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## **CASPIAN ENERGY “POKER GAME” AND TURKEY: Prospects for a New Approach**

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*This paper aims to provide an overview of the Caspian energy prospects and politics on the global scene and to highlight the key role of Turkey as a consumer, transit country and security provider for Caspian energy shipments in relation to other major players active in the region. It argues that Turkey's strategic partnership with the US, its anticipated accession to the European Union, its historic, cultural ties, and geographical proximity to Eurasia and the Middle East all make Ankara an indispensable partner on regional energy co-operation projects in and around the Caspian basin.*

### **“Poker or Chess Game?”**

When I first ventured into the then "terra incognita" of the Caspian oil economics and geopolitics in the late 1980s, there was a great deal of ground to cover and speculate on the future courses of action for major players. Of late, the Caspian “business” is getting increasingly difficult and unrewarding because what needs to be said have been over and again repeated in various international workshops, conferences, journals and intelligence reports. Yet, at the expense of being repetitive at times and in light of the recent developments that have put the Caspian region once again under spotlight, there is still some room to articulate the current issues that are likely to determine the future landscape of the Caspian region and that have a direct bearing on Turkey's (and West's) strategic interests.

In the Soviet era, this region was largely cut off from the political, economic and cultural influences of the West. Since 1991, a wide array of Western states, inter-governmental and non-state organisations have expanded into the region. Western diplomats, businessmen, advisers and consultants have arrived in droves. The extent of this Western penetration has been reflected in growing diplomatic links, bilateral political, military relations, trade and investment ties, and other exchanges. Western preoccupation with the region partly reflects a growing interest in its energy resources, a recognition of its geo-political significance, a desire to balance Russian influence, to stem the growth of drug trafficking, and also to help a region that could be a bulwark against Islamic fundamentalism. On the other side of the coin, in addition to the economic benefits expected to be accrued from natural resource exploitation, many former Soviet republics perceive the engagement of the West as one way to balance the "otherwise overpowering Russian and Chinese influence in their affairs".

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The Caspian oil exploration was, at the outset, like a high-stakes game of poker with several rounds of draw and a large (but unknown) number of wild cards. There was a lot of bluffing. It was, moreover, a "table stakes" game. The poker game was complicated by the fact that it was being played within another game that had other rules. The players were seated at a large geopolitical chessboard, which was multidimensional, with a large number of players. Some of the players were pieces in the games of other players. Recently, with a relative consolidation of the chessboards into patterns at least temporarily fixed, the Caspian oil game is more or less settled. Though the bluffing and high stakes and endemic risk-taking survive from the days of the poker game, strategy as opposed to tactics has become the conditioning environment, as in the chess game<sup>2</sup>.

### **Energy and Security Yesterday and Today**

The Caspian developments have a significant bearing on the world's current and future energy security. The changes over the past 20 years in energy industries have dramatically bettered our security. We now have choices on who we get our energy resources from. We also have a more diverse palette of resources from which to choose. The International Energy Agency (IEA) -- born of the oil crisis two decades ago -- is now developing new ways for the world to responsibly use its resources, alternative fuels, and multilateral responses to energy challenges. These components of the energy policy could almost not be imagined thirty years ago. But now they form the firm foundation for our energy security into the 21st century.

Oil has literally made foreign and security policy for decades. Just since the turn of this century, it has provoked the division of the Middle East after World War I; aroused Germany and Japan to extend their tentacles beyond their borders; the Arab Oil Embargo; Iran versus Iraq; and the Gulf War. We also understand that oil demand will likely increase sharply and that oil import dependence will, also, rise. Oil -- having it; selling it; buying it; keeping it -- remains a central focus of our lives, and will continue to be so. The world is now looking beyond "the usual suspects" in the Middle East, and to an emerging slate of sources: Africa, the Caspian, and Latin America. The resources found in these regions will be critical components to ensuring the globe's future energy stability, as we look to create supply.

A key message of the IEA's "World Energy Outlook" is that fossil fuels will continue to dominate the energy mix. Indeed, with a continued growth of the world economy of 3.1% per annum, world energy demand will increase at the rate of 2% per annum, meaning the world will need 65% more energy in 2020 than in 1995. 95% of this additional energy demand will be met by fossil fuels -- coal, oil and gas. In absolute terms, some 92% of total primary energy demand in 2020 will be fossil fuel-based, 2% more than 1995<sup>3</sup>. Let us highlight the main features of this scenario:

- Oil continues to be the dominant energy source. Most of the increase in oil demand will stem from additional demand for transportation.
- The share of coal in the energy mix remains almost unchanged. Some three-quarters of additional demand for coal will be in the power generation sector. Growth is fast in China and South Asia (mostly India), which are expected to base their future supply on further development of their indigenous coal.
- Demand for gas increases fast, particularly in the OECD regions. Natural gas is the preferred fuel for many applications, especially for new power stations.

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<sup>2</sup> Note that the "poker vs chess" analogy and analysis were quoted from "*The Changing Nature of the Caspian Oil Game*" by Dr Robert M Cutler in FSU Oil and Gas Newsletter, 31 May 1999.

<sup>3</sup> An encouraging feature is that the use of other renewable energy sources increases steadily, actually at the highest annual rate of any primary energy supply source. But even so the share of the "new" renewables will be still below 1% of the primary energy mix by 2020.

- World nuclear power remains almost static. During the outlook period, the retirement of several units will offset the increase in nuclear output from new or refurbished plants.
- Hydropower is expected to show moderate growth, with most of the increase coming from outside the OECD.

### *Drivers of Change*

Many factors affect energy choices and the evolution of the energy system: technology, relative economics, public perception and social preferences, relative abundance or scarcity of resources, geopolitical events, local and global environmental concerns, and public policies. To take one example: the Arab-Israeli October 1973, though not directly motivated by any energy objective, nonetheless was perhaps the most profound source of change in the world's energy supply structure over the past 27 years: We refer to the impetus to reduce dependence on oil, and the stimulus to nuclear power, coal use and the energy efficiency programme.

The main forces acting on today's energy sector include:

- Governments are yielding power to market forces, removing national – and protectionist – barriers by introducing competition into electricity and gas markets, which had previously been perceived as natural monopolies. Giant new companies such as BP-Amoco, Exxon-Mobil, TotalFina-Elf are emerging to meet the challenge of global market.
- As a short term phenomenon – but with possible long term consequences - key members of OPEC, along with some non-OPEC oil producers, are displaying a new self-confidence in their ability to move and shape the market.
- The global future of nuclear energy remains in the balance, with firm adherents confronting fervent abolitionists.
- Environmental constraints weigh ever more heavily on energy production and use. For the OECD countries, the predominant environmental issue is global warming, but for developing countries, local pollution is a more immediate concern.
- The North-South divide persists, exemplified in energy use. The citizen of India, for example, still uses 16 times less energy, on average, than the citizen of the United States. One third of the world's population still has no access to commercial energy. The urgency of economic expansion in developing countries and the concomitant energy needs, mean that most of the world's additional energy demand will arise in those countries.
- And there is a growing sense of social obligation to find effective ways to tap the huge potential of renewable energy sources.

### **The Caspian Oil Supplies**

What sort of volumes are we talking about? Certainly not another Gulf region, but perhaps a new North Sea. There has been some talk recently about downgrading Caspian reserves because of unsatisfactory drilling results in the western Caspian. To date, there have been three disappointing wells drilled in the Caspian, which compares with about 100 in the North Sea before the first commercial discovery were made. The IEA reserve estimates for the Caspian have been among the more conservative: proven oil reserves at between 15

- 40 billion barrels<sup>4</sup>. This represents about 2 percent and 6 percent of world proven reserves. Because much of the region remains to be explored, it is more likely that estimates of the reserve base will increase rather than decrease. To put this in perspective, the most optimistic reserve estimates for Caspian oil still pale in comparison with those for the Middle East, which holds over 650 billion barrels or some 65 percent of the world's proven reserves, but they are nonetheless roughly comparable to those of the North Sea.

Today, the oil production of Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan combined is just less than 1 million barrels per day (mbd), of which about two thirds is used domestically and less than 10 percent is moved through Russia to export markets beyond the Commonwealth of Independent States. If investments in the Caspian region continue at the current pace, and if sufficient export outlets are developed, the annual oil production could reach 3.9 mbd by 2010, of which about 2.3 mbd would be available for export. (Domestic consumption is also expected to grow.) In a "low case" scenario, which assumes some project delays, oil production by 2010 would reach 2.8 mbd, comparable to Venezuela, of which about 1.5 mbd would be available for export. (To put this into perspective, Russia currently exports about 2 mbd.)<sup>5</sup>

The main effect of high oil prices, would be to speed up investments in the region, bringing us closer to the "high case" scenario. There are already examples of accelerated exploration programs and reassessments of the timing of major energy infrastructure. These figures mean that at best the Caspian region will account for about 4 to 5 percent of world oil supply in 2010. By way of comparison, in recent years Middle East-OPEC has supplied over 40 percent, and could supply over 52 percent of world consumption by 2010.

### **Access to World Markets**

One of the things that sets the land-locked Caspian apart from the North Sea and other important marginal suppliers is the difficulty of getting the oil and gas production to world markets. The energy transportation systems of the Caspian region were originally designed and built to serve the strategic needs of the Soviet Union. All oil and gas export pipelines inherited from the Soviet period pass through Russia. Russia's pipeline operators, citing capacity constraints and various tariff problems, have effectively capped exports from the region. In the case of gas, Russia is clearly reluctant to share markets, especially the rapidly growing Turkish market.

The lack of adequate export infrastructure is probably the most difficult problem facing investors in the region. The construction of new export pipelines has become a priority. However, most routing options are fraught with technical, financial, legal and political difficulties. Most proposed pipelines must pass through -- or take expensive detours to avoid -- politically troubled areas. There is reason to expect that some pipelines could become targets for political terrorism. By now, everyone has a pretty good sense for the pipeline options. In principle, the main options are i) to load at ports on the Black Sea and transit through the Straits, ii) to establish an East-West corridor by constructing an entirely new "Main Export Pipeline" such as the Baku-Ceyhan or iii) to transit existing pipelines in Russia or add capacity through south-east Europe. Multiple routes will increase energy security, both for exporters and importers, by making exports less subject to technical or political disruptions on a single route.

It may be useful to enumerate some of the drivers, which will ultimately lead to transportation decisions. There is a substantial consensus on a few things that will be on the minds of those contemplating the alternatives:

- Companies -- not governments -- will build pipelines. If Caspian producers and transit countries do not create the conditions under which companies are encouraged to invest, the marginal dollar can go somewhere else.

<sup>4</sup>Another estimate puts the Caspian Sea basin proven oil reserves at 28 billion barrels. That's nearly twice the size of Europe's North Sea reserves and three times the size of Prudhoe Bay, Alaska's.

<sup>5</sup> "Future Trends in Supply and Demand in the Mediterranean and Black Sea Oil Markets", presentation by Ambassador William Ramsay, Deputy Executive Director, IEA, London, 27 April 1999.

- Multiple pipelines are in the interests of: (a) Shippers, who need export alternatives to position them to negotiate competitive transit terms; and (b) Countries which want to avoid creating single pipe vulnerabilities, either in getting their oil or gas out -- or getting it in.
- There is some limit beyond which the Turkish Straits cannot handle incremental cargoes. No oil pipeline is going anywhere until enough barrels need a way out. No route is without political risk.
- No gas pipeline is going anywhere until there is bankable gas demand at the other end. Economic forecasts of gas demand are interesting, but a commercial gas supply obligation and a viable power purchase agreement are much more compelling.
- Supplier pressures for early pipeline decisions are going to increase substantially as delays in the long promised earnings from oil and gas create political tensions domestically.

### *The Baku-Tblisi-Ceyhan Line*

Turkey, Azerbaijan and Georgia signed a number of technical agreements in October 2000 to initiate concrete work on the Baku-Tblisi-Ceyhan pipeline. The recent announcement of a large oil discovery off the coast of Kazakhstan at Kashagan has generated some excitement, but the projected volumes are still not there for a commercially viable Baku-Ceyhan oil pipeline by 2004. All estimates are provisional. The pipeline projects require an incremental approach grounded in commercial realities, not perceived geopolitical imperatives. Oil cannot be pulled through a pipeline, but can only be pushed when adequate volumes of oil exist and commercial realities allow for reasonable export costs. Kashagan is not expected to produce until 2005 at the earliest.

It is worth remembering that it took six years for the Chevron-led Tenghiz consortium to reach its current production level of approximately 215,000 bpd, up from 60,000 bpd in 1993. Kashagan has yet to be completely explored and, when extraction finally begins, will probably take even longer than Tenghiz to reach peak production, making any estimate of Kashagan's impact on the current pipeline policy debate premature. Moreover, when Kashagan does begin producing in significant volumes, export through Novorossisk via the Caspian Pipeline Consortium (CPC) pipeline from Tenghiz may make far more commercial sense than early commitment to Baku-Ceyhan. The CPC pipeline has ample excess export capacity even when it accommodates the projected peak production of 750,000 bpd expected from Tengiz by 2010.

In the absence of Kazakh oil within the next few years, the commercial viability of the projected Baku-Ceyhan pipeline will continue to rest on the availability of additional Azeri oil. The Azerbaijan International Oil Consortium (AIOC) is currently producing 115,000 bpd, which is directed to markets through the Baku-Supsa pipeline<sup>6</sup>. The AIOC has yet to proceed to Phase 1 of its development plan, which is designed to gradually boost production to around 800,000 bpd by 2010. Theoretically, such volumes would make Baku-Ceyhan commercially viable in a decade. The major practical problem, however, of how the additional incremental oil will be sent to markets pending the completion of Baku-Ceyhan remains to be solved. Since 1995, the AIOC has not hidden its preference for an expansion of the Baku-Supsa pipeline, through which all AIOC production is currently transported, to markets, to handle a major portion of future additional volumes. Expansion has been fiercely resisted by the US and Turkey, however, for fear of damaging prospects for Baku-Ceyhan<sup>7</sup>.

<sup>6</sup> "Caspian Pipelines-Two Steps Forward, One Step Backwards", *Global Oil Report*, Center for Global Energy Studies, May-June 1999, Vol. 10 Issue 3, p.4

<sup>7</sup> The AIOC has also been looking at an offer by the Iran National Oil Company to accommodate up to 800,000 bpd in northern Iran's as part of a swap arrangement. While current U.S. policy effectively prevents U.S. oil companies from taking advantage of this commercially attractive alternative at the moment, it is clear that the AIOC would not mind keeping all its options open for as long as possible, instead of committing irrevocably to the Baku-Ceyhan pipeline.

The cost estimates of the pipeline vary between \$2.2 billion and \$3.7 billion. This compares to about \$2.5 billion for a main oil pipeline to Novorossiysk, and \$1.8 billion to Supsa. The Azeri government will have to take the price of the route into consideration because the AIOC will be able to recoup the construction costs. Financing a large new pipeline would mean lower initial revenues for the Azeri government and we all know that in times of price fluctuations, the first revenue stream to dry up is the government during cost recovery. In order to accelerate a decision on the pipeline to Ceyhan, the onus seems to be on Turkey to provide incentives to lower the effective price of its preferred route. Such incentives could include tax breaks, rights of way and attractive transit fees.

The U.S.-Turkish supported “Energy Corridor” project has succeeded mainly in arranging high-profile ceremonies and agreements that have yet to be implemented. The agreements say, in essence, that if sufficient volumes of oil are available and the companies decide to commit financial resources, the countries involved would be willing to host the Baku-Ceyhan pipeline. Furthermore, the commercial incentives by U.S. export finance agencies hinge upon the creditworthiness of the projects and officials in these agencies have always cautioned that such funds will only be forthcoming when commercial conditions permit. In other words, despite all the rhetoric, the U.S. was never willing to provide any of the direct financing necessary to permit the implementation of the Baku-Ceyhan project. At the same time, US support for the Eurasian Energy Corridor, independent of Russia, was always constrained by the apparently higher requirements of the US Administration's policy of accommodation with Moscow. It remains to be seen what attitude the new Bush Administration would adopt with regard to the Baku-Ceyhan line and other energy projects in the region.

#### *Pipelines and Swaps via Iran*

Iran is considered by some to be an attractive export route for both oil and gas. It already has a well-developed oil and gas transportation infrastructure, including portions of pipeline that could be used for various routes. Some companies argue that an Iranian oil export pipeline to the Gulf could be significantly cheaper than some proposed western routes; others are not so sure. China National Petroleum Corporation, Total and even several US majors reportedly have all separately studied the feasibility of building oil pipeline from Central Asia to the Gulf. Important barriers to pipelines via Iran are sanctions by the United States<sup>8</sup> and its unreliability in times of crises.

A number of companies are already involved in limited oil *swaps* with Iran. These involve delivery to an Iranian Caspian port in exchange for Iranian oil in the Persian Gulf. For example, Kazakhstan has sent crude to Neka in exchange for Iranian exports of equal value from Kharg Island. Iran has organized a tender for a new pipeline to further facilitate swaps by enhancing links with Iranian refineries in Tehran and Tabriz. Iran claims it could absorb up to 1.6 mb per day of crude for existing and planned refineries in the North of the country. However, its plans in this area are not necessarily related to swaps, but seem to focus on straight purchases of oil for use in northern Iran. Caspian oil producers may be reluctant to base their export plans on the market of a country, which is also a supply competitor. Moreover, there is similar security of supply concerns related to oil transported via Iran to the Gulf. Caspian oil does not represent as much of a diversification of global supplies if, by transiting Iran to the Persian Gulf, it becomes subject to the same constraints as much Middle Eastern crude if flows were disrupted through the Strait of Hormuz. This would obviously undermine the value of Caspian oil as an alternative to oil from the Gulf.

#### **The Fundamental Importance of Gas**

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<sup>8</sup> Sanctions have been imposed on Iran as a result of accusations that the Iranian government is supporting international terrorism and developing weapons of mass destruction. Such sanctions could make it difficult for any pipeline project involving Iran to obtain financing.

While access to oil supply is not a pressing issue for Turkey, the question of access to new supplies of natural gas certainly is. The gas business differs significantly from the oil business, and access to supply is a far more vexing problem for gas than it is for oil. For the most part, sources of supply and areas of demand need to be connected directly by pipelines, since shipping gas by tanker is a technically complex and expensive process. Pipelines for gas are typically much more difficult to finance than oil pipelines, since they require credible guarantees of payment from solvent end-users. Turkey is the fastest growing gas market in Europe, and in recent years it has had difficulty in obtaining enough gas to meet its burgeoning near-term demand. Turkish gas consumption-and therefore economic growth-already is being artificially constrained by a shortage of supply. Meanwhile several consortia are proceeding with plans to build new gas-fired power plants in order to meet Turkey's rapidly growing demand for electric power. Should gas not be available to supply these plants in the next few years, it could trigger a serious economic crisis.

The importance of gas supply for Turkey has caused it to pursue a policy toward gas pipelines that is driven far more by economics than by politics (in contrast to its approach toward oil pipelines). Turkey has signed agreements with varying degrees of firmness to purchase new gas supplies from Russia (currently its primary supplier), Turkmenistan, Azerbaijan, Iran and even Iraq, all of which would be delivered primarily through new pipeline infrastructure. In contrast to the oil pipeline situation, Turkey does not need to worry about being bypassed by gas pipelines; it represents the most promising target market for gas in southwestern Asia, and its potential suppliers are just as eager to supply their gas to Turkey as Turkey is to receive it. Indeed, the past two years have seen the development of a race between suppliers to build their pipelines and stake early claims to the market. However, these various projects remain uncertain, and each one faces unique challenges; it remains conceivable that none will proceed rapidly enough to prevent Turkey's gas shortage from growing significantly worse in the near term.

Azerbaijan's aggressive play for the Turkish gas market in the wake of its spring 1999 discovery of a major gas field has caused a variety of problems, which have called into question the US-backed plan to build a pipeline to supply Turkmenistan's gas to Turkey via the Caspian Sea shelf, Azerbaijan and Georgia. With financing arrangements basically completed for Russia's competing "Blue Stream" pipeline, which would bring gas to Turkey across the Black Sea shelf, this project also appears to be nearing the moment of truth when construction begins in earnest. Meanwhile the completion of the infrastructure required to bring gas into Turkey from Iran appears within reach. By mid-2001, barring the unlikely scenario in which all of these pipeline projects run into serious trouble, Turkey will be on course to supplement its current supply with new gas from Iran, probably Russia, perhaps Turkmenistan (albeit via Iran or Russia) and Azerbaijan as well.

#### *Which Gas Project to Take off First?*

The most likely export market for the Caspian gas is Turkey. Gas demand here should be looked at in two phases: the short and long term. In the short term, Turkey will require 8 - 10 Bcm of additional gas, which it has amply booked from a number of suppliers. For long-term, according to Botas, the Turkish natural gas consumption is expected to reach 19 Bcm in 2000, 55 Bcm by 2010 and 82 Bcm by 2020. Agreements signed so far guarantee 45.2 Bcm of natural gas a year, however. The shortfall will be around 10 Bcm in 2010 and 38 Bcm in 2020<sup>9</sup>.

The options are that gas comes from Turkmenistan via Iran or across the Caspian or even north around Caspian; from Iran via Turkey<sup>10</sup>; from Russia via Bulgaria, from Russia across the Black Sea via the "Blue

<sup>9</sup> *Petroleum Economist*, July 1999, p.15.

<sup>10</sup> Under a contract between the two countries, Iran is to export 3 bcm of natural gas to Turkey annually from July 2001 if the Turkish part of the pipeline is completed as planned. The volume of Iranian natural gas exports to Turkey is to reach 7-bcm from 2005 and to 10-bcm from 2007. Iran is busy laying 48-inch gas pipelines in an area of 550 km from Qazvin, in central Iran to Bazargan border with Turkey.

Stream" pipeline, from Russia via Georgia, and from Egypt by pipeline. Then there is always incremental LNG from various sources. With Turkish authorities arguing that demand will rise to justify all the gas projects, there has been a veritable gas rush to Turkey. But Turkish estimates of gas demand by 2020 are generally considered to be unrealistic. Even if its demands reach those figures, Turkey has now signed contracts to purchase gas at volumes that exceed even those optimistic demand projections.

Consequently, the two giant gas projects, Blue Stream and the Trans-Caspian gas pipeline (TCP) plus the Azeri line, are racing to "get to the Turkish market first," knowing that the loser will probably be shut out for some time. The competition between these projects has become part of the strategic competition over the future of the region. With Russia identifying the Blue Stream project as a top priority, the fate of this project will surely help determine the direction of Turkish-Russian relations as well as that of the Caspian basin. Significantly, Russia has made it clear that it wants to not only to continue to monopolize the Turkish gas market but also participate in the profitable local distribution. What remains to be seen is how and when that gas will get to the Turkish market.

#### *Can Turkmen Supply Turkey, together with Azerbaijan?*

Turkmenistan is keen to build new export routes for its hydrocarbon wealth. A small route has been built to neighboring Iran, but more outlets are needed to allow the arid, impoverished state of 4-mn people to realize its potential as a gas supplier. A natural gas pipeline linking Turkmenistan with Turkey, if constructed, would follow an underwater route across the Caspian Sea to Turkey and then pass overland through the southern Caucasus via Azerbaijan and Georgia. Turkey's state pipeline concern Botas has already begun work on some sections of the pipeline and expects to finish laying a new pipeline between the eastern city of Erzurum and the Georgian border by the end of 2001. The Turkish section of the pipeline will carry some Iranian gas, which Ankara will buy under a separate supply agreement with Tehran. Turkmenistan hopes eventually to transport 30 bcm of gas per year through the Trans-Caspian pipeline, with 16 bcm per year going to the Turkish market and 14 bcm per year going through Turkey to Europe<sup>11</sup>.

In February 1999, the Pipeline Solutions Group (PSG) - a joint venture of Bechtel and General Electric, subsequently joined by an upstream partner, Royal Dutch/ Shell - was given a one-year mandate by Turkmen president Saparmurat Niyazov to assemble a package for the construction of the Trans-Caspian Pipeline (TCP). But a bitter dispute between Turkmen officials and their Azeri counterparts, who wanted to export their own gas from Shah Deniz to Turkey, effectively prevented progress on the TCP. The project was also hampered by opposition from Russia and Iran, which have "take or pay" gas agreements with Turkey, as well as existing pipeline connections to re-export Turkmen gas. In February 2000, Niyazov publicly castigated the US Special Envoy for delays in resolving the dispute, blaming him for the failure of Turkmen and Azeri negotiators to arrive at an amicable settlement.

Meanwhile, Russian President Vladimir Putin has pushed ahead with an aggressive policy designed to recover Moscow's regional hegemony. Soon after his 26 March 2000 election, Russia's National Security Council declared the Caspian region to be one of Russia's key foreign policy interests<sup>12</sup>. Former energy minister Victor Kalyuzhny was appointed to a newly designated deputy foreign minister post, serving as special co-ordinator of Russia's Caspian policy. The creation of the post underlined a significant shift from Moscow's ad hoc and disorganised approach seen during the Yeltsin era to more efficient approach to the

<sup>11</sup> Under the agreement, Ankara will buy 16 bcm of Turkmen gas per year for a period of 30 years, beginning in 2003. Turkmen President Saparmurat Niyazov hopes to see his country begin supplying Turkey in 2002. Niyazov stated that Ashkabad was willing to supply fuel at a price of \$ 78 per 1,000 cubic meters, but did not specify whether this figure included the cost of transport from the field to Turkey.

<sup>12</sup> The ominous implications of Russia's new policy were underlined by Andrei Urnov, Russia's ambassador at large and chief of the Foreign Ministry's Working Group on the Caspian Sea, in a May 2000 appearance on Capitol Hill. Soon after Russia had forcibly "pacified" the Northern Caucasus, Urnov told the Washington audience, "it hasn't been left unnoticed in Russia that certain outside forces are trying to weaken our positions in the Caspian Basin, to drive a wedge between us and other Caspian states."



region. Russian leaders focused in particular on the need to compensate for their flagging natural gas production by concluding purchase agreements for Caspian gas in order to maintain the domestic and export obligations of Gazprom, which contributes over one-third of the Russian government's revenues. Gazprom's president, Rem Vyakhirev, visited Kazakhstan in May, and then joined Putin in Ashkabad where they obtained a commitment by Niyazov to increase Gazprom's 20 bcm purchase of Turkmen gas by an additional 10 bcm a year.

Azerbaijan discovered a huge volume of gas in the Caspian in June 1999.<sup>13</sup> The Trans-Caspian line must cross Azerbaijan, but now Baku may be able to supply Turkey with gas that is closer and cheaper than Turkmenistan's reserves. In May 1999, Turkey signed a purchase and sales contract with Turkmenistan, but it included flexible pricing that may be reviewed every six months. The deal could be vulnerable if Azerbaijan undercuts Turkmenistan's price. Russia controls Turkmenistan's northern line through Russia, which was its link to European markets in Soviet days. Moscow could frustrate the Trans-Caspian project by accelerating Blue Stream while simultaneously opening up the northern connection, arguing that a new Turkmen outlet is unnecessary. It could then join with Iran to press its case that the Trans-Caspian line is environmentally risky and illegal without a littoral pact on dividing the waterway.

#### *Blue Stream to Compete*

Turkey has been purchasing Russian natural gas via an overland pipeline through Ukraine, Romania and Bulgaria since 1987. 10 February 2000 witnessed the groundbreaking ceremony for the \$3.2 billion Russian-Italian-Turkish joint venture dubbed "Blue Stream". A major part of the pipeline construction of this project on the Turkish territory has been completed. Officials believe that Turkish part of the pipeline could be completed by April 2001. The length of the pipeline passing through Turkish soil will be approximately 501 kilometres. The Italian Company, SAPIEM, known for its experience in underwater constructions will undertake the construction of the Black Sea passage. The Blue Stream Project has been on the agenda of both Russia and Turkey since the countries signed an agreement in December 1997, envisaging a natural gas transfer from Russia to Turkey for the next fifteen years.

The Blue Stream project constitutes one of the most important facets of Turco-Russian relations<sup>14</sup>. The project envisions bringing 16 Bcm of additional Russian gas directly to Turkey. It is environmentally challenging, as a rupture in the pipeline would release a highly dangerous hydrogen-sulfite gas to the detriment of coastal life. Many observers, however, believe that available technology could overcome such environmental and technical challenges. A more serious problem associated with Blue Stream is its threat to the Trans-Caspian project<sup>15</sup>. From the outset the Blue Stream Agreement has been a highly debated

<sup>13</sup> SOCAR wants to explore and develop deposits that may contain up to 3 trillion cubic meters of natural gas. At present, Azerbaijan produces only about 5.2 bcm of gas per year, and all of it is consumed domestically. Most of the gas comes from the Bakhar and Bulla-Deniz offshore fields. Some gas comes from the fields being developed by AIOC. SOCAR hopes to push gas output up to about 8 bcm a year by 2002, with production levels rising to 15 bcm per year by 2010. However, much work will have to be done before SOCAR can achieve its goals. Baku must first secure export markets for its gas. The most obvious target is Turkey, where demand for natural gas is swelling. Azerbaijan would not need to draw up a major export scheme unless it could push production above the level of 16 bcm per year. The country will not be able to sustain production levels of more than 24 bcm per year unless it has a major export scheme in place.

<sup>14</sup> During Kasyanov's visit in late October 2000, Turkey asked Russia, its main gas supplier, at 12 Bcm this year, for an extra 12 Mcm of gas per day in addition to 33 Mcm already being pumped. In addition, while Turkey wants to purchase electricity from Russia via Georgia, Russia is asking Turkey to help Russian companies in the construction of pipeline tenders in Turkey. Turkey expects its electricity deficit to rise to 7 billion kWh at the year's end from 2 billion kWh in 1999, after a drought forced authorities to run coal and gas-fired plants to offset losses from hydroelectric stations.

<sup>15</sup> Washington keenly supports the Turkmenistan-Turkey pipeline because it bypasses Russia and Iran—two rival players in the Caspian, and agreed to submit detailed financial proposals for a pipeline from Turkmenistan to Turkey by the end of March 2000 in a bid to boost the troubled project's viability. President Niyazov, frustrated at the lack of progress in this U.S.-backed plan to pump Turkmen natural gas to Turkey, cast the project's future in doubt in late February by agreeing to supply vast volumes of gas to Russia over 30 years. But he has already pledged to supply the Turkish line with an eventual 30 Bcm (bcm) a year. Turkmenistan would be unable to meet that demand while at the same time pumping 50 bcm to Russia annually. (Turkmen gas production last year was only 23 bcm.)

project in Turkey, as it was reached behind closed doors<sup>16</sup>. The argument in favor of the project was that Turkey and Russia are two giant neighbors that would gain from co-operation instead of regional rivalry. To underline the significance of the newfound partnership, then Prime Minister Chernomyrdin declared after the signing: "No more Chechen and no more PKK problems."<sup>17</sup>

With construction under way and financing apparently secured, Blue Stream has steamed ahead of its faltering competitor, the Trans-Caspian Project. While American policy priorities<sup>18</sup> may very belatedly be shifting from Turkmen gas to Azeri gas in order to keep the gas portion of the Eurasian Energy Corridor project alive, rapid progress seems doubtful. The Turkish energy officials realise that the provision of cheaper Azeri gas is likely to raise further doubts in the minds of Turkish consumers about the advisability of even greater dependence on Russia, which primarily benefits certain Turkish companies as well as their Russian partners. However, one problem they may have to confront is that British Petroleum, which leads the Shah Deniz gas consortium as well as the AIOC is implicitly linking its possible support for the Baku-Ceyhan pipeline to Turkish willingness to buy Azeri gas.

It is unlikely that all of these projects can win the Turkish gas race unless they are synchronised over a longer time horizon and unless a reliable connection to the European gas market can be constructed via Turkey and through South East Europe.

### **Turkey's Energy Matrix and Interests in Caspian Energy**

The widening 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 of its demand for energy by 8 percent per annum whereas the world average is 1.8 percent. Turkey's energy consumption in 1998 was 76 million tones of oil equivalent (mtoe) and is expected to reach 179 mtoe by 2010, and 319 mtoe by 2020. Turkey has been pursuing policies in order to meet its expanding energy need based on diversified, reliable and cost-effective supply sources.

Former Turkish President Suleyman Demirel warned last year that Turkey needed to invest \$130 billion in energy over the next 20 years<sup>19</sup>. Such huge investments cannot be realized through state funds only; international resources should be mobilised to make the necessary energy investments<sup>20</sup>. Yet, energy investments have declined since 1994, as plans to privatise the sector were raised. But the sector was pushed into chaos because the privatisation attempts began before the necessary legal and institutional infrastructure was established. Meanwhile maintenance and renovation work on state power plants was neglected. Due to a mismatch of energy demand and supply, Turkey would face electricity shortages this year and in 2001 unless some solid short-term solutions, including power conservation, can be produced and activated. Power cuts would be inevitable in 2001.

<sup>16</sup> The Energy Ministry, under Yilmaz's direction, was accused of hiding the full content of the agreement from the rest of the Turkish State. In fact, it was speculated in the press that, if the president and the Foreign Ministry had not intervened at the last minute, the agreement would have given excessive concessions to Russia.

<sup>17</sup> He was referring to Russia's belief that Turkey aided the Chechens during the 1994-1996 war and to Turkey's own suspicions that Russia supported the terrorist PKK group. Prior to his arrest in February 1999, the PKK leader Abdullah Ocalan sought shelter in Russia to the dismay of Turkey. Blue Stream advocates have argued that certain Russian circles could revitalize the PKK unless there was strong commercial co-operation, with Blue Stream at the heart of the strategic partnership.

<sup>18</sup> One should also note here that Romano Prodi, the President of the European Commission, assured Russian President Vladimir Putin on 4 October 2000 that the EU supports the creation of the east-west energy corridor proposed by Russia. Under its terms, Gazprom will sign agreements with major German, French, and Italian concerns to provide gas for 20 years. To support that effort, the two sides will construct new oil and gas pipelines from Russia to Europe. Gazprom Chairman Petr Rodionov said that that this project would require the construction of "at least seven major pipelines both to meet our obligations and to keep Ukraine out of this."

<sup>19</sup> "Energy policy or politics of slogans?", 15 April 2000, Turkish Daily News, "Opinion" By Professor Huseyin Bagci

<sup>20</sup> "Energy study suggests more use of coal", Turkish Daily News, 1 November 2000. Annual energy deficits would have reached 4-5 billion kilowatt-hours if Turkey had not supported private producers, mobile and floating generators and build-own-operate projects. Build-operate-transfer, build-operate, transfer of operating rights and auto-producer models have helped channel private-sector investment to the energy sector

Competition worldwide for money is fierce, and Turkey has to work hard to provide the right incentives to investors in the energy sector. Private investors, both domestic and foreign, are ready to step in, but political uncertainty and administrative hurdles have left the national power policy somewhat in limbo. The Ministry of Energy and Natural Resources is pushing for the private sector to take a bigger share, but reaching consensus on how to approach the issue is not proving easy, with several state institutions sharing responsibility for the sector. Because of the weak legal structure, opponents of privatization find ample scope to delay projects. The present chaos in the energy sector is due to a lack of a comprehensive national energy policy that is above politics and fits the nation's interests<sup>21</sup>.

It may well be a cliché to describe Turkey as the country where Europe ends and Asia begins, but this is particularly true in its strategic position as a bridge between energy supplies from the East and consuming markets in the West<sup>22</sup>. The country is a natural transition point for hydrocarbon supplies from Russia, Iran, Iraq and, more recently, the Caspian region<sup>23</sup>. It is therefore not surprising that Turkey figures largely in some of the major pipeline projects in the region, both as a consumer and as a transit point for exports beyond its territory into Europe. Besides, as one of the biggest investors in the region and its close historical, cultural and economic ties with the countries of the region, Turkey acts not only along with its commercial interests but also feels a special responsibility for supporting these nations in their social and economic development.

Turkey's interest in the Caspian pipeline issue began as just one of the many strands of late President Turgut Ozal's broad policy of engagement with the newly emerged Turkic states. The concept of making Turkey the main export corridor for oil from Azerbaijan and perhaps Central Asia as well-by means of a pipeline linking Baku to the Turkish port of Ceyhan on the Mediterranean Sea-was first discussed at a political level by Presidents Ozal of Turkey and Elchibey of Azerbaijan in 1992. As Turkey's grander ambitions in the region began to fade and the Caspian oil boom picked up steam, the Baku-Ceyhan pipeline project increasingly became the core of Turkish policy towards the Caspian region and indeed an important priority of Turkish foreign policy overall.

The justification for the Turkish emphasis on the Baku-Ceyhan pipeline has three components<sup>24</sup>.

- First, Turkey has come to see the pipeline derby as a proxy for strategic competition in the region and ultimately the main determinant of Turkish political influence in the Caspian. For the Baku-Ceyhan pipeline to be built would at very least represent the symbolic fulfillment of its activist foreign policy vis-a-vis the region; at most it could create a long-term economic and political bond between Turkey and the Turkic states.
- Economic interests are the second factor driving Turkey's support for Baku-Ceyhan. The pipeline's construction would generate some business for Turkey's dynamic construction and engineering sector. Meanwhile the state budget would receive transit fees from users of the pipeline. "Access to oil supply" is sometimes cited as another reason for Turkish interest in the Baku-Ceyhan project, but this is a less important driver as Turkey has ready and secure access to Middle Eastern oil supplies.

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<sup>21</sup> It is difficult to speak of Turkey having a co-ordinated and consistent policy on energy issues. There are too many players on the energy scene, each preferring to go its own way. Influential people and groups on this issue include the president and Prime Minister and their offices, the Energy Ministry, the Foreign Affairs Ministry, the State Planning Organisation, the state-owned Pipeline Company (BOTAS), the Turkish Petroleum Corporation (TPAO), various Turkish construction companies and finally the National Security Council. When former President Demirel asserted that Turkey should not lose time and that the next two years would be very important, he was actually complaining of this "mess of decision-making procedures," and there he was right on target. Turkey had conducted no serious research on the questions at hand, but rather has developed a policy of "slogans."

<sup>22</sup> Temel Iskit, "Turkey: A New Actor in the Field of Energy?" *Perceptions*, I, no. 1 (March-May 1996).

<sup>23</sup> "Economic Potential Undermined", *Petroleum Economist*, July 1999, p.14.

<sup>24</sup> For this section, the author benefited considerably from the views contained in "*Turkey and Eurasia: Opportunities and Risks in the Caspian Pipeline Derby*", Vol. 54, No. 1; Pg. 217-236; Laurent Ruseckas, CERA, 2000.

- The third and most complex reason for Turkey's support of the Baku-Ceyhan pipeline is related to its deeply felt environmental concerns regarding the passage of oil tankers through the Turkish Straits. To pass from the Black Sea into the Aegean Sea and the Mediterranean beyond, ships must pass through two narrow straits, the Bosphorus and the Dardanelles, as well as the Sea of Marmara. Should pipelines for Caspian oil terminate on the Black Sea rather than the Mediterranean, the number of oil tankers transiting the Straits and particularly the Bosphorus would grow significantly<sup>25</sup>. Occasional accidents have served to emphasize the ongoing environmental risks of the passage, most disastrously in 1979 when a tanker ran aground and spilled nearly 100,000 tons of oil-more than twice the volume spilled by the Exxon Valdes ten years later in Alaska.

### **Caspian Economics Prevail over Geopolitics**

A number of signs point toward the possibility that the regional political context in Central Asia, and the Caucasus may undergo some subtle but significant changes over the course of the next year or two. It is undeniable that Moscow's show of force in Chechnya and the image of vitality and effectiveness presented by Vladimir Putin have affected the way that Russia is perceived by the Caucasian states. Azerbaijan has taken a few subtle steps away from the unrestrained anti-Russia and pro-US (and pro-NATO) stance it had previously displayed, and the same is arguably true to a limited extent in Georgia as well. These two states continue to see Russia as a threat to their independence-but as a threat that must be dealt with subtly. Their partnership with Turkey and the US in what might be called the "Baku-Ceyhan bloc" is not immediately threatened, but both Azerbaijan and Georgia are recognizing that more flexibility and balance will be required in their relations with the new Russia. If Putin and his team manage to offer not only threats but also the possibility of tangible benefits to these two states, then they have a fair chance of at least limited success as they seek to rebuild Russia's influence and stature in the Caucasus.

If Moscow's policies in the South Caucasus turn more aggressive without becoming any more subtle or constructive, then Russian actions could prompt a serious increase in regional tensions. Similarly, the presidential succession which lies in Azerbaijan's future is not likely to go smoothly, and the potential succession crisis could conceivably draw in neighboring powers, mainly Russia, Turkey and Iran. Turkey has demonstrated its capacity for restraint and composure during times of international crisis, and these qualities will be important in the Caucasus<sup>26</sup>.

Over time, a wide range of forces and crosscutting relationships will work to counteract today's polarization and weaken the current regional blocs. Falling into this category is a long list of potential sea changes, none of which are guaranteed but all of which will become increasingly possible over time: a more constructive and less threatening Russian policy in the Caucasus; US-Iranian rapprochement; a warming of relations between Turkey and Russia driven by further growth in economic ties; a growth in Armenia's sense of unease over its political dependence on Russia coupled with the possibility of Turkish-Armenian rapprochement; a lower level of US engagement in the region; and greater involvement by the European Union coupled with the EU's growing pull on Turkey. These are significant changes, and some of them might be unsettling to Turkey at first. But in the long run, it is in Turkey's interest to see a multilateral geo-political balance in the Caucasus take the place of today's blocs and a playing field where Turkish co-operation with Iran, Armenia and especially Russia can be freed from any political constraints.

Meanwhile, a new administration in the US could bring a review of US policy toward the Caucasus and toward Caspian energy development. A consensus is beginning to take shape in Washington that it is a propitious time for such a review. There are also the signs of a more active approach toward the southern

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<sup>25</sup> While the very largest supertankers do not attempt this passage, there is currently considerable traffic in somewhat smaller (though still large) tankers, with a capacity up to about 120,000 dead weight tons. Ten to fifteen fully loaded tankers of this size or smaller transit the Bosphorus each week.

<sup>26</sup> "Turkey and Eurasia: Opportunities and Risks in the Caspian Pipeline Derby", Vol. 54, No. 1; Pg. 217-236; Laurent Ruseckas, CERA, 2000.

tier of Eurasia on the part of the European Union. This has special consequence for Turkey now that it has been put back in the queue for EU membership. The foreign policy apparatus of the EU is immature, and while the Caspian region is recognized as an area where EU interests are engaged, it is far from being a top priority. Still, over time the EU can be expected to play an increasing role in the region, and to pursue a policy that blurs regional divisions rather than reinforces them. Today, Turkey still sees the US, rather than the EU, as its chief partner in the region; but as the EU engages, the US re-focuses, and Turkey grows ever closer to the EU, this could slowly change.

In terms of its policies toward Caspian energy, Turkey already has a good model to follow: the approach it has taken thus far (for the most part) toward the question of natural gas. Given the great significance of new gas supplies to the Turkish economy, policymakers recognized early that they could not afford to politicize the issue. The same approach should now be adopted for Caspian oil. Turkey has done all it can to support the Baku-Ceyhan project, and its efforts have given the project a very solid chance at viability despite a number of geographic, geological and economic obstacles. Now the focus is where it should be: on the daunting commercial challenges that are inherent in the financing and construction of expensive, trans-border pipeline infrastructure.

### **The New Activism in Turkish Foreign Policy<sup>27</sup>**

Turkey's playing an active role in Caspian energy politics is closely related to its new foreign policy approach that considers energy security in the region as a top national interest. Throughout the Cold War, Turkish foreign policy was typically insular and passive. Turkey focused its energy on internal development and sought to avoid foreign tensions that could divert it from that goal. It remained neutral during almost all of World War II, joining the allied side only in the war's waning days with the outcome already decided. In joining the Gulf War coalition, Turkey broke several of its long-standing taboos. It took sides in a Middle Eastern dispute and assumed a war-like posture on its borders for the first time since a brief period of tension with Syria in 1957. It forged a strategic partnership with Israel.

The activist trend in Turkish foreign policy since the Gulf War includes both a wider scope for imaginative diplomatic initiatives and a greater preparedness to use or threaten to use force. Preoccupied as it is with fighting a Kurdish separatist insurgency since 1984, Ankara is far from adventurist in its foreign policy. It continues to try to use diplomacy and multilateralism, as far as possible, to promote stability and prosperity in its various regions. Most manifestations of its assertiveness are in the realm of diplomatic initiative, not the use of force. Its activism is a measured activism.

Whereas during the Cold War Turkey's foreign and security policy outlook was relatively circumscribed and naturally dominated by the country's role in the containment of Soviet power, the last decade has witnessed a sweeping enlargement of the country's external horizons. The notion that Turkey's interests and potential influence stretch from the Balkans to western China has proven quite realistic, even if some of the early assumptions about Ankara's role in the newly independent Turkic republics of Central Asia proved somewhat overblown.

Turkish policy interests and initiatives mirror this expanded concept of Turkey's security space. Recent examples include defending the welfare of Turkish residents in Germany, and more active diplomacy in the Caucasus. The rise of Turkish nationalism and closer attention to sovereignty questions as political forces within Turkey have led Ankara to vigorously defend its interests in recent years. The most impressive examples in this regard have included the use or the threatened use of force beyond Turkey's borders. Ankara credibly threatened to attack Russian-supplied S-300 surface-to-air missile sites if the system was deployed on Cyprus; the missiles were not deployed. Turkey made clear its willingness to act

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<sup>27</sup> Extensive use has been made here of the article by Alan Makovsky of the Washington Institute *SAIS Review*, Winter-Spring 1999.

against Syria if Damascus did not end its crossborder support for the Kurdistan Workers' Party (PKK) and expel the PKK leader, Abdullah Ocalan; Ocalan left and Syrian support for the PKK essentially ceased. In their counter-insurgency campaign against the PKK, Turkish forces have for some time engaged in extensive cross-border operations in northern Iraq and have established a de facto security zone in the region. With the important exception of the 1974 Turkish intervention in Cyprus, these assertive actions would have been difficult to imagine in previous decades and under Cold War constraints.

During the Cold War, Turkey's strategic importance to the West turned on the country's role in the containment of Soviet power but the West now values Turkey's geo-strategic significance in different ways. Notwithstanding Western opinions, and despite the fact that Turkey no longer shares a border with Russia, Ankara continues to view Russia with concern. A long tradition of Russian-Turkish competition contributes to Turkish unease, and reinforces more modern worries about Moscow as a geo-political competitor and source of regional risk<sup>28</sup>. Two issues stand out in this regard.

- First, there is a possibility that a resurgent and more assertive Russia would find new spheres for competition with the West, outside the center of Europe, on the Balkan and Middle Eastern periphery. Competition along these lines, which could, for example, take the form of increased Russian transfers of military technology to Turkey's Middle Eastern neighbors, would directly affect Turkish security. Even more tangibly, a reinforced (and permanent) Russian military presence in the region would go against the limits on Russian forces set out in the Conventional Forces in Europe agreement. Turkish military planners fear that Turkey might be left to face such revived flank risks alone, as NATO focuses more heavily on other missions.
- Second, Turkey is exposed to spillover risks associated with instability in the Russian near abroad, along the lines of the crisis in Chechnya. Turkey worries that in the future it might confront sudden and large-scale refugee flows, arms smuggling and terrorism on its borders as a result of developments in or around Russia and the Black Sea region. Risks of this sort might also negatively affect the progress and reliability of new energy infrastructure projects (for example, the Blue Stream, Trans-Caspian and Baku-Ceyhan pipelines) that are important to Turkey's own energy supply and economic prosperity. Russia has emerged as Turkey's largest trade partner, largely because of Turkish energy imports. Quite apart from Russo-Turkish competition, Turkish security interests are therefore closely interwoven with developments across the Black Sea. The risk of friction with Moscow over regional policy has also encouraged a relatively conservative Turkish approach to developments in the Caucasus and Central Asia, where there continue to be opportunities for more active Turkish involvement.

Nevertheless, the Turkish-Russian relationship of today is far more relaxed than it has been for decades. Mitigating security concerns has been a boom in commerce. In the 1990s, bilateral trade and Turkish investment in Russia have shot upward. The Russian prime minister Mikhail Kasyanov's visit to Turkey in late October 2000 has not produced much in political terms, but economically it resulted in many important compromises. These include plans for electricity purchases from Russia through Georgia, co-operation in the defence industry, co-production of some weapons<sup>29</sup>, additional natural gas purchases through existing pipelines, an increase in bilateral trade volume and the settling of Turkish contractors' debts in Russia<sup>30</sup>. Despite some troublesome points, relations between the two countries currently seem to be on the right track. Kasyanov's words, "Turkey and Russia are not rivals but partners," also demonstrate that the two countries are determined to improve relations for the sake of regional stability.

<sup>28</sup> Sabri Sayari, "Turkey: The Changing European Security Environment and the Gulf Crisis," *Middle East Journal*, 46, no. 1 (winter 1992) p. 11.

<sup>29</sup> Turkey plans to spend some \$150 billion on weapons during the next 25 years and Russia is keen to win some of these lucrative weapons contracts.

<sup>30</sup> "Turkey and Russia Aren't Rivals but Partners", *Turkish Scanner*, October 2000

Iran's interests in the South Caucasus revolve around Caspian oil, its concern that Azerbaijan might subvert the internal ethnic Azeri population (who sometimes call the part of Iran they live in "Southern Azerbaijan"), and the chance to use Armenia's and Azerbaijan's territory as energy transit routes. Iran suggests that it can also act as a mediator in settling ethno-political conflicts. But after Iran mediated a cease-fire of the Nagorno-Karabakh conflict in May 1992, the Organisation for Security and Cooperation in Europe organized the Minsk Group to find a solution to the issue without Iranian involvement. The possibility of a Southern Azerbaijan issue becoming an international problem should be taken very seriously. Iran's northwestern province bordering on Azerbaijan is populated mostly by Azeri Turks identical to those across the frontier. There have been semi-nationalist movements in the province during past decades and some of the Iranian Azeris seek unification with Azerbaijan. Iran and Azerbaijan have normal relations and are in continuous dialogue. The Azerbaijani government discourages pan-Azeri nationalism. Still, a heightening of this issue could cause considerable friction some day.

During his October 2000 visit to Central Asia, the new Turkish President Ahmet Sezer gave signals of a change in Turkey's approach vis-à-vis its Central Asian cousins. The traditional policy adopted by Turkey towards these republics during the term of his predecessor was one based on rhetoric of brotherhood and personal relationships. Despite Turkey's wish to strengthen the ties with these countries, there have been few concrete results in practice. The new Central Asian strategy aims to foster more solid, institutional bases. A convergence of mutual interests will be actively pursued. President Sezer called for the institutionalization of relations in the region and mainly focused on the issues of security, military cooperation against Islamic terrorism and efforts to implement the energy projects to transport the petroleum and natural gas resources of the region to Western markets through Turkey. Over time, as a Turcophone elite inevitably replaces the current Russophone elite, Turkish gains are likely to be considerable. To what extent President Sezer's pragmatic Central Asian policy, aimed at institutionalizing relations and the promotion of mutual interests, will be successfully implemented and to what extent it will change anything in practice is something that remains to be seen. But it is certain for the time being that relations, which have soured over recent years now, seem to be getting back on track.

### **Good Governance and Caspian Finance**

Countries in the Caspian region have to recognise that, ultimately, most petroleum companies have the choice to invest their money elsewhere. Production costs of the region may be below those of the North Sea and Russia, but they are certainly higher than those in the Middle East, where some countries are sending enticing messages about foreign participation. Furthermore, it is not enough to produce the oil. It must also get to market. Central and Western Africa, where companies have for years had access to offshore reserves, will also be a major competitor for investment. Governments in the Caspian region that hope to attract production and transit investments must keep in mind that they are competing with other regions for investment funds. Political considerations that become too onerous could easily price Caspian oil out of the market.

The Caucasus and Central Asia were a hotbed of corruption and nepotism during the Soviet era, a trend that has continued even as the region became the energy industry's most promising frontier. The Caspian region possesses both remarkable mineral wealth and highly educated workforce, yet it received a mere \$5 billion of the \$150 billion invested in developing countries worldwide in 1999. Despite the Caspian's promise, Western firms recurrently cite corruption as the singular factor discouraging investment. Unchecked corruption has had political, economic, and security consequences for the region, as demonstrated by the 1999 diversion of 40 Soviet-vintage MiGs by high-ranking officials from Kazakh stockpiles to North Korea, allegedly for private gain.

Transparency International's 1999 index, which ranks countries by the number of reported experiences with corrupt officials, placed Kazakhstan at 84 out of a possible 99. Its neighbours Armenia and Russia ranked 80 and 82 respectively, while Georgia tied with Kazakhstan. Kyrgyzstan and Uzbekistan came in at

87, and Azerbaijan, which joins Kazakhstan at the nexus of the Caspian oil rush, ranked a 96. Interestingly, Azerbaijan edged only slightly ahead of energy-rich Indonesia and Nigeria on the index, illustrating that economic development and improved standards of living do not necessarily follow from hydrocarbon revenues<sup>31</sup>.

Against this background and given the region's dubious reputation as a hotbed of political intrigue<sup>32</sup> -- not to mention its lack of pipeline infrastructure --, raising finance for oil and gas projects in the Caspian region will always be tricky. Oil price fluctuations and financial crises in emerging markets only made matters worse, prompting bankers to think twice about funding projects in Azerbaijan, Kazakhstan and Turkmenistan. And now, a string of well-advertised exploration failures has prompted many to adjust their expectations of the Caspian's potential. For all this, the region still has its fair share of oil and development projects that need to be financed. For instance, the 14 biggest projects in Azerbaijan alone will require total investment of \$45-bn and that figure does not include export pipelines<sup>33</sup>. Even if many schemes fall by the wayside, the scope for project finance is potentially huge.

The EBRD and the World Bank's IFC have set out to prove that where there is a will there is a way: The two institutions have signed off in March 1999 a \$400-mn funding package for participants in AIOC. They will pump in \$100-mn each, with the remaining \$200-mn to be syndicated among commercial banks. Citigroup, Dresdner Bank and Societe Generale are acting as co-arrangers, each committing \$25 mn. The access of state oil companies in the Caspian region to commercial funds was dealt a serious blow by Russia's financial collapse in 1998. Arranging pre-export financing, a borrowing model much liked by Russian oil producers, has also been hard to do because most crude exports cross at least one other country and it is difficult to provide solid guarantees.

However, the sponsors of two competing projects to supply gas to Turkey are already on the hunt for finance, a key consideration that will largely decide who wins the race. Gazprom has secured the heavyweight backing of ENI for its Blue Stream project in return for granting ENI rights to 50 percent of the pipeline's capacity. The rival Trans-Caspian pipeline's cost can be substantially reduced if the gas pipeline construction will be combined, with construction of the proposed Baku-Ceyhan oil pipeline<sup>34</sup>.

Key conditions need to be met if the Caspian oil and gas projects will attract the much-needed foreign investments:

- Governments should redouble their efforts in attracting investment in the oil infrastructure, in particular for import and transit facilities.
- Procedures for granting investment rights should be reasonable, practical, transparent and based on published criteria.

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<sup>31</sup> Another recent study conducted by the European Bank for Reconstruction and Development (EBRD) confirms these findings. According to EBRD, 23 percent of firms doing business in Kazakhstan report frequent requests for bribes, a trend echoed in Russia and Georgia. In Armenia, 40 percent of companies surveyed reported frequent solicitations, while in Azerbaijan, 59 percent of respondents complained of incessant delays and charges requested to move business matters along. The EBRD study concluded that corruption incurs an unofficial "tax" of sorts on business ventures operating in the former Soviet territories, averaging between 4 percent and 8 percent of annual revenue.

<sup>32</sup> The recent escalation of the conflict in the northern Caucasus region of Dagestan threatens to engulf the Caspian region in yet another violent cycle of confrontation marked by the already present flight of a large number of refugees and displaced people. Similar to the Chechen conflict of 1994-1996, the events in Dagestan and the Russian military response to the situation pose challenges to the neighbouring countries of Georgia, Armenia and Azerbaijan. The geostrategic importance of the Caucasus to Russia as its vulnerable southern flank is compounded by the presence of the sole export pipeline utilised by Azerbaijan to transport its oil exports from the Caspian Sea's offshore reserves.

<sup>33</sup> "The Boom That Is Surely Coming (Some Day)", *International Petroleum Finance*, March 1999, p.8.

<sup>34</sup> "Shell: Turkmenistan gas, Trans-Caspian pipeline, PSG", *Caspian Oil Industry News*, 10 August 1999



- The investment climate should be buttressed by a stable and comprehensive framework of national law, including enforceability of contracts, debt recovery mechanisms and access to international dispute settlement instruments.
- Taxation systems should be clear, stable and non-discriminatory.
- As with all large infrastructure projects, and particularly in a region where investment remains risky and project costs uncertain, companies must ultimately make decisions on commercial grounds. The commercial risk must be assumed by the private sector, with governments setting the political, legal and regulatory framework and ensuring the enforcement of law.

### Conclusion

In the complex Caspian equation, energy security has to be balanced against economic feasibility. Too many pipeline routes would mean smaller economies of scale -- and greater expenses -- for each project. Into this balance one also must add political realities. Though oil companies may have little enthusiasm for political considerations, they deal with them every day. Those companies operating in the region recognize how important the Ceyhan pipeline is to Turkey and its allies, and they will give that due weight in finding an export solution. As for gas, there are clearly identifiable markets in Turkey, Bulgaria and Greece. Primary interest in the Caspian has focussed on oil, a flexible marketable commodity. But gas trade is now. How gas trade develops in the short term, initially into Turkey, will have substantial implications for how long-term, high-volume gas will flow in the future, and will influence shippers' attitudes about routes for incremental oil pipelines<sup>35</sup>. All the same players are involved. So much more of our creative genius should be directed at finding solutions to imminent gas trade challenges, which could ultimately ease the way for oil.

Although Turkey is undoubtedly an important player in the region, events today are being driven largely by other players. Competition between Russia, China and the US is shaping the geo-political environment, while energy development is proceeding primarily on the basis of the market realities reflected in the investment. Turkey's most sensible approach as politics and pipelines sort themselves out would be caution and moderation coupled with a focus on market-based economic co-operation rather than power politics. A policy along these lines would help to maximize the economic opportunities that the Caspian region offers to Turkey while minimizing the risks of instability and geopolitical confrontation. Meanwhile, Turkey should try to reach an understanding with Russia, Iran, the US and other external powers that explicitly rules out any direct intervention in the internal politics of the Caucasian states.

What is, in fact, required is a thorough review of all aspects of the Caspian pipeline policy, which will hopefully lead to the realignment of strategy to conform to commercial, as well as geopolitical realities. In this process, it is also important for the US, European nations and Russia to realise that a more self-confident Turkey is rather inclined to dig in its heels on what it views as its rights in regional disputes. A stronger, more activist Turkey has emerged and will strive to advance its national interests in tandem with those of its allies. As crucially located as it is, Turkey will therefore remain important to Western and Russian policy initiatives in the Caspian and Central Asia region. Its strategic partnership with the US, its prospective accession to the European Union, its historic, cultural ties, and geographical proximity to Eurasia and the Middle East all make Turkey an indispensable partner on all regional energy co-operation projects. The "Caucasus Stability Pact" that was proposed by former Turkish President Suleyman Demirel in late 1999 and has been well received by countries of the region and major Western powers could be an important step toward such a regional co-operation.

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<sup>35</sup> "Turkey and Eurasia: Opportunities and Risks in the Caspian Pipeline Derby", Vol. 54, No. 1; Pg. 217-236; Laurent Ruseckas, CERA, 2000.

