averse to pipelines via Russia. In the past, the United States strongly supported a Tengiz-Novorossiysk major pipeline, and a smaller Baku-Novorossiysk one (about 100,000 b/d or less). Yet, although the Russian state-owned pipeline operator Transneft has invested in capacity upgrades, unrest in Chechnya and elsewhere in the Northern Caucasus is detrimental to the viability of this option.

The supergiant offshore oilfield Kashagan, where prospecting is now being completed, may offer a last chance to reduce Kazakhstan's dependence on Russian transit, and the first chance to bring major volumes of Kazakhstan's oil to the western Caspian shore and from there directly to international markets. Kashagan will be a make-or-break test of Russia's policy to monopolize the transit of oil from Kazakhstan. And that monopoly means controlling the lion's share of Caspian oil flows.³⁰³

Aktau-Baku-Tbilisi-Ceyhan: (Route 3 on the map) The recent discovery at Kashagan prompted plans to connect the proposed Baku-Tbilisi-Ceyhan (BTC) pipeline with a route from the port of Aktau on the Kazakh coast of the Caspian Sea. The entire route would have a total length of about 2,300 kilometers, although the proposed pipeline route would only run from Baku to Ceyhan. Kazakhstan "politically supports" the BTC route, and proponents of the BTC pipeline believe that the likely absence of routes through both Iran and China will probably make this the most commercially and politically viable route for vast reserves of Kashagan oil.

³⁰³ Vladimir Socor, *Russia and Eurasia Review* Volume 1, Issue 3, July 2, 2002

At a September 2002 conference off the coast of Greece sponsored by the Hellenic Foundation for European and Foreign Policy (ELIAMEP), the consensus among participants was that the Caspian Basin could probably support only one more main export pipeline beyond the existing CPC pipeline, and that a second pipeline could complement a major natural gas pipeline to create a stable transport system for the region's fossil fuels. That description fits quite well with the BTC and parallel Baku-Tbilisi-Erzurum natural gas pipeline project.³⁰⁴

Most crude shipped through the BTC pipeline is expected to come from Azeri fields for about 10 years. Then around 2015, officials expect crude from Kazakhstan's offshore Kashagan field to dominate shipments.³⁰⁵

Kazakhstan-Turkmenistan-Iran: (Route 4 on the map) A proposed pipeline from Kazakhstan to Iran via Turkmenistan has been discussed. The pipeline would have a crude capacity of 1 million b/d, have a length of 1,600 kilometers, and require \$1.2 billion in investments. Although this route is one of the shortest and cheapest, U.S. opposition and sanctions against Iran are likely to keep this project shelved for some time. The destination of exported oil and gas is also another determining factor, depending on whether it is targeted towards Asia or Europe.

Kazakhstan-Turkmenistan-Afghanistan-Pakistan (and India): (Route 5 on the map) Eastern and southern routes for both oil and gas, such as the oft-invoked route across Afghanistan, are being considered by parties involved in the Caspian hydrocarbon

³⁰⁴ Michael Lelyveld, *ibid.*

³⁰⁵ Maureen Lorenzetti, *ibid.*

development, but many experts doubt that Afghanistan or South Asia could offer investors assurances of political stability.³⁰⁶

Kazakhstan-China: (Route 6 on the map) Since this project has been discussed extensively in the China section of Chapter V, here I would like to delve upon some summary arguments dealing with this route.

Many experts do not rule out the possibility of construction of a pipeline connecting the Caspian Basin with China's Pacific Coast. However, some of them like John Roberts, hold the view that a pipeline from Kazakhstan to China would be extremely costly and unfeasible, given the lack of enough volume commitments from the Kazakh Government. Such a pipeline, in order to reach China's Pacific Coast, would need to extend 5,500 kilometers and would cost upwards of \$8 billion. (The BTC route runs 1,760 kilometers.) According to Roberts, available oil in Kazakhstan could pump 400,000 barrels of oil a day through such a pipeline, but it would take a million barrels a day to make the project enticing for investors. He calculates that Russia would have to participate to deliver this volume, necessitating a three-way pact between Russia, Kazakhstan and China. Such multilateral projects, Roberts says, are difficult to negotiate and implement.³⁰⁷

By-pass Routes via Bulgaria and Ukraine (Route 7 on the map) In January 1997, Bulgaria, Greece, and Russia agreed on a plan to build an oil pipeline linking the Bulgarian Black Sea port of Burgas with Alexandropolis on the Mediterranean coast of Greece. The proposed 178-mile, underground pipeline would allow Russia to export oil through the Black

³⁰⁶ Ibid.

³⁰⁷ Ibid.

Sea while bypassing the Bosphorus. However, a wide range of technical and economic disputes has stalled the \$600 million project. Primarily, there are no discernible sources of financing for such a pipeline, and there is not enough oil commitment from the producing countries of the Caspian Basin to make the pipeline feasible.³⁰⁸

A second route to by-pass the Turkish Straits is the Albania-Macedonia-Bulgaria Oil pipeline, alternatively known as the AMBO pipeline. The AMBO project would take four years, linking the Bulgarian port of Burgas on the Black Sea to the Albanian port of Vlore on the Adriatic with an 890-kilometer (550 mile) pipeline worth 1.13 billion dollars. The pipeline capacity would be 750,000 bpd. Even though the plans for this project were designed in 1996, large U.S. petroleum companies, Exxon Mobil and Chevron Texaco, have dismissed AMBO claims that they have considered a role in the venture, saying that it was "far too early" for such a decision.³⁰⁹

A third by-pass option would be the Odessa-Brody pipeline. The chief components of Ukraine's strategy to bring oil bypassing the Bosphorus across its territory are the \$750 million Pivdenny oil terminal and the 500,000-bbl/d Odesa-Brody pipeline. Ukraine already plays a major role as a transit country for Russian oil exports to Europe, and the country is hoping that the Odesa-Brody pipeline will help Ukraine reap tariffs for Caspian oil exports, as well.

With concern over the Turkish Straits ability to handle increased tanker traffic, Ukraine decided to build the Pivdenny terminal and Odesa-Brody pipeline to lure Caspian region oil exports to transit Ukrainian territory. The 400-mile pipeline, which Ukraine

³⁰⁸ <http://www.eia.doe.gov/emeu/cabs/caspblk.html>

³⁰⁹ www.ekonomist.co.yu

constructed with its own funds and completed in August 2001, has an initial capacity of 180,000 bbl/d, eventually rising to 500,000 bbl/d. The pipeline runs from the Black Sea Pivdenny terminal, which became operational in December 2001, to the northwestern Ukrainian city of Brody, where it can tie in with the southern Druzhba pipeline.

Application of the Bueno De Mesquita Predictive Model

As it was presented in the results chapter, there are ten actors in total: Russia, United States, Companies, European Union, Turkey, Iran, Azerbaijan, Kazakhstan, China and Turkmenistan. As it was explained by Bueno De Mesquita (BDM), before embarking upon prediction activity and likely scenarios, one has to determine where the median vote stands on the scale of actors. To do this, one has to first look at the official positions of the actors in terms of their preferred routes.

Table 8.1.

Actors	Actors' official route preferences- officially considered routes					
	Russia	Turkey	Iran	Pakistan-India	Bulgaria-Ukraine	China
Russia	X				X	
U.S.		X				
Companies	X	X	X	X		
E.U.	X	X				
Turkey		X				
Iran			X			
China						X
Azerbaijan		X				
Kazakhstan	X	X	X		X	X
Turkmenistan	X	X	X	X		

It is clear from the above table that the median vote is between Turkey (7) and Russia (5) and closer to Turkey. This is more about the general position held with regard to overall Caspian energy resource export routes. However, the model's predictive precision comes into play more with each individual vote calculation. According to the BDM Model, each actor has a vote to cast, and this vote is determined by saliency and the resource scores of each actor. An actor's individual vote is equal to saliency score multiplied by resource score.

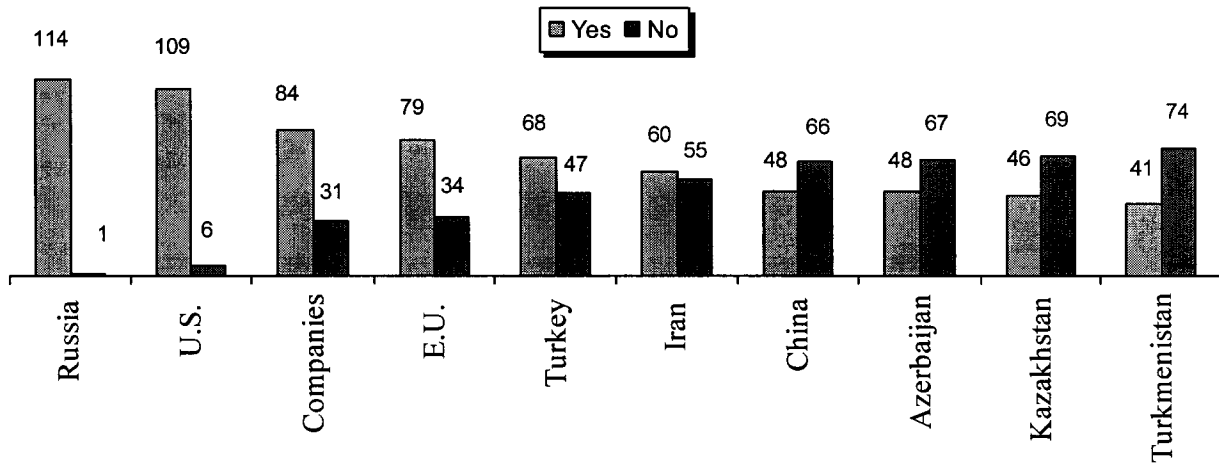
$$\text{Actor's vote} = \text{Saliency Score} \times \text{Resource Scores}$$

Based on results of the experts' judgmental scores attributed for each actor's saliency and resources, (Table 8.2.) a scale of actors from strongest to weakest is shown in Figure 8.4.

Table 8.2. Actor's votes

BASED ON WHOLE DATA SET ACCORDING TO MEAN VALUES			
	RESOURCES	SALIENCY	VOTES
RUSSIA	81,65	82,32	6721
TURKMENISTAN	27,47	79,76	2191
IRAN	41,16	77,26	3180
AZERBAIJAN	35,17	89,33	3142
TURKEY	45,16	74,18	3350
KAZAKHSTAN	37,27	88,65	3304
U.S.	87,98	65,27	5742
COMPANIES	62,38	68,75	4289
E.U.	47,86	56,86	2721
CHINA	26,54	58,18	1544
AVERAGE			3618

Figure 8.4. Who are the major actors ?



According to the votes calculated based on the BDM Model, the ranking of the major actors changes. Russia still maintains its first position, United States is again in second place, third is still companies, Turkey becomes fourth, fifth is Kazakhstan, sixth is Azerbaijan, seventh Iran, the European Union drops to eighth place, Turkmenistan is ninth and China comes in last.

Figure 8.5. Votes of the actors= ResourcesxSaliency based on Mean Values / Average Vote: 3618

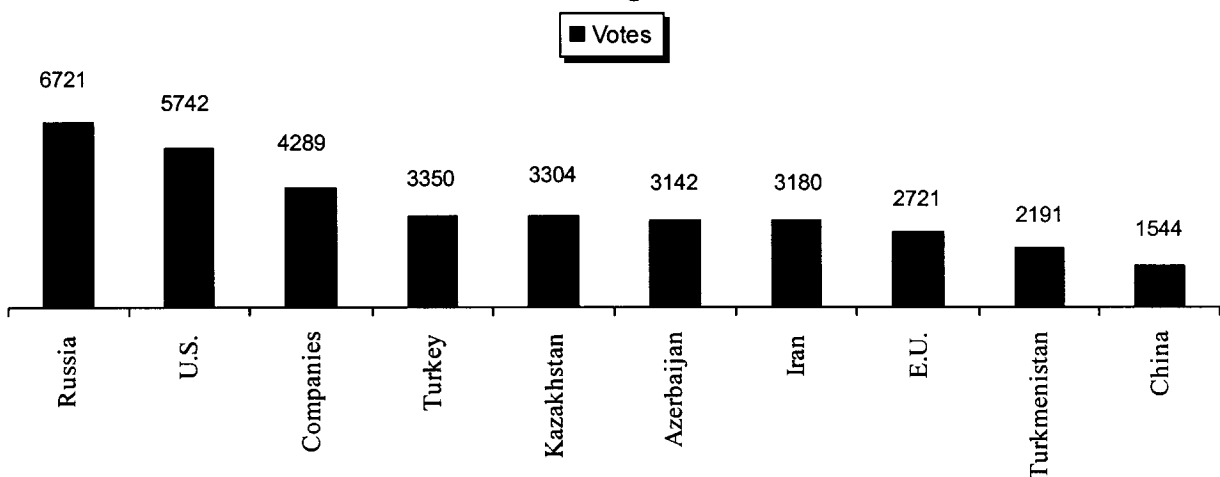


Table 8.3. Possible Coalitions among the actors

RU&KA	10025
RU&KA&TM	12216
TU&AZ	6492
RU&KA&TM&CO	16505
TU&US&AZ&EU&CO	19244
TU&US&AZ	12234
TU&US&AZ&EU	14955
TU&US&EU&AZ&KA	18259
TU&US&EU&AZ&KA&TM	20450
TU&US&EU&CO&AZ&KA	22548
TU&US&EU&CO&AZ&KA&TM	24739
TU&US&AZ&KA	15538
IR&KA&TM	8675
IR&TM	5371
CH&KA	4848

When we look at the de-facto coalitions that are already in place in terms of cooperation or declared priorities for the possible export routes (Table 17), it becomes obvious that with the combined votes of Turkey, Azerbaijan, United States and European Union (14955), the BTC route will be the winner among the Kashagan export routes, too. The rival coalition would include Russia, Kazakhstan and Turkmenistan (based on the countries' priority options and de-facto situation of dependency to the Russian route) and their votes would be 12216. However, companies will hold the key in the selection of the main export route for the Kashagan field. Holding 4289 votes in hand, companies may change the outcome of the export route selection process.

If Turkey and the United States secure solid commitment from the Kazakh government for the Aktau-BTC option (with 18259 total votes), then even the companies will not be able to change the outcome. Although not yet plainly seen on the horizon, with the

increased likelihood after the Baku-Tbilisi-Erzurum natural gas pipeline's realization, Turkmen commitment would make this coalition even stronger (total votes of this coalition would be 20450).

Iran is the number one choice of companies, based on cost effectiveness, but is out of the picture for the foreseeable future. Most of the companies who maintain majority stakes in the Kashagan consortium of Agip KCO also hold majority share in BTC's parent operating consortium AIOC. Given these facts, the Turkish route seems the most likely route to be chosen in the future.

Some concerns about the likely scenario

In parallel with the prediction made above, most Turkish media and political establishment circles also expect that when the BTC starts pumping oil in 2005, Kazakh oil will begin flowing in the pipeline, as well; if not right away, soon afterwards. After all, the BTC's capacity of 1 million barrels/day (50 million tons/year) was designed largely on the premise that Kazakh oil would be part of the flow stream.

Despite all the hype about Kazakh oil, Kazakhstan's participation in the BTC remains uncertain. Earlier statements made by Kazakh officials notwithstanding, in 2002 and 2003 Kazakhstan was leaning more strongly towards other options such as the Russian and Iranian routes.

During a keynote address to a small group (including this author) at the James A. Baker III Institute for Public Policy at Rice University in Houston in late December 2001, the Kazakh president stated that the "efficiency of Baku-Ceyhan is not proven," and that the oil companies would make the decision on export routes for Kashagan oil. The statement was

rather revealing. Also revealing was Nazarbayev's downplaying of the importance of the Iran route. The President refrained from calling this route the preferred option for Kazakhstan, noting that it was merely an option. This was in stark contrast to the position he had held earlier in December 2001 at a joint press conference with U.S. Secretary of State Colin Powell in Astana. On that occasion, Nazarbayev, while saying that he backed BTC, called the Iran route "most beneficial" for Kazakhstan. Nazarbayev, however, received no support from Powell on the Iran option, and the two agreed to disagree.³¹⁰

Viewing these developments in context, several conclusions become evident. One, in questioning the "efficiency" of the BTC, Nazarbayev was reflecting the opinion of Agip KCO (the assessment related to Kazakh oil only). The consortium must have concluded, at least on a preliminary basis, that the Iran route was the most cost-effective for Kashagan oil.

A second conclusion is that senior Kazakh officials, including Nazarbayev himself, while personally inclined to favor BTC, have decided to leave the choice of export routes to the oil companies. It is essentially a hands-off attitude, and it makes Kazakh officials' support of the BTC appear halfhearted.

A third obvious conclusion is that Nazarbayev now finds himself in a predicament. The Iran route, that he said is most suitable for Kashagan oil, is strongly opposed by the United States. Nazarbayev cannot afford to ignore the strong U.S. position on the issue. That explains why the President, at his Houston talk, downplayed the importance of the Iran route. With the memory of his public standoff with Powell fresh in his mind, and with former U.S.

³¹⁰ Ferruh Demirmen, "Analysis of Caspian Oil Scene," *Turkish Daily News*, 26 Feb., 2002, Houston Chronicle, 18 December 2001

Secretary of State Jim Baker in the audience, Nazarbayev was careful not to step on sensitive political toes by emphasizing the Iran route; it was a matter of diplomatic finesse.³¹¹

While the contribution of Kazakh oil would be advantageous for BTC, its absence would not adversely affect the commerciality of the project. As stated earlier, this was made amply clear by Lord (John) Browne, CEO of BP, at the conference in Istanbul in June 2001. Lord Browne declared that BTC is commercially viable even without Kazakh oil.³¹²

Kashagan production ("early oil") is scheduled to start between 2005-2007, and the consortium must soon decide on a suitable export route for this oil. A temporary solution for early oil is needed, leaving the decision for a more permanent solution, involving pipeline(s), for a later date. One way and apparently the best way to transport early oil is to use tankers and barges from Aktau to Baku. To facilitate this alternative, the United States has already financed studies aimed at upgrading port facilities at Aktau and Dubendi, the latter a tiny port on the Apsheron peninsula in Azerbaijan.

The Aktau-Baku surface transport solution for early oil, however, faces competition from the CPC, which Kazakhstan is also considering. The CPC's capacity is at present 600,000 b/d, and will eventually be expanded to 1.34 million b/d by 2015. Although Kazakhstan currently faces the under-utilization of its pipeline network to the tune of 280,000 b/d, as production from Karachaganak's gas-condensate field increases and other Kazakh fields go on-stream, the excess capacity may disappear by 2005. If this materializes, the CPC's capacity expansion could be expedited by 2005 to accommodate early oil

³¹¹ Interview with Ferruh Demirmen - Dr. of geology of Stanford University, an international oil consultant, International Center for Caspian Studies, Brussels <http://www.caspiancenter.org/> October 27, 2001

³¹² From his keynote address at the Fourth Annual "A Tale of Three Seas" Conference held in Istanbul, Turkey on June 19-21, 2001.

(probably as much as 200,000 b/d) from Kashagan. If excess capacity continues, the CPC could readily receive early oil from Kashagan. In either case, the CPC would pose serious competition to the Aktau-Baku surface transport alternative. If the CPC alternative were implemented ("Russian solution"), Turkey would be the obvious loser, both strategically and economically. To a lesser extent, Azerbaijan and Georgia would be on the losing side, as well.

A compromise solution, splitting Kashagan's early oil between BTC and the CPC, is not out of the question. That could mean that BTC would receive some 100,000 b/d peak contributions from Kazakh sources.

Beyond early oil, the transport of Kashagan crude, depending on (recoverable) reserves possibly as high as 10-12 billion barrels of oil, will require construction of one or more pipelines. A trans-Caspian sub-sea pipeline connecting Kashagan to BTC, while favored by the United States, currently stands little chance, because the oil companies oppose it. Russia, too, is against such a pipeline; purportedly on ecological grounds. Not surprisingly, Iran is opposed, as well.

Regardless of which pipeline route(s) is (are) selected, huge financial stakes, colored by geopolitical considerations, will be involved in the export of Kashagan oil. The financial stakes will be further magnified by virtue of the fact that Kashagan also holds significant gas reserves linked to oil production. The export game will be interesting to watch -- certainly no less interesting than the one witnessed with Azeri oil and BTC.

Some other problems that can hinder development efforts

The most important problems that may hinder oil development in Kazakhstan are linked to corruption and the government's eagerness to re-negotiate the existing production sharing agreements (PSAs) in order to secure more concessions from the companies.

The corruption issue in Kazakhstan -- which in most part applies to the investment and development of the giant Tengiz oil field -- could delay the development of the even bigger Kashagan field, which is expected to drive exports over the next 10 years. It is not certain yet, to what extent the corruption scandal -- involving alleged kickbacks of approximately \$1.5 billion to Kazakh President Nursultan Nazarbayev and his family and cronies -- will or won't hamper future foreign investment.³¹³

Another huge problem with foreign direct investment in Kazakhstan is the government's attempts to change the already-agreed PSAs. Huge problems arose with foreign investors in the nation's oldest oil venture at the Tengiz field and posed a threat to put Kashagan on hold. In November 2002, the U.S.-led TengizChevrOil consortium shelved a \$3 billion expansion project after arguments with KazMunaiGaz about funding and tax revenues from the deal.

The dispute deepened on 4 December as a Kazakh court upheld a fine of 11 billion tenge (\$71 million) against TengizChevrOil for open storage of hydrogen sulfur extracted from its export oil. Company officials have argued that the government knew from the start about the sulfur and storage plans.

³¹³ Nikola Krastev, "Multinationals Pushing Oil Projects Despite Instability, Corruption," *EurasiaNet* [RFE/RL](#), March 31, 2002.

Foreign companies see the fine as having less to do with pollution than with the business environment, which has suffered from Kazakhstan's efforts to pressure them into renegotiating terms of their contracts. In November 2002, Kashagan investors also suggested that they would postpone their project unless the government dropped plans for a new law that would limit their rights to appeal disputes.³¹⁴

Kazakhstan, in early January 2003 mended its rift with the investors and reached an agreement without changing the original contract. However, this incident was a sort of a wake-up call for the companies. This was not considered as the settlement of one issue; instead, it was regarded as the start of a period in which they will face similar accusations and demands. The evolving government attitude towards foreign energy-sector investment, coupled with the corruption issue, means investors may have to worry more in the future about how the government will treat their contracts. As Martha Brill Olcott, senior associate at the *Carnegie Endowment for International Peace* and author of "Kazakhstan: Unfulfilled Promise" (2002) asserts, "The question of the re-nationalization of oil and gas assets is now becoming a bigger issue. It is becoming apparent that the government will try to own a majority, rather than just a part, of future energy deals. The sanctity of contracts has been a problem, and this means it could get worse."³¹⁵ From the Kazakh side, it is not yet certain whether officials realize the fact that, without the two projects (Tengiz and Kashagan), the country's astonishing 22 percent growth in oil exports in 2001-2002 could soon come to a halt.

³¹⁴ Maureen Lorenzetti Watching Government: Caspian finish line, OGJ Aug 19 2002

³¹⁵ Mark Berniker "Despite Corruption Concerns Kazakhstan Continues To Lure Investors" 28 April 2003 www.eurasianet.org

Conclusion

Kazakhstan has very ambitious oil export plans. If they aren't backed by real export growth, they will be useless for the country. Kazakhstan cannot wait. It has the emerging developing energy industry³¹⁶ and needs to have ChevronTexaco and/or other investor companies in Kazakhstan. With the new discoveries of enormous oil and gas deposits in the Caspian basin, a renewed geopolitical offensive is on course to upset the delicate political landscape of the region. The size of the new discoveries accelerated the international haggling over the selection and construction of pipeline export routes. With huge estimated reserves, Kashagan returns the region to the top of the geopolitical agenda for the world's major powers.

³¹⁶ During the period covering 1989-2001, Kazakhstan attracted \$11.36 billion in foreign direct investment, according to statistics compiled by the European Bank for Reconstruction and Development (EBRD). Kazakhstan's total for this period was more than one-third of overall foreign direct investment in all FSU states, including Russia. Ibid.

CHAPTER NINE

This chapter reflects my final observations, which point to some overarching conclusions on the following areas:

- On the model and analysis used (the model I was trying to develop by studying the Baku-Tbilisi-Ceyhan and Kashagan cases to provide guidance as to how decision making might determine other pipeline choices in the region as well as in other parts of the world).
- Geopolitical implications of oil and gas development in the region.
- Importance of political factors in oil and gas development.
- The commercial energy dialogue between the United States and Russia and possible effects on the Caspian region.
- On some of the key actors such as Russia, Iran, Turkey, multinational companies, Kazakhstan, Azerbaijan and Turkmenistan.

By delving into these areas, I think I will be able to cover some issues that I was unable to underline with enough clarity in the results chapter (Chapter Seven), where I presented all the data that I was able to gather through the interviews but unable to reflect all the opinions that were expressed by the experts. My aim in this chapter, therefore, is to underline, as I did in the preface, the questions that I was interested in, their broader implications and connections to issues like interaction of politics and economics, the dominance of political factors in energy development projects, and subjects like transition to pluralism and the significance of transportation bottlenecks for the Caspian Basin.

CONCLUSIONS

I. ON THE MODEL AND ANALYSIS USED

As mentioned in Chapter Three, this research is in part modeled on the approach introduced by Bruce Bueno De Mesquita (BDM) to provide practical guidance on how to explain and predict the evolving policy choices and events related to energy development in the Caspian region. Although Mesquita's interpretation of *expected utility model* and elements incorporated from the *game theory analysis* make some sacrifices on theoretical grounds, they achieve more analytic purity and give more empirical leverage. Chapter Eight showed that BDM model is also applicable in the context of energy development, which is different from the original and traditional fields of application for this model. The model actually better fits situations and regions like the Caspian basin, because the political factors and geopolitical conditions are very particular to that region. The model, therefore, is the best in terms of remaining faithful to the strategic perspective, which suggests that actors do what they believe is in their best interest, and their individual or combined strategically motivated behavior can affect the outcome, which is determined equally by the context and structure of relations in that specific region. I conclude that we can develop a model based on certain factors to predict which export route will be chosen for the energy resources of the Caspian Basin.

The model proposed by Mesquita, therefore, is sufficiently general to forecast the results of almost any policy question at any level of politics. To increase the accuracy of the model and better understand or predict the policy choices affecting energy export routes or any other energy related issue in the Caspian Basin, further detailed research towards identifying more actors (such as the existing and future transit countries like Georgia,

Armenia, Ukraine or additional hydrocarbon producers in Central Asia such as Uzbekistan) and looking into positions of individual Companies would give more insight.

To further strengthen the accuracy of the insights, it would be helpful to increase the number of area and energy experts as the basic source of data. Although I think I presented enough evidence to show that excluding Turks from the data base did not change any conclusions previously made based on the whole data set, it would be more balanced if I could involve more area experts, for example from Iran and Russia. It is reasonable to assume, however, that the type of regime in Iran and the reluctance of officials to express their true views limit the quality of information that could be drawn from official sources in that country. I hope that this research encourages other area scholars to look into matters related to the Caspian in a broader but well focused perspective.

II. ON THE ISSUES

A. Geopolitical implications of the oil and gas development in the region

As this study has shown, the rivalry between Turkey, Russia and Iran over the Caspian Sea mineral resources and the oil and gas export pipelines is a complex one. It involves not only the three rivals' efforts to outflank the others, but also the Turkic Caspian littoral states' calculations of how to reap the economic benefits of their mineral resources without antagonizing either Russia, Iran or Turkey, and without becoming dependent on any one of them. Reliance on only one country could make Azerbaijan, Kazakhstan or Turkmenistan hostage to the goodwill of the former. Furthermore, it could provoke hostile reactions on the part of the two outmaneuvered countries, which, in order to recoup lost ground, could pursue policies detrimental to the viability of the Caspian states. In particular,

Moscow's and Tehran's actions in recent years show how irritated they can become when they perceive that oil and gas contracts with Western consortia could leave them out.

It was in Central Asia where Russia and the British Empire pursued the so-called "Great Game" in the 19th century. Now, the new kind of Great Game is being played by multiple major powers for new geopolitical stakes (that is, hydrocarbon resources and transportation routes). The author does not think the new game will simply revisit the old pattern. First, there are a dozen more powers joining the game. Among them are Russia, the U.S.A., the E.U., China, India, Iran and Turkey. No single power has a capability that comes close to hegemony on the region (Starr, 1998). Although there is some evidence that Russia has a preference to re-establish its economic, political and military dominance over the region (Nuriyev, 1998), this country has, at the same time, realized that its dominance, both economically and politically, seems to be no longer possible in the present day.

The Caspian Basin and Central Asia are the only non-OPEC areas, together with Russian oil production, where the United States and Western powers can use low oil price threats against OPEC by increasing production levels. Russia, as of 2002, roughly produces 8 million barrels of crude oil per day. Kazakhstan and Azerbaijan are not as of 2003 among the top 10 oil producers, but they, along with Russia, are expected to see considerable growth over the next decade. International Energy Agency (IEA) estimates that by the end of this decade, Russian production will grow by over 2 million barrels a day. In Kazakhstan, oil production is projected to grow by about 1.5-2 million barrels, and in Azerbaijan by 1 to 1.5 million barrels.³¹⁷

³¹⁷ www.iea.doe.gov

Due to their growing needs, the United States, the E.U. and other western countries are currently importing more than half of their oil, and will grow more import dependent. Oil and gas imports will pass 60 percent in the years to come. Meanwhile, Western countries have also demonstrated their strong need for multiple oil and gas resources from the Gulf, Siberia and the Caspian Sea, in order to diversify their import sources. So they are seeking low risk, low priced sources that they can have under their own terms, to secure the future energy demand of their industry and way of life. The Caspian basin gives them this opportunity.³¹⁸

B. Importance of political factors in oil and gas development

This research began with the fundamental assumption that the Caspian energy resource development is, in the final analysis, a political process, and that politics, more than economics, will play the fundamental part in deciding which pipeline is to be built and how to proceed with the resource development strategy. Despite what the rules of economics may dictate, it is politics that makes the difference and changes the energy policy choices in the region. I make this conclusion because almost every single area expert that I have interviewed identified political issues more than economic factors as the major and most important factors in determining resource development strategy in this region.

1. Energy projects are catalysts for regional cooperation and political stability

Multilateral trade relations between countries in and around the Caspian Basin can be initiated and expanded through economic cooperation, integration and improved relations in the region. Joint energy projects along this corridor would bring economic benefits to all the countries and would ultimately create favorable ground for win-win type outcomes in the

³¹⁸ Dow Jones News (1997), "Resourceful competitors", The Wall Street Journal, July 28, 1997.

region. Energy related projects of the region would also serve as a catalyst for political dialogue, regional peace and stability. Shared economic benefits are a powerful incentive for feuding countries to resolve issues (including historical acute ones) and to come to peaceful terms. Moreover, energy projects would undoubtedly trigger other trade relations among the countries, giving rise to a cascade effect in trade relations, further contributing to regional stability.

However, energy projects, just like any other commercial enterprise, do not materialize overnight. Before putting up capital for such projects, foreign investors would want to first assess the technical, economic and political risks associated with any proposed project. The primary obstacle for investors, however, is political uncertainty. Oil companies want to be able to get a return for their money. There was a rush between American and European companies to get there first, but they both soon realized that, until political risk is removed from the equation, they would have to move cautiously. No project could move forward unless these risks were reduced to acceptably low levels. It is a geopolitical fact of the Caspian region that political risk is currently the most serious risk, and in fact an obstacle, for joint energy projects involving countries like Azerbaijan, Armenia and Turkey or Azerbaijan, Iran and Turkmenistan or to a certain extent Turkey and Russia.

Thus I conclude that it is a self-evident truth that energy projects entailing all countries of the region can only materialize if a political climate conducive to political dialog is in place. What is needed is a political vision that transcends current disputes and squabbles and looks to the future with courage and boldness, a vision that avoids recriminations and accusations and sees the common good in improved relations, a vision

that views regional relations, not in terms of obstacles but in terms of opportunities, a vision that seeks consensus rather than dispute, and a vision that seeks dialogue and accommodation rather than strife or triumph.³¹⁹

It may seem ironic that joint economic activity would enhance political stability and integration, and that, on the other hand, political dialog is a prerequisite for economic cooperation. Which should come first: economic cooperation or political dialog? While there is much mutuality and voluntary or involuntary interdependency here, as has been described in previous chapters, I would argue that political dialogue is the more important ingredient, without which no economic cooperation can be realistically expected.³²⁰ The significance of energy projects in the context of political dialogue and economic cooperation is that benefits accruing to the parties involved from such projects would be huge.

2. Which one is more challenging, production or transportation of hydrocarbon resources of the Caspian Basin?

Exploration by its very nature is a risky business. Pessimism about the Caspian area hydrocarbon resources potential was expressed by some scholars (Myers 1998, 2000; Barnes & Soligo *OGJ* 1998) between 1998 and early 2000, only to have the pessimism turn to optimism in a year's time. What discourages some of the oil companies in the Caspian Basin, is not unfavorable geology, but the difficulty of securing viable transport routes to world markets. Therefore, the first lesson of the Caspian energy puzzle is the realization that the key to dominating the region rests with control over the pipelines crucial for the export of

³¹⁹ From the paper presented by Ferruh Demirmen, Dr. of geology of Stanford University, an international oil consultant, at the Turkish, Azerbaijani and Armenian journalists workshop in Urgup (Cappadocia), on March 9 and 10, 2002.

³²⁰ Ibid.

the energy reserves. The second lesson consists of the need to safeguard and secure the export routes. Without an adequate and reliable distribution network of pipelines and port facilities, the energy wealth of the region remains a mere potential and illusory prize.

The final selection of the Caspian crossing pipeline routes covering both offshore and onshore sections depends not only on technical parameters of production and resource assessment, but also on political decisions; mainly on issues of transportation. As discussed above, this aspect is the key in terms of influence over the choices of different routes for oil and gas exports from the Caspian Basin.

3. Security and stability in the region

The key to Caspian security is political. As argued above, a strong, vibrant regional economy will emerge as the result of political stability. Stable countries will seek peaceful solutions to common problems. Peace in the region, especially in Transcaucasia (Azerbaijan, Armenia, Georgia, Chechnya), must be achieved before economic takeoff can occur.

That said, the Caspian region is very unstable. Uncertainties about Russia's intentions aside, the Azeri-Armenian dispute over Nagorno-Karabakh is on hold but far from resolved. Chechnya's fragile situation could further deteriorate if its political demands from Russia go unheeded. Conflict amongst the dozens of disparate and desperate Caucasian ethnic groups could easily flare up. On the other side of the Caspian, the chaotic experience in Afghanistan, the near-chaos in Tajikistan and ethnic and religious tension in Uzbekistan and Kyrgyzstan as well as Uighur uprising in Xinjiang province of China are constant reminders of the region's vulnerability in terms of security. Domestic unrest in Iran, which is more observable following the United States and Britain's joint operation in Iraq, raises additional

security concerns about the region. Some sort of multilateral mechanisms to address these kinds of vulnerabilities in regional security are imperative now more than ever.

In the final analysis, however, these internal instabilities (even international ones, such as the dispute over the legal status of the Caspian Sea³²¹ and environmental concerns) will not stop the development of Caspian resources, but they could well slow it down. Oil and gas can enhance security in the Caspian only if its states can achieve multiple export routes that do not depend solely on transit through the territory of their competitors.

4. Regime change and succession issues

Throughout the Caspian Basin and Central Asia, communist institutions and ways are aging and declining along with leaders from the old Party apparatus and its distinctive ethos. Further change is coming, though it remains to be seen whether it will be sudden or gradual. Leadership successions, already beginning in Azerbaijan and Georgia, open up the easiest path to sudden change. Here democratic change is entirely possible. The decisive moment will be the holding of "free" elections without which no president can claim legitimacy. The elites that have ruled will attempt to manipulate these elections, and the question of how much fraud is too much will become decisive. Popular reaction and Western pressure may decide whether elections are in fact free and fair, and whether the winner is accepted. Democracy, pseudo-democracy, or the continuation of authoritarianism are all possible outcomes.

³²¹ Dispute over the legal status of the Caspian Sea have had little practical effect. They have not held up any exploration contracts, and the Azeris have started pumping oil from their fields. Indeed, Boris Nemtsov, Russia's deputy prime minister, attended the celebrations in Baku in November 1997 to mark the first flow of new Azeri oil. Individual demarcation disputes may slow the exploitation of one or two oil fields, but they will not hold up the region's overall development. Something else might, though: the unresolved issue of where the export pipelines should run.

5. Political Islam

The religious revival will go on throughout Central Asia and the Caspian Basin. But Islamic fundamentalism, as the Taliban once represented, is not found anywhere in the Caspian. The possibility of these countries adopting Islamic fundamentalist rule is unlikely, given their history and the role that Islam has played in it. The likely model for the Caspian states to follow in this issue would be the Turkish example of secularism.

C. United States-Russia Commercial energy dialogue and possible effects on the Caspian region

The basic motive behind the United States-Russia Commercial Energy Dialogue that took shape in late 2002 in the wake of events after September 11 is an obvious one; independence from the politically highly risky Middle East. But is this a realistic expectation? The short answer is no.

Historically, the amount of offset to Middle East oil that came from the Soviet/FSU countries came mainly from Russia. In 2002, Russia produced little over 7 million b/d oil, of which some 5 million b/d were exported, mainly to Europe. In contrast, in 2002, the Caspian region countries excluding Russia and Iran produced some 1.3 million b/d in total, of which 900,000 b/d were exported.³²² In time, however, oil production from the non-Russian Caspian countries will increase dramatically. In years 2010 and 2020, these countries could produce a total of 4-5 and 5-6 million b/d, respectively, mainly from the Azeri-Chiragli-Guneshli fields in Azerbaijan and the Tengiz and Kashagan fields in Kazakhstan. Most of this oil would be available for export. Therefore, in time, non-Russian Caspian oil will make up significantly increasing amounts of FSU oil as an offset to Middle East oil. In theory,

³²² BP World Energy Statistics 2002.

Russia, with an estimated 50 billion barrels of oil reserves, could also increase significantly its oil production and export volumes, but as discussed earlier, Russian oil sector suffers from remote geography, aging field equipment, poor infrastructure, high oil taxes, complicated legal framework, and low capital investment.³²³

It is also a bit far-fetched to compare Saudi Arabia and Russia in terms of oil production and export capacity. Saudi Arabia's oil industry does not suffer from the disadvantages of the Russian oil industry that have been noted above, and Saudi Arabia exports 85% of the oil that it produces (9.2 million b/d). Russia, in contrast, can currently export little more than half of what it produces. Furthermore, Saudi Arabia has a ready surplus production capacity to the tune of 2-2.5 million b/d. Reserves and unit production costs are also beyond comparison.³²⁴ For instance, Russia's chief Caspian negotiator, Deputy Foreign Minister and former energy minister, Viktor Kalyuzhnyi himself cited expert estimations that in 2005-2007, 70 % of Russian oil will be produced in hard-to-access areas and, therefore, the cost of the oil will reach 15 dollars per barrel.³²⁵ Whereas, in the Middle East, a field that costs \$10 per barrel to find and develop can be operated and depleted for only \$2 to \$5 a barrel once the original capital requirements for platforms and other infrastructure have been met.³²⁶

Incidentally, in terms of security of supply, the U.S. does not see Russian oil as an offset to OPEC or Middle East oil. An offset in a security sense is more seen as coming from

³²³ Interview with Ferruh Demirmen - Dr. of geology of Stanford University, an international oil consultant international center for Caspian studies, Brussels <http://www.caspiancenter.org/> October 27, 2001

³²⁴ Ibid.

³²⁵ *Interfax News Agency*, 26 March 2003.

³²⁶ Edward L. Morse, "A New Political Economy of Oil," *Journal of International Affairs*, Fall99, Vol. 53 Issue 1, p1, 29p.

Mexico, Canada, the North Sea, the newly independent states in the Caspian region (in the future), and deep offshore in the Gulf of Mexico, Brazil and West Africa.³²⁷

III. OBSERVATIONS and CONCLUSIONS ON SOME of the KEY ACTORS and SEVERAL CRITICAL ISSUES SURROUNDING THEM

1. Russia

Russia would like to play a more active part in the oil and gas development of the Caspian. In order to do that, however, it had better start being a more cooperative partner with something to offer the region. Its contribution must include reform in the Russian energy transport system by applying market economy rules fully and opening up their domestic market to competition.

Not only is the Commonwealth of Independent States (CIS) weakening as time passes, but Russia is under increasing pressure from players outside FSU who normally would have had a role in the Caspian 50 years ago, but were excluded because of the “Iron Curtain.” Now with the collapse of the Soviet Union, all sorts of Western countries, as well as other neighbors — Turkey, Iran, China, and E.U. are involved in the game. (Fuller 1994)

Although Russian presence and pressure has been, at times, perhaps the single greatest destabilizing factor throughout the Caspian and Central Asian regions, it is clear now that a further isolation of Russia from the region in parallel with the decline of its power could also have a negative impact by creating a power vacuum, which in turn could lead to chaos and instability. After all, it was in the void following the collapse of the USSR that numerous disturbances arose throughout the newly independent states. Judging from the positive examples of Georgia and Tajikistan, where Russia has managed to provide tentative

³²⁷ www.eia.doe.gov

and precarious security in the early 1990s through the armed forces it maintained in the region, it could be argued that a healthy amount of contact with Russia would help to solve the problems related to active ethnic conflicts. In the meantime, however, the Russian position against the influences of regional powers, nationalism and Western economic penetration is increasingly pronounced and sometimes gives the impression that it may over-react to the perceived threats to, or the loss of, its traditional sphere of influence, possibly even resorting to the use of armed force. The bottom line is that, as geography cannot be changed and Russia will, at any rate, attempt to maintain a strong presence in the region, the key to regional peace and stability is in Russian hands. The question is how they will direct their influence in the longer term.³²⁸

Russia will emerge politically stronger than it was in the 1990s, and its influence on the oil and gas export routes from the Caspian region is likely to increase in the decade ahead. But this influence will not mean a return to the Russian monopoly of earlier. Furthermore, it is clear that Russian influence will be moderated or offset by that of the United States and its allies in the region, namely Turkey, Azerbaijan and Georgia. Given political stability, further dilution of Russian influence can be expected in time from China, Iran, India and Pakistan, which can provide additional export routes for Caspian oil. In any case, the "winners" in the Caspian oil scene will not be just the Russian government and Russian companies, but also other countries owning the resources and the companies investing in resource development and transport.

³²⁸ News and Interviews, *International Center For Caspian Studies*, Brussels <http://www.caspiancenter.org/> October 27, 2001

2. Iran

Following George W. Bush's election as the President of the United States, many U.S. oil companies initially had high hopes for some sort of rapprochement between Iran & United States which might lead up to greater investment in Iran's energy resources. But Iran's inclusion in U.S. President George W. Bush's "axis of evil" has sidelined any such plans for the moment. Many of these companies, knowing that Iran is not really in the short-term plans, are increasingly looking at alternative places in the region where they can put some of their investment dollars; particularly at Kazakhstan, Azerbaijan and Russia.

Given the current geopolitical circumstances, Iran cannot win in this game politically or militarily. If it leans more heavily on Azerbaijan, it will lead Turkey's political and /or military assistance to Azerbaijan with American backing. Russia, while paying lip service to Iran's cause, will want to stay out of the conflict because doing otherwise would jeopardize its larger strategic interests vis-à-vis the United States and European Union. Russia's military involvement could even bring the United States and Russia face to face, which Russia would rather avoid.

Iran certainly sees Russia as a major player and competitor in the Caspian region. Whether it accepts Russian dominance in the long term is questionable. Iran's proven oil reserves are nearly twice those of Russia's and with the help of foreign investment, the country has ambitious plans to boost its current oil production to 5.5-6 million b/d by year 2010. The Iranian sector in the Caspian Sea is poorly explored, and the country's aging onshore fields will benefit from gas injection schemes currently underway. With high-quality, low-cost oil within easy reach to export markets, Iran, given foreign investment, is poised to play a major role in the Caspian region, not dominating Russia, but also not

subsidiary to it.³²⁹ However, as the senior U.S. adviser for the Caspian Basin energy diplomacy Stephen Mann once declared, “Iran could only be a player when it changes those elements of policy (financing terrorist organizations, nuclear program etc.) that are deeply troubling to the U.S.”³³⁰

3. Turkey and the future of BTC project

The east-west energy corridor, with its implications on energy security, among other issues, is a cornerstone of U.S. and Turkish foreign policies in Eurasia. New oil and gas lines to Europe will be necessary because existing old FSU systems are technically limited and unsuitable for accommodating additional export volumes. For geographical reasons, Turkey appears to be the logical market for Caspian gas. Demand is already high today and will grow further.

Key for the security and future of the BTC project are the relations between Russia and Georgia. Relations between Russia and Georgia have long been strained, and Russian President Vladimir Putin would not mind to see the Georgian President Eduard Shevardnadze toppled. Using the presence of the Chechen insurgents within Georgia's borders as a pretext, a politically emboldened Russia could destabilize Georgia by inciting the Abkhazian separatists and inflaming renewal of armed conflict in that country. A politically unstable Georgia, and even worse, a Georgia afflicted with civil war, would be a disincentive for the AIOC partners to continue with BTC. This would resuscitate the "northern route" (in this case an enlarged Baku-Novorossiysk pipeline) as an alternative to

³²⁹ Mediapress News Agency, Baku, 27 August 2001

³³⁰ “Mann: US Adviser Switches BTC focus to Kazakhstan,” *Nefte Compass Energy Intelligence Group*, 18 June 2003.

BTC. Such a scenario would suit Russia well, which has long opposed BTC and advocated the "northern route."

At first glance, the September 11 terrorist attacks and subsequent operations for regime change in Afghanistan and Iraq may be construed as having reduced the importance of the BTC project. One of the developments that could lead to that conclusion or impression is the lifting of U.S. sanctions against Iran and opening of the Iran route as an alternative to BTC following a similar regime change operation in Iran by the United States. Under this scenario, oil and gas companies operating in both Azerbaijan and Kazakhstan would then have the opportunity to route Azeri and Kazakh oil to the West through Iran rather than Turkey. However, I do not think this is a realistic scenario. Firstly, the sanctions imposed by the U.S. could be lifted if Iran cooperates with the U.S. in the fight against international terrorism and the issue of weapons of mass destruction. However, Iran made overt moves in sympathy with the remnants of the Taliban regime and the Al-Qaeda terrorists. To this date, Iran shows no intention of stopping its nuclear program either.

Secondly, even if (and that is a big if) the Iran option opens, it is not at all certain that it would provide a more secure and more economic alternative than the BTC if the marine component of oil transportation to the West were taken into account. In any case, given the geographic distance, transportation of Caspian oil and gas to Western markets through the Persian Gulf is likely to be costlier than the Mediterranean route.

Thirdly, the BTC is a project well in its tracks, and dropping the project now in favor of an alternative route, say the Iranian or Russian route, would be a major setback for Azerbaijan and the AIOC consortium of investors insofar as plans to export Azeri oil. BTC has reached its point of no return. Any change in the plans at this stage would mean re-

drawing of agreements and negotiations from scratch, with the result that full development of the Azeri offshore fields and the commensurate oil export volumes would be delayed for at least 2-3 years. Such a delay would adversely impact the profitability of oil development, a consequence that foreign investors and also Azerbaijan would be loath to see happen. In short, the BTC is too large a project and at too advanced a stage to be adversely affected by future events. Among all the oil and gas projects in Azeri waters, exploitation of the Azeri-Chirag-Gunashli fields and implementation of BTC hold a special place, and the stakes of the current participants (more than 2bn dollars investment so far, plus strategic interests) in these projects are too great to have the projects derailed by any dispute that may arise in the future.

All of the steps of the BTC Crude oil pipeline project will be useful in the search for a kind of blueprint for energy development of the region. Three countries, eight international companies and their governments are working together with close cooperation and synchronized efforts in an effective manner. I think that this project will constitute a very good example and will be a model for other pipeline projects in the region.

4. Multinational Companies

The development of prospective fields requires huge investments, and it is clear that countries in the region are not capable of raising the funds without foreign investment. U.S. Energy Department officials say Kazakhstan will require \$50 billion to \$70 billion in investment, while Azerbaijan will need around \$60 billion. Kazakhstan and Azerbaijan have production-sharing arrangements that are already in place and have been able to attract substantial amounts of investment to date. For instance, Kazakhstan already has brought in \$10 billion of investment. In Azerbaijan they brought \$3.5 billion. This can be contrasted

with Russia, which has not brought that level of Western investment into its oil and gas industry. The fundamental reason for this is that they do not have stable production-sharing agreements (PSAs) and tax regimes in place (Krastev 2002). Companies can facilitate the achievement of effective and beneficial PSAs for all parties involved. In addition, they can also contribute to set the fiscal terms, like tax regimes, consistent with each country's resource endowment (based on realistic numbers and not on inflated 'official' estimates). Cooperation among the countries and companies is essential. Ultimately, the countries have to create an attractive investment environment to attract foreign capital; they just don't have the resources for self-financing. So, rule of law can be better established with pressure from the companies. The fundamental principles of western oriented market economies and democracies - legitimacy, transparency and free enterprise - are not yet established. It will take time to break the monopolistic structure. Companies can certainly do a better job in convincing governments in the region to establish transparent regulatory regimes than major actors like the United States and E.U. or any other international organization.

Multinational corporations can also prove to be beneficial to the Caspian oil development landscape in a number of other ways. Such corporations provide capital, management and project-development expertise, technology, exposure to modern environmental protection methods, and social development.

5. Kazakhstan, Azerbaijan and Turkmenistan

Oil and Gas Development

Both Kazakhstan and Azerbaijan already have drawn significant foreign interest in their oil industries. They are firmly moving toward to become primary actors in this game.

Exploration of the Kashagan oil field in Kazakhstan was led to make Kazakhstan the biggest new energy source of the basin.

Despite its significant natural-gas reserves, Turkmenistan at present is considered of little interest to foreign energy firms because of political and logistical complications. Therefore, Turkmenistan is seen as the most problematic country in the Caspian oil and gas scene. For most of the Caspian area there's plenty of development; it's not a near-term issue. For Turkmenistan it's a problem, because as long as Turkmen officials maintain that fields that are under development by Azerbaijan belong to Turkmenistan, they're not going to get any pipeline going anywhere (see the section of Legal Status of the Caspian in Chapter Four). This was the major hurdle for the TCGP – the Trans-Caspian Gas Pipeline from Turkmenistan to Turkey. It wasn't clear where the Turkmen thought this thing was going to go, but it needed to go across Azerbaijan. As long as they leave this issue unresolved their gas is going to be trapped and only bound to Russia. And I think they are doomed to lose as long as they have that problem and as long as President Niyazov is in the office.

Transition to what?

Many pseudo-democratic and economic reform laws were passed during the last decade in the new independent states of the Caspian Basin, but the notion of legal accountability and transparency really did not exist. Legal accountability became an empty principle that the ruling elites could manipulate from the top down, as they found necessary. Satisfying the lust for welfare on the part of the governing elites (corruption), while satisfying popular needs, requires a very difficult and sometimes impossible balance. In the next decade it will become clearer where these societies will begin to gravitate: toward greater transparency or toward more corruption. In this respect, the leaders of these newly

independent countries are at a decisive time in their administrations; either they will move toward greater transparency and reform or further consolidate power in the hands of their family. It seems that they have chosen the latter.

There is clear and present danger that dramatic consolidation of political and economic power, in the hands of the top ruling elites in Kazakhstan, Azerbaijan and in Turkmenistan in the hands of the ruling family and their representatives and friends bring those countries to the level of state collapse that we have seen in Africa. Nigeria often comes to mind as a valid comparison. One of the area experts, Martha Brill Olcott, characterizes one of the likely scenarios for the future of the region as “Nigeria without ports,”³³¹ a likelihood that poses the worst possible outcome. Venezuela comes to mind as another unsuccessful model of a country with enormous oil and natural gas resources. In fact, except North Sea, there are no successful models that can be applicable to the Caspian Basin. There is no successful model outside of the European context that was roughly analogous to the Caspian region. As the area and energy experts suggested, I think it’s up to the countries of the Caspian Basin to make their own successful model. I don’t believe the examples of Indonesia or the Middle Eastern countries could be comparative to the region, simply because the comparison between these examples would not be possible at least in terms of population (the Caspian region is relatively under-populated), education levels or patterns of employment and industrialization. However, it seems that the Norwegian model for managing the oil in the North Sea would be the best model to follow in the Caspian Basin.

³³¹ Interview with Martha Brill Olcott “Washington Post Online”, April 18, 2002

In my opinion, the outcome of the future state and development model in the Caspian Basin will be decided basically by two factors: 1) The extent of Western influence, and 2) Leadership problems.

The extent of Western influence

This is a time when the U.S. and the Europeans have the maximum amount of leverage over the governments of the region. There is not adequate U.S. or any other western foreign assistance in the region to facilitate transition to pluralism. If we look at western assistance in these countries, compared to foreign direct investment, it's minimal. As Martha Brill Olcott argues, the United States and Europeans are willing to see societies of the region through the eyes of the governing elites. They accepted the presentations of the governing elite, who maintained the society was immature and could not take a large degree of empowerment. There was also this notion that "we shouldn't expect more or better from these post-Soviet Asian societies; that somehow, they weren't capable of providing more than their leaders said that they were able to provide."³³²

Leadership problems

The problem in Kazakhstan, Azerbaijan and Turkmenistan (Caspian Three or Trio) is the unwillingness or inability of their leaders to rise to the responsibility, and the challenge of personal example, which are the hallmarks of true leadership. The reason the region might very well become "Nigeria without ports," would be largely a failure of leadership. As with leaders of so many other resource-rich states, the demand for mineral reserves has placed

³³² International Eurasian Institute for Economic and Political Research,
http://iicas.org/english/enlibrary/libr_24_04_02_1kz.htm

extraordinary temptations before these countries' rulers, making Western arguments for good government that much harder to sell. (Olcott 2002:5)

Publicly, the leaders of the Caspian Trio explain that any shift in political emphasis is necessary for the countries to work out their national identity, and, until that takes place, the country cannot withstand a succession crisis. Few among the ruling elites in these countries truly believe that popular participation is necessary to legitimize the state. Most of them still believe as the old Soviets did, that popular will can be shaped through ideological indoctrination. They more likely understand an Asian approach to be one that legitimizes the policies of political crackdown when they serve the purpose of economic transformation. Once economic recovery is ensured, they promise that political democracy will be introduced. The evolution of South Korea, Taiwan, and Singapore is often cited as proof of the soundness of such a strategy. However, it is not clear whether the nations of the Caspian Basin have the will for self-discipline, so often demonstrated by that the "Asian tigers." Moreover, the leaders have yet to accept the contention that a civil society offers the legal infrastructure that is necessary for the protection of private property. (Olcott 2002: pp.21-22)

Since the early 1990s, fundamental changes in oil and gas development of the Caspian Basin have affected and will continue to affect the geopolitical atlas of world energy in a number of ways. This research was the product of a motive to explore and understand some of the effects. I hope that I have made some contribution to that end.

APPENDIX I

QUESTIONNAIRE

Hello, I'm Tuncay Babali with the Department of Political Science at the University of Houston. I am conducting PhD research regarding the Caspian energy resources, in general, and the development of those resources, in particular. If you have a few minutes, I'd appreciate it if you could complete the following questionnaire and return it back to **tbabali@yahoo.com** e-mail address OR fax it to 713 623 6639.

1. How much do you agree or disagree with each of the following statements?

Completely agree (1) /- generally agree (2) /- generally disagree (3)/ - completely disagree (4)

A. In today's volatile energy geopolitics, issues of transportation and delivery of the hydrocarbon resources to the markets are much more important for the development of these resources than the actual production problems and proven resource assessments.

B. The Caspian energy resource development will eventually create interdependence among major actors (great powers, countries and companies) in the region and will expedite westernization, democratization and secularization of the countries of the region.

C. Political Islam and terrorism are major threats to security of the countries of the region, as well as economic development in the Caspian area.

D. For the time being, the most suitable regime for the Caspian region is authoritarian rule.

E. In the long run, the best regime for the countries of the region is democracy.

F. Transition to democracy will require a period of 5 to 10 years with willing people and political leaders.

G. The average person in the region does not know much about democracy.

H. With regard to countries with regimes other than democracy, first priority should be to educate the people about democracy.

2. a) Are we witnessing a contemporary version of the old "Great Game" with new players and new rules in the Caspian basin?

b) Regardless of your answer to (2a), according to your opinion who are the major actors and what are the rules to be effective in the region? (Put a "+" beside each option you think relevant)

Major Actors:

- Russia
- U.S.A
- Iran
- Turkey
- The other countries of the region
(Kazakhstan, Azerbaijan and Turkmenistan)
- Companies
- Other(s): Please specify

Secondary Actors:

- E.U.
- China and Japan
- India and Pakistan
- Other(s): Please specify

Rules of the Game:

c) Please rank the rules of the "game" in terms of importance to you ("1" being the most important to "9" being the least important) and/or put a "+" beside each option you think relevant.

- Military power
- Economic power
- Political power
- Cultural influence
- Geo-strategic location
- Know how and technology
- Control of the export routes
- Ability to create spheres of influence and/ or launch coalitions and alliances around the shared goals and interests.
- Consideration for environmental issues
- Other(s):

d) With regard to the Caspian basin, if you had to assign a range of values for each of the below listed actors' commitment to pursuing an issue over all others OR the preparedness of each to focus on the issue when it comes up, even if it means putting aside some other issue (saliency), what would be your judgment? (The issue being overall Caspian energy development.) Please check appropriate boxes with an "X"

	90—100: This issue is of the utmost importance. An actor would drop whatever she is doing and turn immediately to this issue whenever asked.	70—89: This issue is very important to an actor. She would try very hard to reschedule to handle this issue when it arises.	50—69: This is one of several important issues. Others are more important. An actor would have to drop this if one of those more important issues arose.	30—49: This is an issue that an actor cares about but that is not very important to her. She has many more important issues to deal with and so generally would not drop what she is doing to deal with this one.	10—29: This is a minor issue. An actor rarely makes much effort to deal with it.	Less than 10: An actor really doesn't care about this issue.
RUSSIA						
U.S.A						
KAZAKHSTAN						
AZERBAIJAN						
TURKMENISTAN						
IRAN						
TURKEY						
OIL&GAS COMPANIES						
E.U.						
CHINA						

e) With regard to the Caspian basin, if you had to attribute a numerical value to an actor's potential influence or power, often referred to as "resources," (whatever you might think relevant) in terms of shaping energy resource development in the region, what would be your assessment for the following actors? (100 being the most powerful and 10 being the least.) Please check appropriate boxes with, an "X"

	100	90	80	70	60	50	40	30	20	10
RUSSIA										
U.S.A										
KAZAKHSTAN										
AZERBAIJAN										
TURKMENISTAN										
IRAN										
TURKEY										
OIL&GAS COMPANIES										
E.U.										
CHINA										

3. Do you think, in the long run, it will be conflict and/or cooperation prevailing in the region?
Why?

4. Which of the following, do you think, is more likely to characterize the near future of the region: "a zero-sum game" and/or "win-win solutions"? Why?

5. Is there a particular solution, blueprint (scheme) or proposition that is relevant to the development of the energy resources of the Caspian that you feel strongly about? If yes, what is it?

6. In talking about the history of the region, we often find that many nations in the region seem to be confronted with enmities inherited from the past. Which of the following statements best describes your attitude toward this issue?

- a) I do not think that history should matter in today's contemporary world.
- b) I think history dictates the extent of cooperation in the region.
- c) I think cooperation should be seen as a means to overcome prejudice stemming from history.
- d) I think history school books used in the countries of the region should be re-written in such a way that they should not rationalize and perpetuate historical enmities.

7 (8). Could you please rank the following problems of the region in terms of importance to you? ("1" being the most important to "6" being the least important)

- Ethnic problems
- Religious differences and the rise of political Islam
- Economic inequality and poverty
- Authoritarianism, cumbersome bureaucracy and corruption
- Legal status of the Caspian
- Environment and ecology

8 (11). In your opinion what might be the most preferable options to export energy resources of the Caspian basin? (Put a "+" beside each option you think relevant and/or rank them from "1" being the most relevant to "6" being the least preferable options)

- Through Russia
- Through Iran
- Through Turkey
- Through Pakistan and India
- Through Bulgaria and Ukraine
- Through China
- Other(s): Please indicate.

9 (12). Some people seem to follow what's going on in the Caspian. Others aren't that interested. Would you say you follow what's going on in the Caspian basin: most of the time, some of the time, only now and then, or hardly at all.

10 (13). In the past six months to one year:

- Have you attended any policy-planning meeting regarding the Caspian region? (Yes, No).
- Have you conducted any research or study regarding the region? (Yes, No).
- Did you discuss policies toward the Caspian energy resources with friends, professionals or bureaucrats? (Yes, No).

11. What is your job title?

12. What kind of work do you do?

13. Do you have any college / postgraduate degree(s) ? If yes, what degree(s)?

14. In addition to being an American, a Russian/Kazakh/Turkmen/Iranian/Azeri/Turk, what do you consider your sub or upper- identity (ethnic or national)?

OPTIONAL (Although not necessary, the following information would be quite helpful.)

15. What is your name?

16. What are your contact number(s), e-mail and address?

Thank you for your time.

APPENDIX 2:
RESULTS BASED ON WHOLE DATA SET & EXCLUDING TURKS

Figure 1: Comparison of the results for the “do you agree or disagree” section.
(1) Completely Agree, (2) Generally Agree, (3) Generally Disagree, (4) Completely Disagree

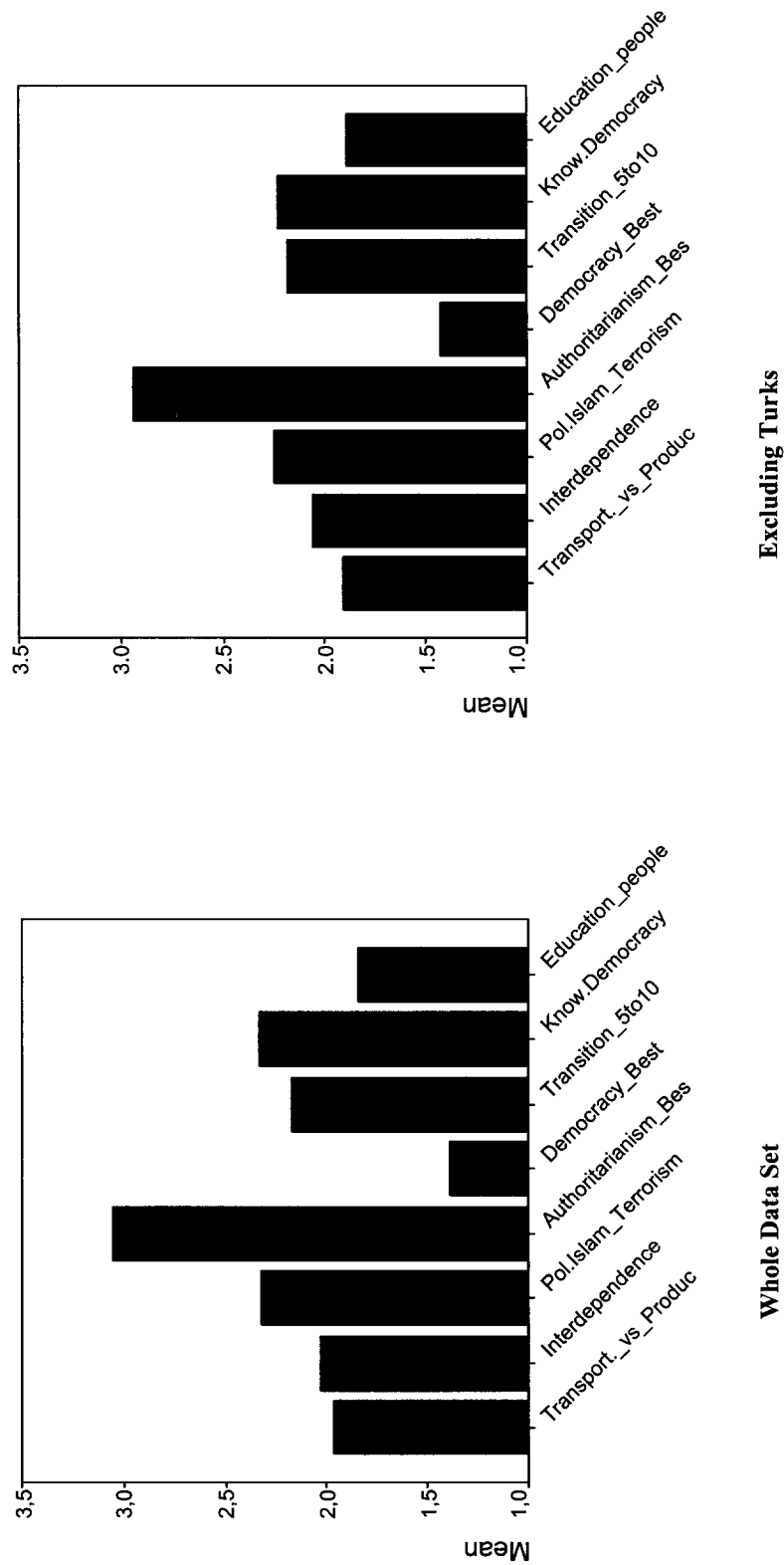


Figure 2: Are we witnessing a contemporary version of the 19th century Great Game in the Caspian?

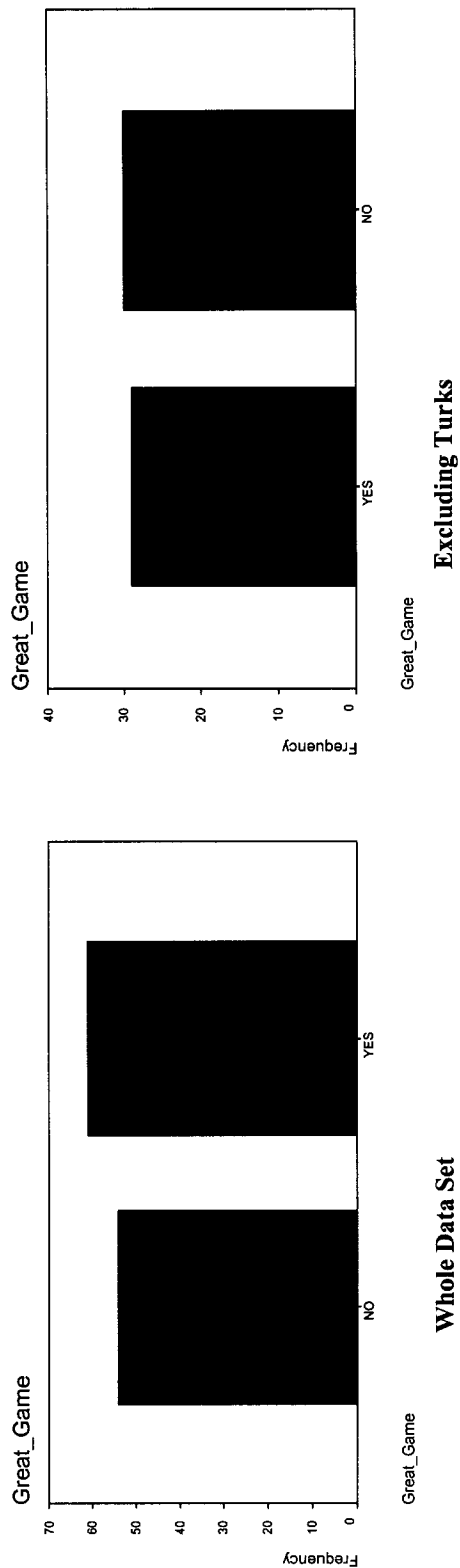


Figure 3: Rules of the Game

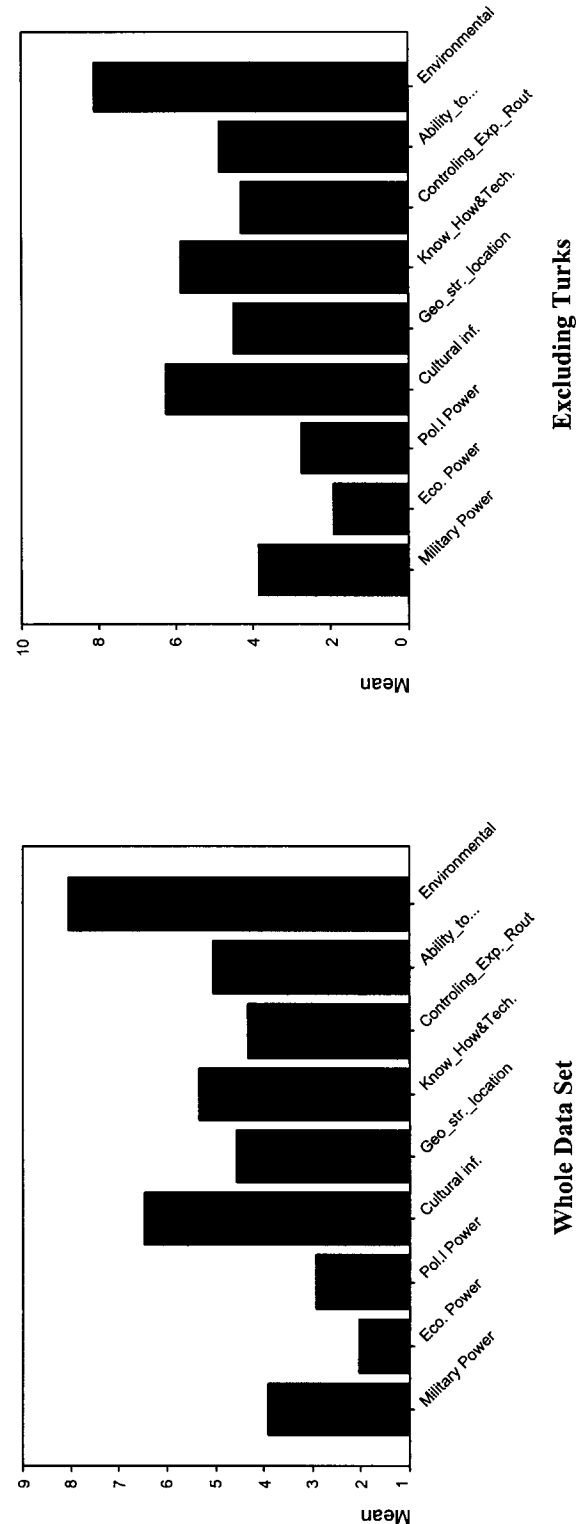


Figure 4: Rules of the Game - The Most Important Factors
Based on Whole Data Set

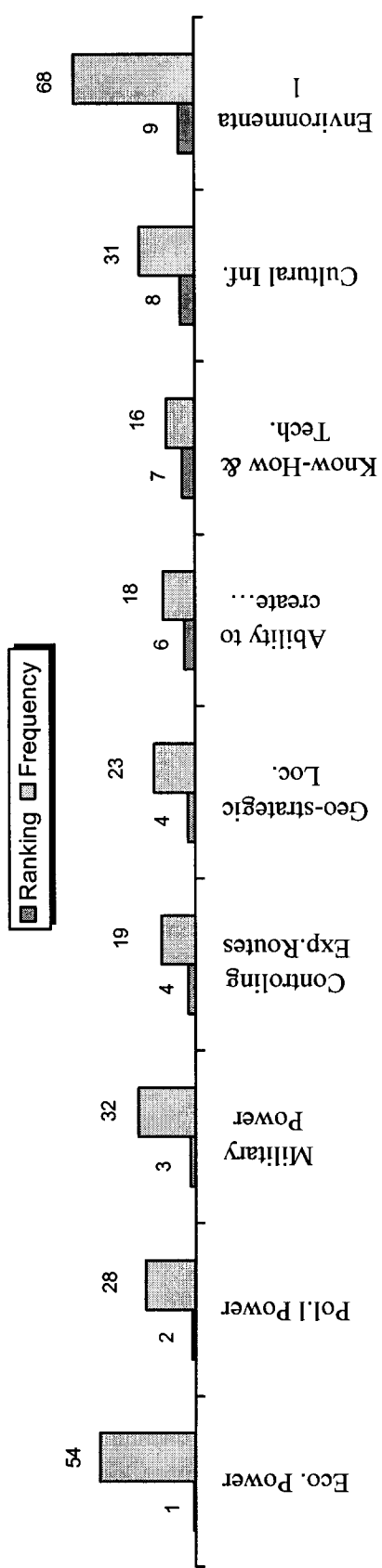


Figure 5: Rules of the Game - The Most Important Factors
Based on Data Set Excluding Turks

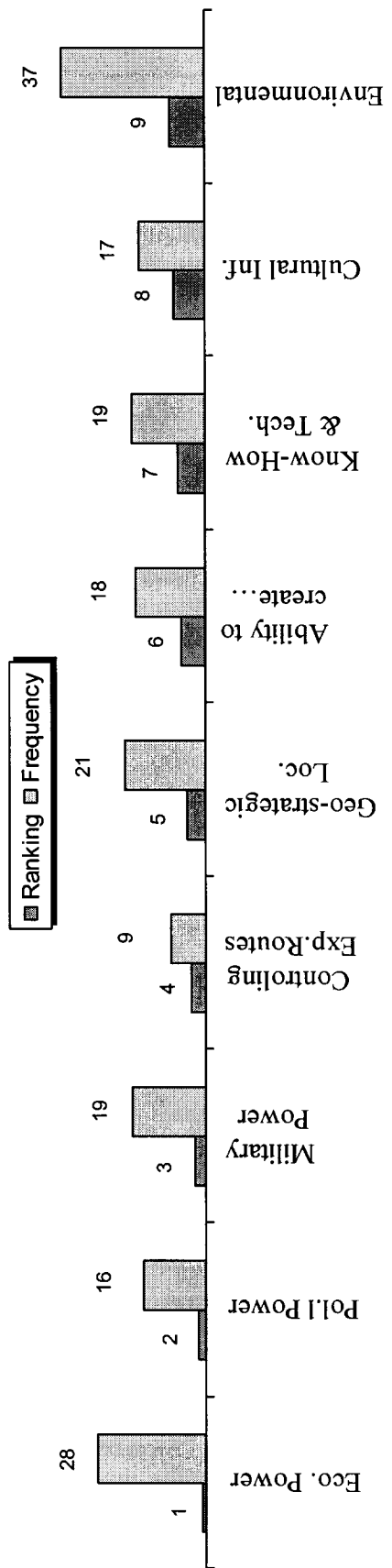


Table 1: Saliency Scores Based on Whole Data Set

Statistics										
	R-Saliency	TM-Saliency	I-Saliency	A-Saliency	T-Saliency	K-Saliency	US-Saliency	C-Saliency	EU-Saliency	China-Saliency
N	Valid Missing	114 2	104 12	104 12	104 12	104 12	113 3	104 12	102 14	88 28
Mean	82.32	79.76	77.26	89.33	74.18	88.65	65.27	68.75	56.86	56.18
Mode	80	80	80	95	80	95	60	60	60	60

Table 2: Saliency Scores Based on Data Base Excluding Turks

Statistics										
	R-Saliency	TM-Saliency	I-Saliency	A-Saliency	T-Saliency	K-Saliency	US-Saliency	C-Saliency	EU-Saliency	China-Saliency
N	Valid Missing	59 1	52 8	52 8	53 7	51 9	58 2	51 9	54 6	47 13
Mean	82.54	77.98	75.77	88.85	73.87	88.24	65.00	66.37	56.30	57.02
Mode	80	80	80	95	80	95	60	60	60	60

Figure 6: Saliency Scores Compared

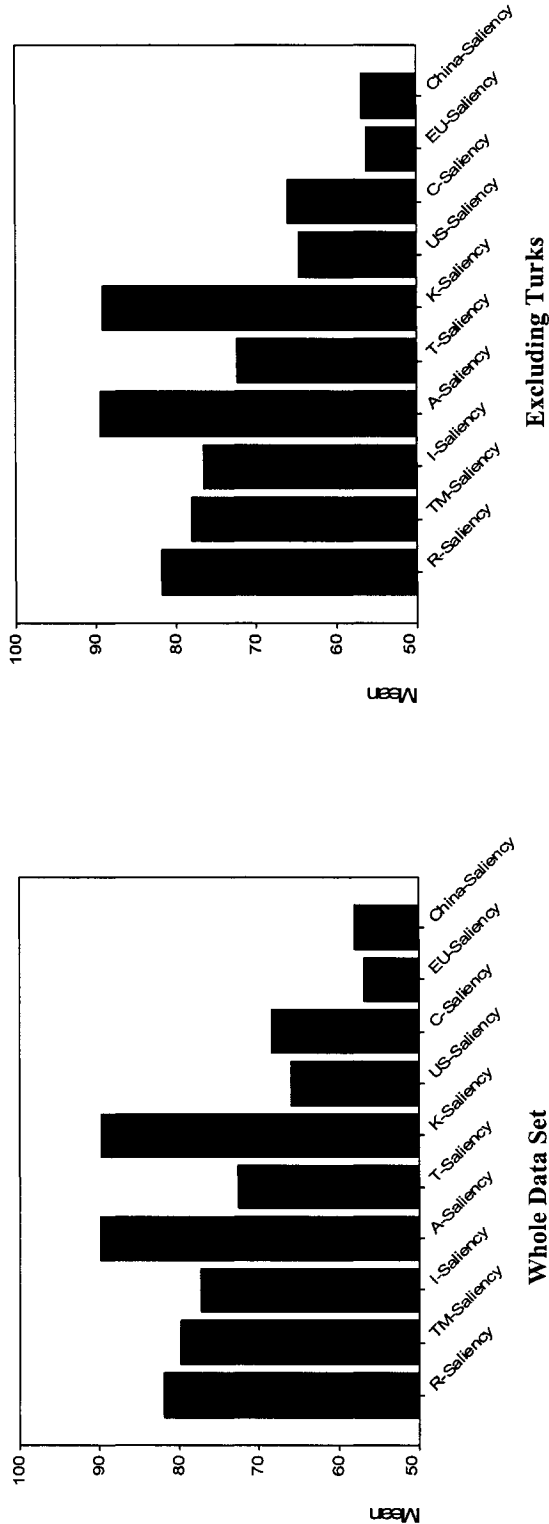


Table 3: Resource Scores Based on Whole Data Set

Statistics										
	R_res	TM_res	I_res	A_res	T_res	K_res	US_res	C_res	EU_res	China_res
N	Valid Missing	91 25	86 30	81 35	93 23	88 28	99 17	84 32	84 32	81 35
Mean	106 10	27.47	41.16	36.17	45.16	37.27	87.98	62.38	47.86	26.54
Mode	81.65 90	20	40	30	40	30	90	60	50	30

Table 4: Resource Scores Based on Data Base Excluding Turks

Statistics										
	R_res	TM_res	I_res	A_res	T_res	K_res	US_res	C_res	EU_res	China_res
N	Valid Missing	53 7	49 11	46 14	54 6	50 10	56 4	43 17	47 13	45 15
Mean	81.70 90	27.55	40.20	36.52	46.30	38.40	88.21	59.30	47.23	26.44
Mode	90	20	40	30	40	30	90	60	50	30

Figure 7: Resource Scores Compared

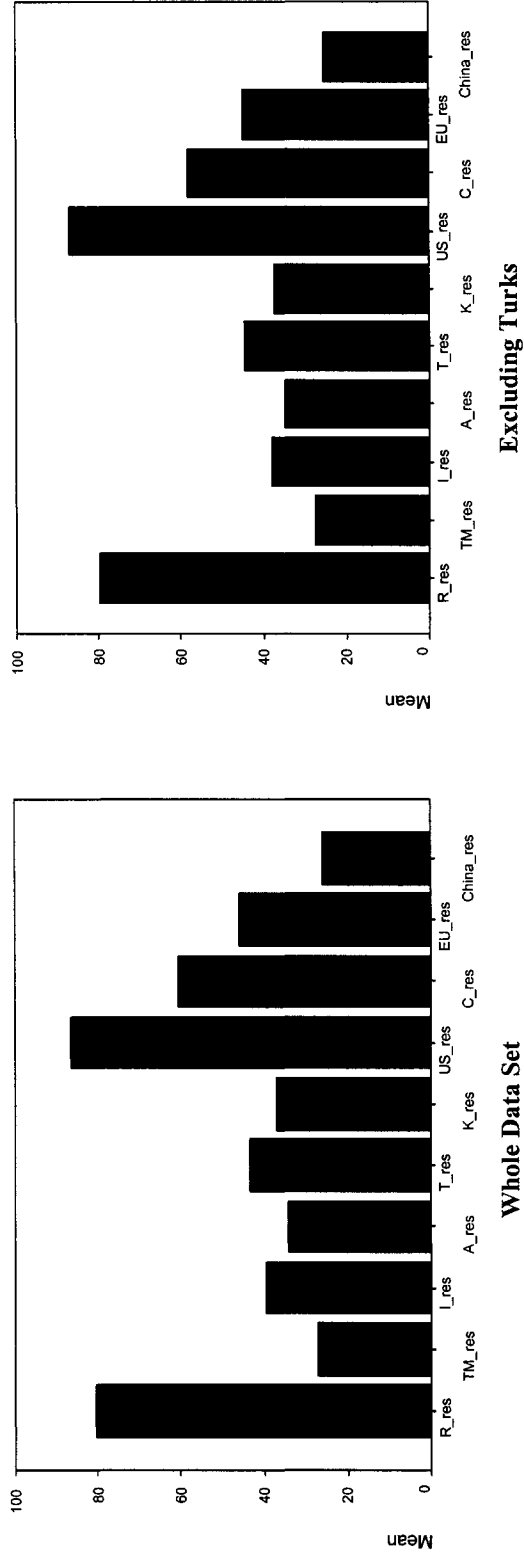


Figure 8: Who are the major actors? - Based on Whole Data Set

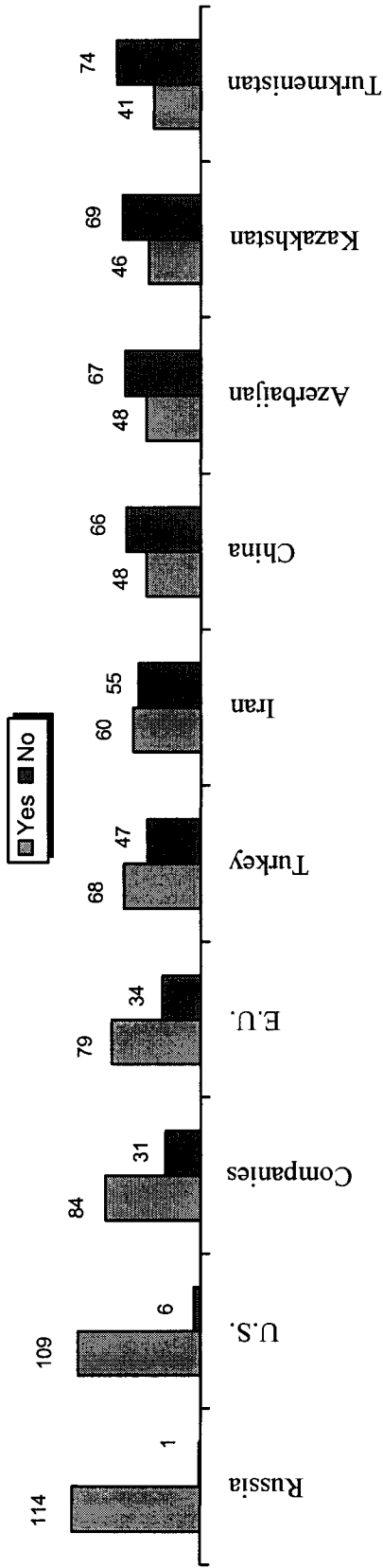


Figure 9: Who are the major actors? - Based on Data Set Excluding Turks

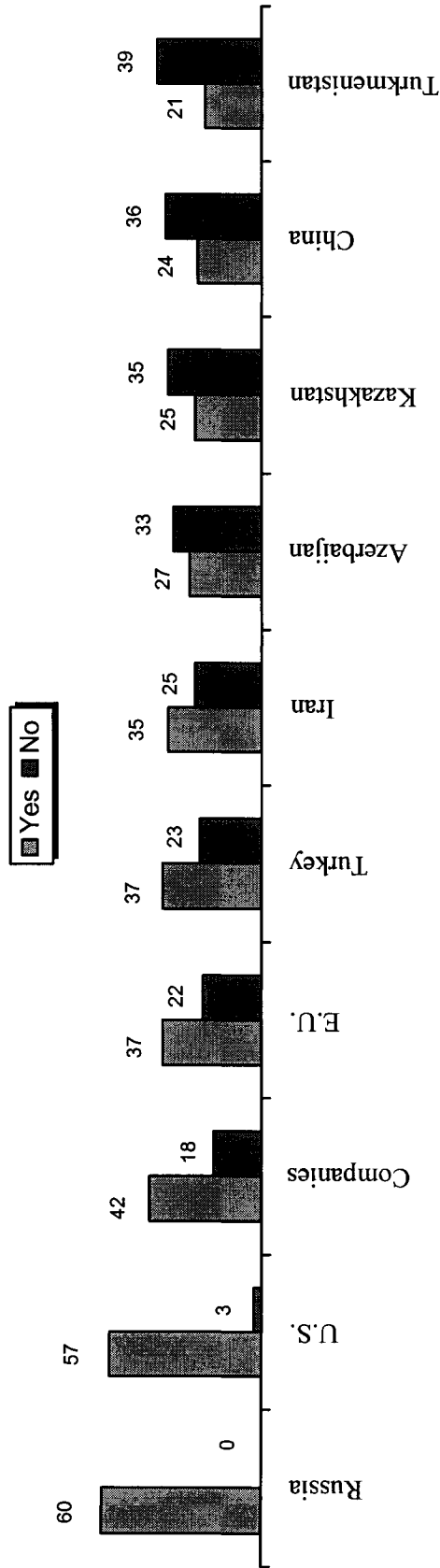


Figure 10: What are the viable export routes? - Based on Whole Data Set

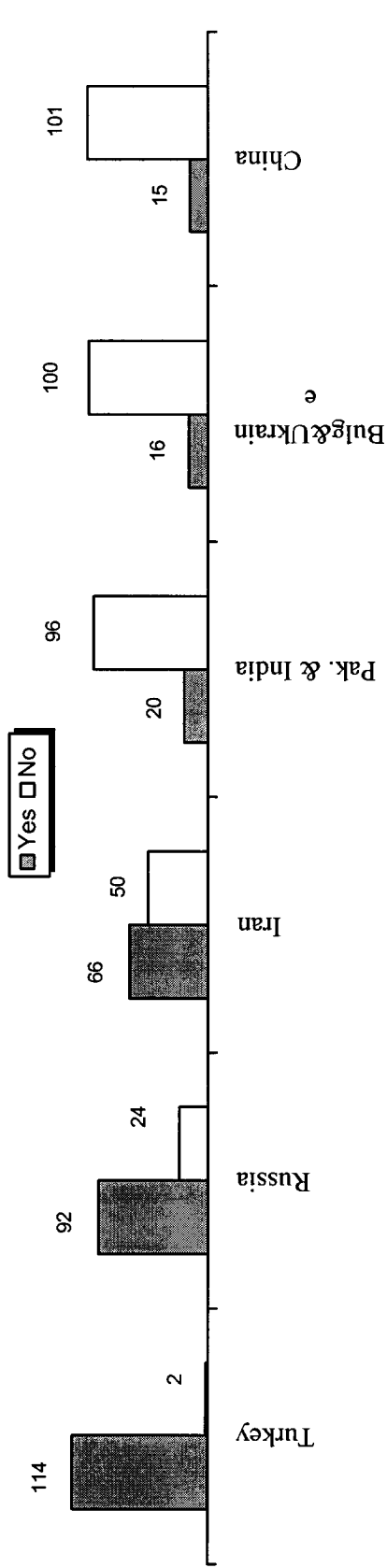
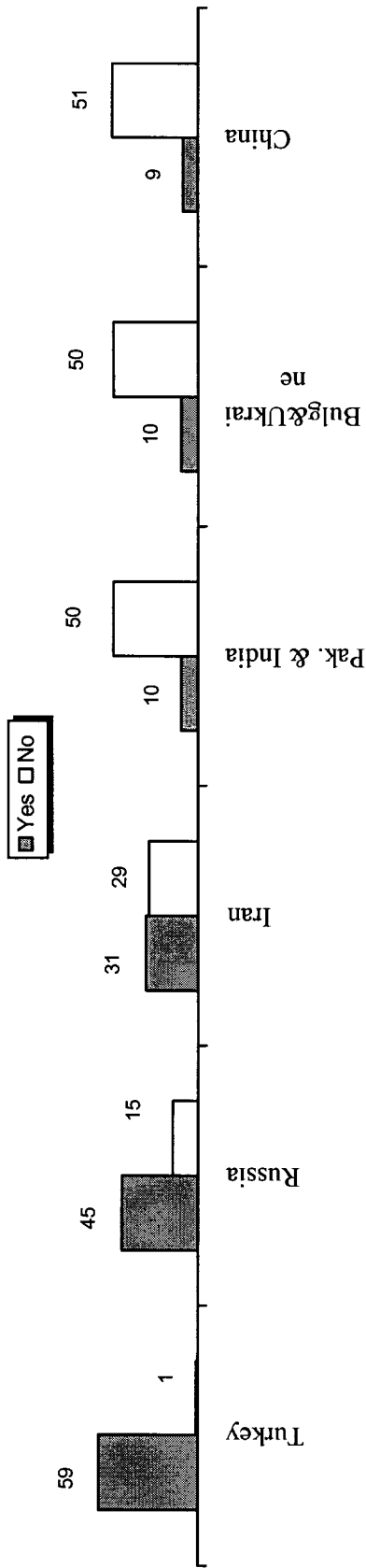


Figure 11: What are the viable export routes? - Based on Data Set Excluding Turks



**Figure 12: Ranking of the Major Problems of the Region (by mean values)
(A&B&C: Authoritarianism & Bureaucracy & Corruption)**

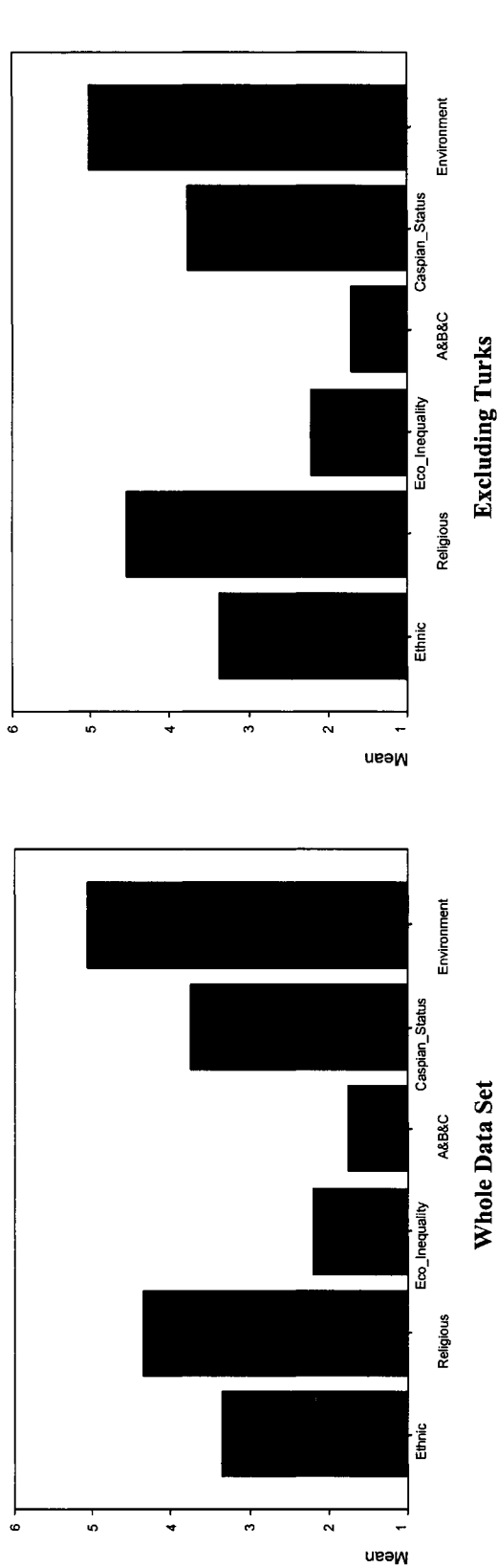


Figure 13: Major Problems of the Region Based on Whole Data Set

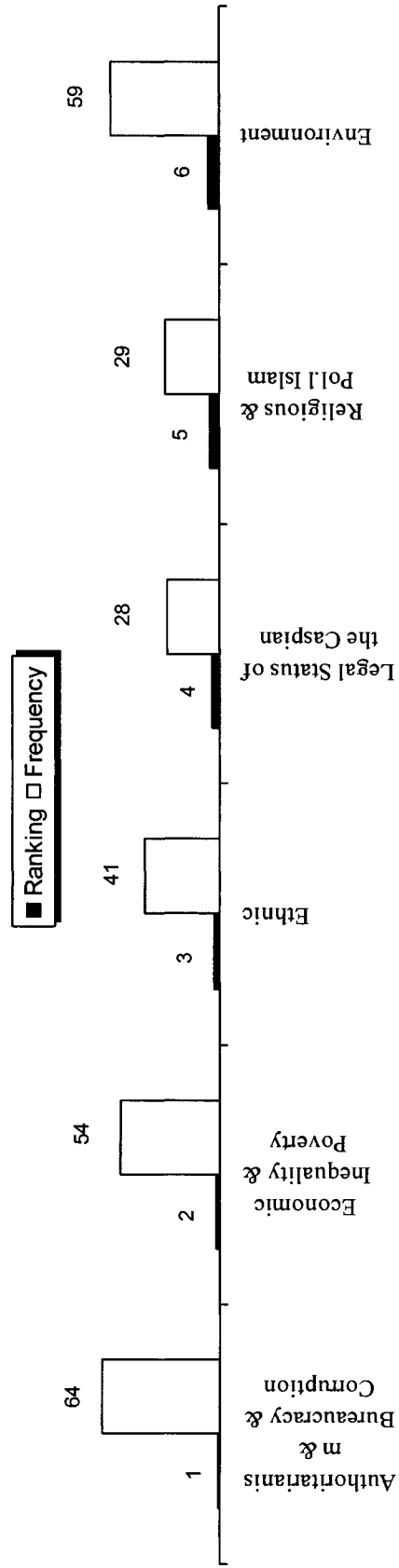


Figure 14: Major Problems of the Region Based on Data Set Excluding Turks

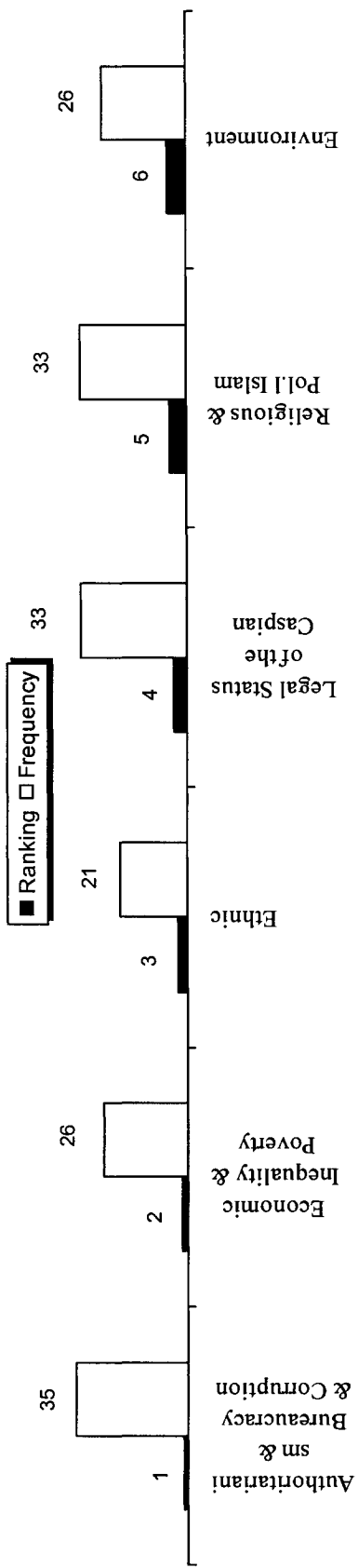


Figure 15: a) Which one will prevail? (Closer to 1: Conflict & Zero-sum Game; Closer to 2: Cooperation and Win-win solutions)
b) Is there any particular solution for the region? (1: No; 2: Yes)

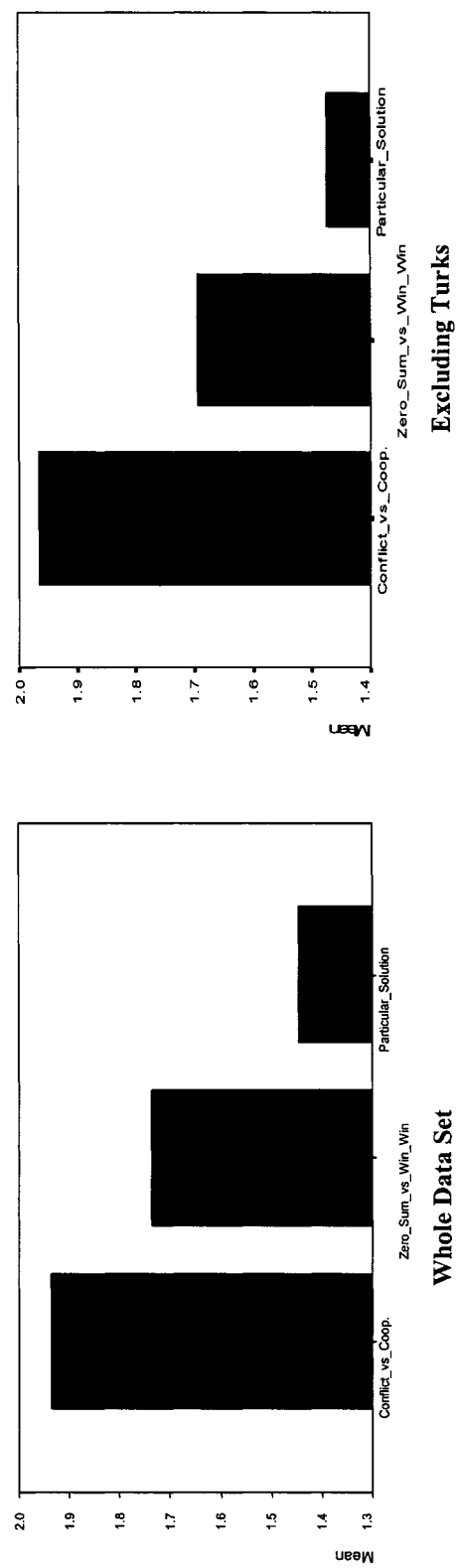


Figure 16: Which of the following statements regarding the burden of history in the region is correct? (Question 6) (1: No; 2: Yes)

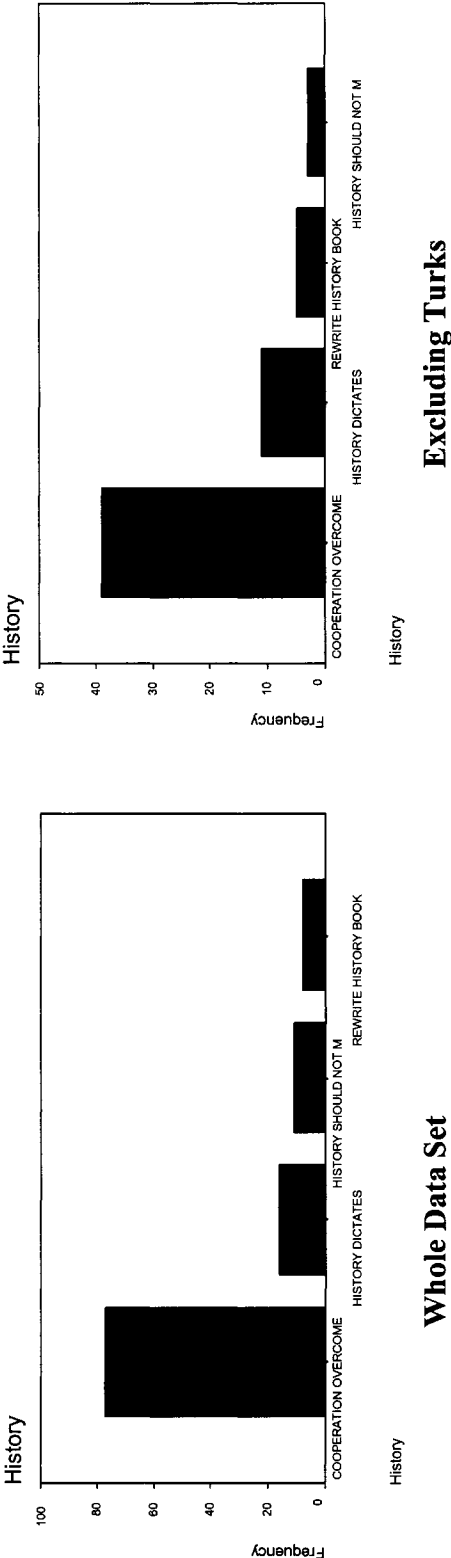


Figure 17:

- a) Are you interested in the region?
- b) Have you attended any policy planning meeting regarding the Caspian basin?
- c) Have you conducted any research or study regarding the region?
- d) Did you discuss policies with friends, bureaucrats and professionals? (1: No; 2:Yes)

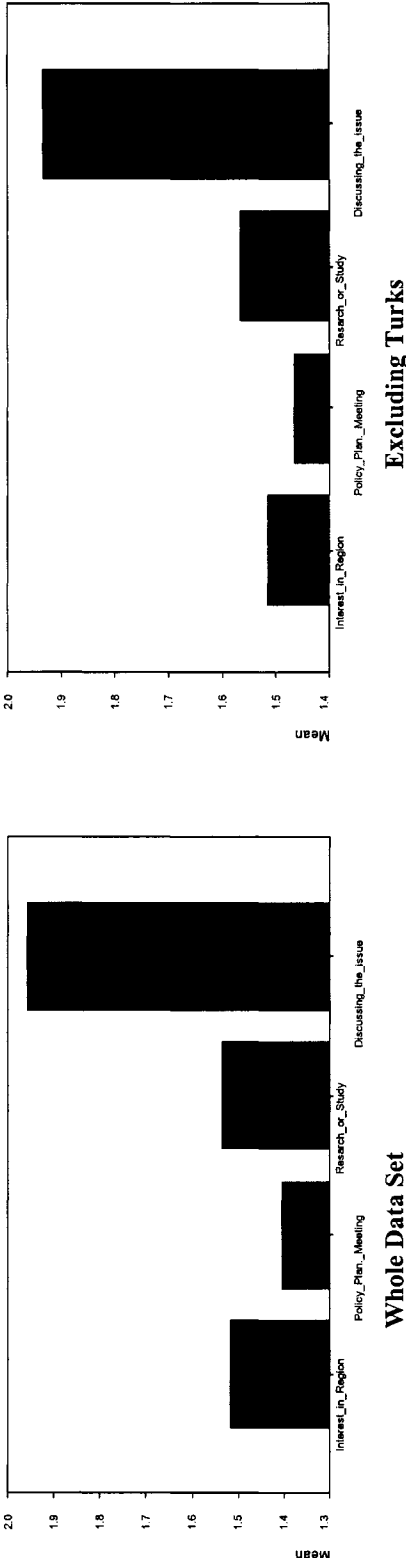


Figure 18: Education Level Comparison

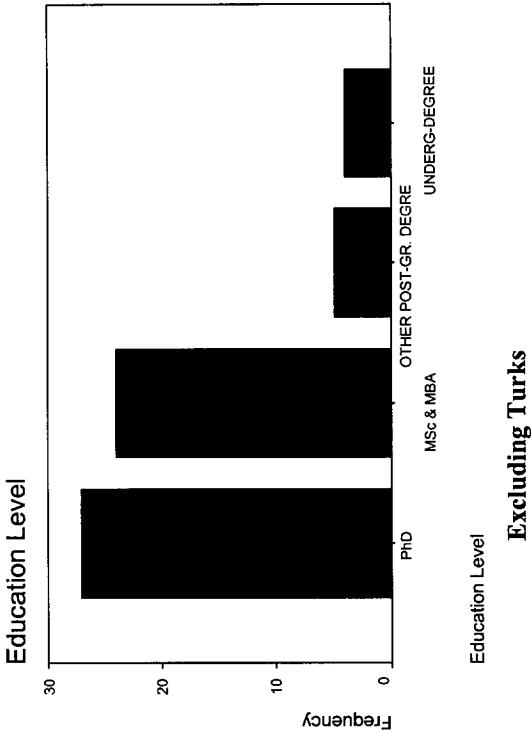


Figure 19: Nationality of the Respondents

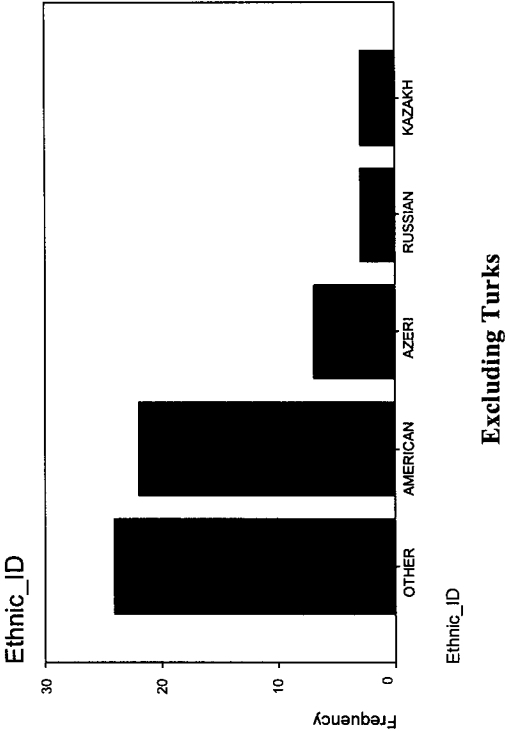


Figure 20: Specialty Area of the Respondents

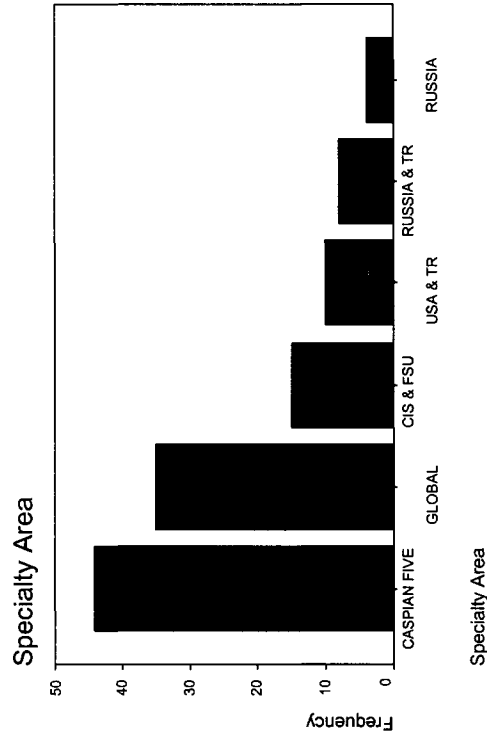


Figure 21: Job Groups Comparison

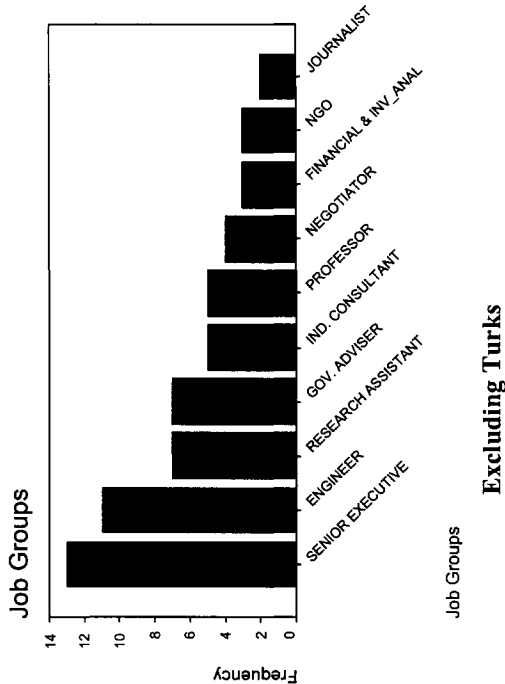
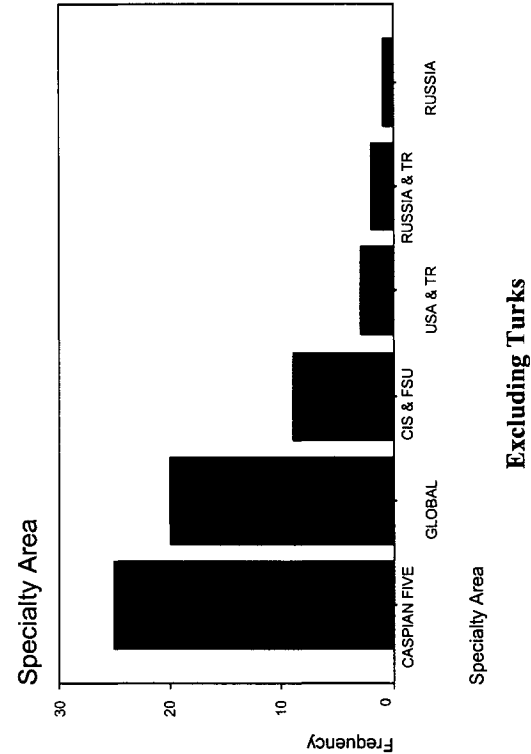
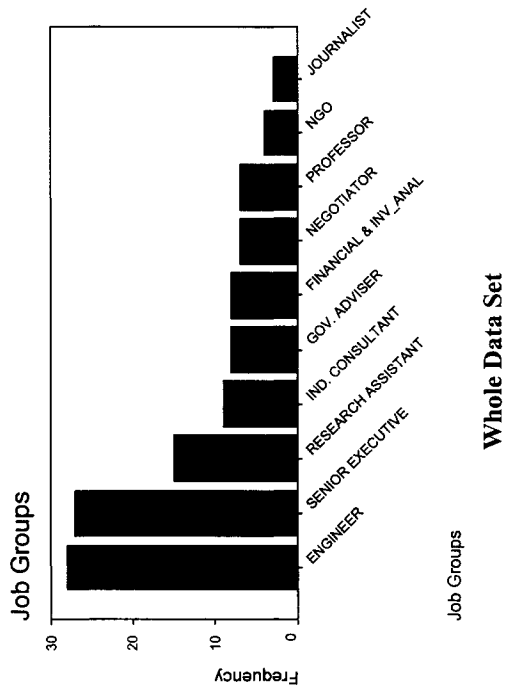
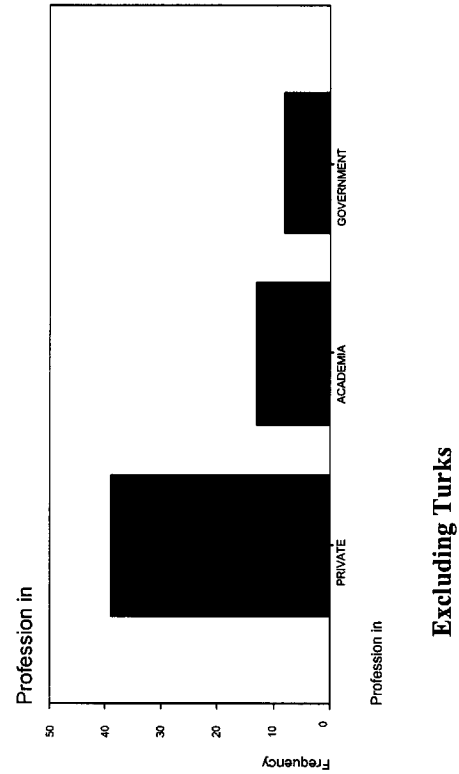


Figure 22: Profession in Sectors



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