THE AFTERMATH OF BAKU-TBILISI-CEYHAN PIPELINE: CHALLENGES AHEAD FOR TURKEY

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Turkey's geopolitical location is crucial to diversify and secure the energy-transportation routes for the EU energy markets. However, the challenges stemming from the EU's energy policy, the geopolitics of Kazakh oil and Turkmen gas, and the increasing turbulence in Middle East are important to secure and diversify resources for the planned energy hub in Turkey. Rather than the EU members' individual initiatives, an external energy policy should be in place to carry out the planning and the financing of the required infrastructure in coordination with the on-going projects for an energy hub in Turkey. This article argues that there is no political determination to create a fully integrated internal energy market and a coherent external energy policy in the EU. In the lack of such a political determination not only the EU energy security strategy but also the planned energy hub in Turkey, emphasized as "strategic importance to the EU," will be undermined.

Keywords

Energy security, Turkey's energy policy, EU's energy strategy, the Caspian region.

Introduction

In the aftermath of the inauguration ceremony for the Baku-Tbilisi-Ceyhan (BTC) pipeline in July 2006, energy security remains to be a special topic in Turkish foreign policy. A major aspect of Turkey's energy policy is to become an energy hub, transporting oil and gas resources of the Caspian region, Russia, and Middle East to European markets.

However, the multi-dimensional energy strategy of Turkey faces some challenges in an increasingly tight and volatile global oil market. The war in Iraq, Hurricane Katrina, China and India's emergence as major energy importers, the dispute between Russia and Ukraine, and most

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recently the turmoil in the Middle East have contributed to the heightened fears about energy security.

This article aims to stimulate a policy debate by highlighting the challenges for making Turkey an energy hub to secure, stabilize, and diversify the energy transportation routes for the European Union (EU). The first section presents shortly the current pipelines and major projects to build the required infrastructure for such an energy hub. Section two analyzes the challenges to transform Turkey into an energy hub. Following these background sections, policy implications are discussed in section three. The article ends with a brief emphasis on energy security and the importance of Turkey's role as an energy hub.

Pipeline Projects to Build an Energy Hub in Turkey

The key premise of the pipeline projects is to secure, stabilize, and diversify the expanding energy need of Turkey. Although OPEC (Organization of Petroleum Exporting Countries) and Russia, particularly in gas, will continue to be the major suppliers to the global energy market for decades to come, the question is beyond handling any disruption of oil and gas supplies from producing countries. Today long-distance, cross-border pipelines are important to expand energy security and make an alternative to the many vulnerable chokepoints along the sea transportation routes.[1] Furthermore, the threat of terrorism, instability or a nationalist backlash in some oil and/or gas exporting countries, geopolitical rivalries, and natural disasters are the renewed range of vulnerabilities to protect the entire energy supply chain and infrastructure. Thus, Turkey's geopolitical location is crucial to diversify and secure the energy-transportation routes not just for the domestic market but also for the EU.

Within this framework, a major aspect of Turkey's energy strategy is to complete "the East-West Energy Corridor".[2] The east-west energy corridor essentially aims to transport the energy resources in the Caspian

[1] About 2/3 of the world crude oil and refined products move by tankers. Along the way, tankers pass through "chokepoints" or narrow channels. These are Strait of Hormoz (Oman/Iran, connects the Persian Gulf with the Gulf of Oman and the Arabian Sea), Bab-el Mandab (Yemen/Eritrea, connects the Red Sea with the Gulf of Aden and the Arabian Sea), Bosporus and Dardanelles Straits (Turkey, connects the Black Sea with the Mediterranean Sea), Suez (Egypt, connects the Red Sea and Gulf of Suez with the Mediterranean sea), Malacca (Malaysia/Singapore, connects the Indian Ocean with the South China Sea and the Pacific Ocean), and Panama Canal (Panama, connects the Pacific Ocean with the Caribbean Sea and the Atlantic Ocean).

[2] For official statement on Turkey's energy policy see Ministry of Foreign Affairs of Turkey. <http://www.mfa.gov.tr/MFA/ForeignPolicy/MainIssues/EnergyIssues/>

Sea region to Western markets by alternate routes bypassing Russian territory. The proven oil and gas reserves in the Caspian Sea region are as large as the North Sea oil reserves an important non-OPEC oil supply region while the total proven and estimated reserves exceed North Sea reserves. Thus, rich oil and gas reserves in Kazakhstan, Azerbaijan, and Turkmenistan could help diversify, secure, and stabilize world energy supplies in the future, as North Sea resources have done in the past. For example, significant oil and gas reserves in the North Sea were discovered in the 1960s; however, it emerged as a key, non-OPEC oil producing area after the 1973 oil crisis and embargo, and it helped considerably to stabilize world oil and gas markets.

A quick glance at the major pipelines and planned projects will shed light on the current status of strategic partnerships as well as the challenges to complete the east-west energy corridor.

(i)Baku-Tbilisi-Ceyhan (BTC) Crude Oil Pipeline: The inauguration ceremony of the BTC pipeline on July 13, 2006 was an important milestone for the east-west energy corridor connecting landlocked Azerbaijan to Western markets. Total capacity of the 1768 km long pipeline is 50 million tones of oil per year (or 1 million barrels a day). The final decision on the BTC pipeline and beginning construction required long negotiations between the conflicting interests of Russia, Iran, Turkey, and the Western oil MNCs.

The Azerbaijan government chose the BTC route that best met its interests on the basis of the results of the main export pipeline project feasibility study and within the geopolitical parameters of each option.[3] The Azeri leadership relied on the support of Turkey and the US to satisfy both the commercial concerns of the foreign oil companies and the regional stability required for the security of the BTC pipeline route. In fact, the importance of the BTC project for the foreign policies of Azerbaijan, Turkey, the US, and Georgia is demonstrated by the fact that it has been carried out despite changes in these countries' governments.

[3] The results of the study are summarized in S. Bagirov, "Azerbaijan's Strategic Choice in the Caspian Region," in G. Chufrin (ed.), *The Security of the Caspian Sea Region*, Oxford University Press, New York, 2001, pp. 178-194. For a detailed explanation on the political preferences of Azerbaijan on its policy regarding multinational corporations' investment in its oil and gas sector see P. Ipek, *Multinational Corporations' Investment in the Oil and Gas Sectors of Azerbaijan and Kazakhstan: Divergent Corporate Behavior in the Age of Globalization*, Unpublished PhD dissertation, University of Pittsburgh, 2003, Chapter 3.

(ii) South Caucasus (Shah Deniz) Natural Gas Pipeline (SCP): A pipeline to carry gas from Azerbaijan's offshore Shah Deniz field via Baku and Tbilisi, Georgia, runs parallel to the BTC oil pipeline for most of its route before connecting to Turkey's national gas pipeline grid at Erzurum, Turkey. The SCP will be completed by the end of 2007. Total capacity is planned to reach 6.6 billion cubic meters per year by 2009.

(iii) Trans-Caspian Oil and Gas Pipeline Projects: There are two trans-Caspian pipelines planned as part of the east-west energy corridor. One is the trans-Caspian Kazakhstan-Azerbaijan-Turkey oil pipeline. The trans-Caspian oil pipeline project aims at merging upcoming increased production from the offshore Kashagan fields of Kazakhstan to the BTC pipeline for export to Western markets starting in 2008.[4] The agreement signed between Kazakhstan and Azerbaijan on June 16, 2006, will allow for up to 500,000 barrels a day of Kazakh oil to be shipped by tankers from Aktau on the north Caspian Sea to Baku.[5] However, construction of a trans-Caspian oil pipeline is not included in the agreement.

The studies to build a trans-Caspian Turkmenistan-Turkey-Europe gas pipeline project have been underway since 1991. The Natural Gas Sale and Purchase Agreement between Turkey and Turkmenistan was signed in May 1999.[6] However, the project was halted mostly because slow-paced political and economic reforms under President Niyazov's authoritarian rule have caused the financial withdrawal of most major Western firms. Various protocols and memorandum of understandings were signed since then, but no development has occurred yet.

(iv) Nabucco Natural Gas Pipeline Project: The project aims to transport Caspian gas via Turkey to European markets. This route is planned to pass through Bulgaria, Romania, and Hungary to reach Austria; and later to other Western European countries. The Nabucco project secured political backing from the European Commission on June 26,

[4] The trans-Caspian oil pipeline has been planned to be built underwater from the port of Kirik located 76 km from Aktau, Kazakhstan, to the Azerbaijani terminal at Dyubendi, near Baku.
[5] G. Dinmore and I. Gorst, "Kazakhstan signs pipeline accord," *Financial Times*, 17 June 2006, p. 3.
[6] According to the agreement 16 billion cubic meters per year of Turkmen gas would be supplied to Turkey starting on 2002-2004. Under this agreement gas would be purchased at Turkey-Georgia border and Turkmenistan would take whole responsibility for the construction and operation of the pipeline section between Turkmenistan and Georgia. Since Turkmen authorities have not extended the mandate letter to the consortium that would lead the construction of the Turkmen section of the pipeline, the companies withdrew from the consortium.

2006.[7] According to the feasibility studies, the maximum capacity of the 3,300 km long gas pipeline will reach 31 billion cubic meters per year. The Nabucco project will be in operation by the year 2011.

(v) Turkey-Greece-Italy Natural Gas Pipeline Project: The project is developed as a result of the creation of South Eastern Gas Ring interconnecting gas networks of Turkey and Greece. An extension of the natural gas pipeline from Turkey to Greece to Italy by an offshore pipeline is planned according to the Natural Gas Sales and Purchase Agreement of the Turkey-Greece signed in December 2003. First gas delivery to Greece is planned to start by the end of 2006. Total capacity of the pipeline is 3-3.6 billion cubic meters per year to Greece.

(vi) Iraq-Turkey Natural Gas Pipeline Project: A frame agreement for the transportation of Iraqi gas to Turkey by a pipeline was signed in December 1996. However, the project was halted following the embargo imposed on Iraq by the United Nations under an "oil-for-food" program introduced in April 1995. There are considerations to revitalize the project in the long-term in the light of a progress towards a peaceful and stable Iraq. Turkey is revising the project's scope as "pipe gas to EU" and "LNG (liquefied natural gas) to US" markets.

(vii) Egypt-Turkey Natural Gas Pipeline Project: This project aims to diversify the gas supply sources of Turkey by an offshore pipeline from Egypt. The parties declared their intention in this regard by signing a protocol in February 2000. A final agreement would be signed if there were supply deficiency following the studies made by the board on supply-demand balance at BOTAS, Turkey's state petroleum pipeline corporation. However, this project was canceled after a long period of inaction.

Currently, technical and commercial feasibility studies have started for a brand new project to transport of Egyptian gas through Turkey to the European markets under a framework agreement between Turkey and Egypt signed on March 17, 2004. The new project plans to expand the Arab Gas Pipeline through Egypt, Syria, Turkey, and then to Europe. [8]

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[7] S. Wagstyl, "EU blessing for 3300km gas pipeline Dollars 5.8bn –Caspian project," *Financial Times*, 27 June 2006.

[8] For more information on the planned projects see Botas, Turkey. <http://www.botas.gov.tr/eng/projects/projects.asp>

The Challenges

Before an analysis of the challenges it is important to note the technical differences in the transportation of oil and gas, with the latter being a network-bound commodity with pipelines connecting at regional hubs near major demand centers. While crude oil can be transported by pipelines, railways, trucks, or tankers, natural gas is more difficult to transport. Natural gas may also be converted to liquefied natural gas form (LNG) and then shipped, but this is a relatively expensive and time-consuming process. Furthermore, oil is a strategic global commodity and can be stored for long-term use, whereas natural gas is dependent on pre-fixed markets or customers. Buyers are usually identified before a gas field is developed and a pipeline is constructed.

Thus, while the progress on gas pipeline projects largely relies on the pace of developing new markets or finding customers, increasing oil production is important to build oil pipelines.

Accordingly, the challenges stemming from the EU energy policy, the geopolitics of Kazakh oil and Turkmen gas, and the increasing turbulence in Middle East are important to secure and diversify resources for the planned energy hub in Turkey.

The EU's energy policy:

The EU is today the world's largest energy consumer without its own significant reserves. The EU imports 50 percent of the energy it needs and the projections predict that the dependence on imported energy will rise to 70 percent by 2030.[9] Furthermore, roughly half of the EU's gas consumption comes from only three countries (Russia, Norway, and Algeria).[10] On current trends, gas imports would increase to 80 percent in the next 25 years.[11] Thus, the Green Paper, a policy framework for the EU's energy security, acknowledges the urgent need to promote diversity of energy type, country of origin, and transit.

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[9] The EU energy consumption by fuel is distributed as 37% oil, 24% natural gas, 18% solids (i.e. coal), 15% nuclear, and 6% renewables. The European Commission, *Annex to the Green Paper, A European Strategy for Sustainable, Competitive, and Secure Energy: What is at Stake- Background Document*, Brussels, 2006.
[10] The European Commission, *Green Paper, A European Strategy for Sustainable, Competitive, and Secure Energy*, Brussels, 8 March 2006.
[11] Ibid.

The Green Paper identifies six priority areas for the European Council and the European Parliament to react on.[12] Among these priorities, enhancing security of supply in an internal energy market and a coherent external energy policy are especially appropriate for addressing the challenges for facilitating Turkey's role as an energy hub.

The EU is committed to creating a fully competitive internal energy market for electricity and gas. However, it is an ongoing process and the goals have not been sufficiently fulfilled yet. There are several problems to tackle. Two major issues are of special concern to Turkey's plans to become an energy hub. First, there must be an effective legislative and regulatory framework to overcome monopoly issues such as access to national grids and networks. Many markets remain largely national or dominated by a few companies.

Second, there is a need for new investment in infrastructure in gas markets. An adequate interconnection and access to new transport routes must be assured. Accordingly, in many member states, reserved capacity for former incumbents under long-term gas contracts must be freed up to foster investment in new transit routes such as trans-Caspian pipelines. In fact, a critical issue for developing the Caspian gas fields and building trans-Caspian pipelines is access to the EU energy market. The planned trans-Caspian pipelines will enhance supply and diversify transit routes for the EU energy market by interconnecting to the Turkey-Greece-Italy and the Nabucco (Turkey-Romania-Bulgaria-Hungary-Austria) gas pipelines.

On the other hand, a coherent external energy policy in the EU is essential to minimize vulnerabilities to the monopolistic nature of major energy suppliers particularly in gas.[13] There are already bilateral and regional level energy dialogues with supplier or transit countries, such as Russia, Norway, Ukraine, the Caspian region, the Mediterranean countries, the OPEC, and the Gulf Co-operation Council. However, the effectiveness and coherence of the EU's external energy policy is dependent upon the

[12] These six priority areas are energy for growth and jobs in Europe, an internal energy market that guarantees security of supply, tackling security and competitiveness of energy supply, an integrated approach to tackling climate change, encouraging innovation, and towards a coherent external energy policy. Ibid.

[13] The dependence on oil, gas, and coal could reach 90%, 70%, and 100%, respectively. For details of the EU members' energy consumption by type see The European Commission, *Green Paper, Towards a European Strategy for the Security of Energy Supply,* Luxembourg: Office for Official Publications of the European Communities, 2001, pp. 22-27.

creation of a fully integrated internal market for energy. Thus, the priorities for the construction of new infrastructure should be clearly identified and built into strategic partnerships with Turkey and the Caspian region.

The Green Paper acknowledges the need for "clearly identified priorities for the upgrading and construction of new infrastructure necessary for the EU energy supplies," notably new gas pipelines and LNG terminals. Therefore, the need to promote diversity of energy type, country of origin, and transit requires a coherent external energy policy enabling political backing for a coordinated approach to new investments in infrastructure in gas markets.

There is currently a lack of competition between gas suppliers and independent gas pipelines from the Caspian region. A strategic partnership, built on such an external policy between the EU, Turkey, and the Caspian countries will offer security and predictability for all sides by spreading the economic risks for new investments. Accordingly, it is the right time to establish an "EU-Caspian Energy Dialogue Directorate" under the European Commission similar to the EU-Russian Energy Dialogue Directorate.

Moreover, such a coherent external energy policy of the EU would have a greater value than what can be gained in a mercantilist race to secure energy supplies. Thus, rather than a zero-sum approach of "Great Game" policies, the EU and Turkey recognize the strategic partnership with Russia in energy security and the collaboration to build alternative pipeline routes to diversify and secure the EU energy markets.

The geopolitics of Kazakh oil and Turkmen gas:

The long-sought agreement between Azerbaijan and Kazakhstan on June 16, 2006 to pump Kazakh oil to the BTC pipeline is as important as the completion of the BTC pipeline bolstering the east-west energy corridor. However, the agreement should be interpreted cautiously.

Although Kazakhstan is a signatory of the Istanbul Declaration, signed during the Organization for Security and Cooperation in Europe (OSCE) Summit in November 1999 and endorsing the construction of the BTC pipeline, the substantial talks to start building a seabed pipeline to connect Kazakh oil to the BTC is on hold. The Kashagan field, which is the

biggest offshore oil discovery anywhere in the world in the last 30 years, is decisive for building the trans-Caspian pipeline. Agip Kazakhstan North Caspian Operating Company (Agip KCO, formerly known as OKIOC) estimated the field's recoverable reserves at 7 to 9 billion barrels of oil equivalent, with further potential totaling 9 to 13 billion barrels.[14] However, slow progress and disagreements in the Kashagan project make Kazakh political leadership reluctant to start building a trans-Caspian pipeline.[15]

Furthermore, in December 2005 the state-owned China National Petroleum Corporation (CNPC) inaugurated an oil pipeline running from Atasu, located in northwestern Kazakhstan, to Alashankou, in China's northwestern Xinjiang region. Initially, half of the oil pumped through the new pipeline will come from Russia because of insufficient output from nearby Kazakh fields.[16] This means closer Chinese-Kazakh-Russian energy cooperation, which is likely to put the trans-Caspian oil pipeline project into jeopardy. However, Chinese oil companies, with their supply-diversification efforts in the Caspian Sea region, face swift competition from Western companies and the US government, which have demonstrated a strong commitment to the east-west energy corridor.[17]

While China sees Kazakhstan as a safe source of oil, the perception of the Kazakh public on Kazakh-Chinese relations reflects a mixture of fear

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[14] The Offshore Kazakhstan International Operating Company (OKIOC) was formed in September 1998 to explore the Caspian shelf under a production-sharing agreement signed in November 1997. Italy's Agip/ENI, British Gas, Shell, a BP (UK)/Statoil (Norway) alliance, Mobil (US), Total (France) and Kazakhstan's KazakhCaspiShelf founded the consortium, each with a one-seventh interest. KazakhCaspiShelf sold its stake to Inpex Nord Ltd. of Japan and Phillips Petroleum of the U.S. in the fall of 1998. British Gas (BG) also decided to sell its 16.7% share of the field. In March 2005 after drawn-out negotiations, consortium members decided to redistribute BG's share, giving half to themselves and half to Kazmunaigaz. As of July 2006 the consortium members of Agip Kazakhstan North Caspian Operating Company (Agip KCO, formerly OKIOC) are: Agip/ENI (operator), Total, ExxonMobil, and Shell (18.52%), ConocoPhillips (9.26%), Kazmunaigaz (8.33%), and Inpex (8.33%).

[15] Costing approximately $29 billion to develop, the Kashagan field has presented particular challenges for the Agip KCO. Kashagan contains a high proportion of natural gas under very high pressure, the oil contains large quantities of sulfur, and the offshore platforms require construction that can withstand the extreme weather fluctuations in the northern Caspian Sea area. There has been slow progress on the field's development, thereby possibly delaying the start of production beyond 2008. N. Buckley and C. Hoyos, "Pipe dreams blighted by ice and taxes," *Financial Times*, 3 December 2005.

[16] US Department of Energy, EIA, *Country Analysis Briefs, Kazakhstan,* July 2005.
<http://www.eia.doe.gov/emeu/cabs/kazak.html > (access date: July 2006).

[17] In March 2003, the British Gas (BG) reached agreement with China's 2nd and 3rd largest companies, CNOOC and Sinopec to sell them each a half of its 16.7% share in the Agip KCO. However, most of the partners in the Agip KCO exercised their rights of pre-emption, whereby they were entitled to purchase BG's stake at the same price offered by the Chinese. Furthermore, in July 2005 if CNOOC had been allowed by the US government to acquire Unocal, an American oil company, the Chinese company would have also increased its stake in Azerbaijan.

and suspicion.[18] However, President Nazarbayev opted for the Kazakhstan-China pipeline as an extra oil export route to reduce its dependence on Russia.[19] Nevertheless, lacking in trained military personnel and technology, Kazakhstan is firmly in favor of strategic partnerships with Russia, China, and the US to maximize its security. Kazakhstan is pursuing a multi-vector foreign policy aimed at not favoring any power at the expense of the other. For example, Kazakhstan is a member of both the Shanghai Cooperation Organization (SCO) and the Collective Security Treaty Organization (CSTO). Likewise, Kazakhstan has participated in the NATO-sponsored defense cooperation initiative, Partnership for Peace (PfP) since 1994.[20]

Thus, Kazakhstan deliberately balances the influence of Russia and China with the regional security policy of the US, while avoiding a bold pro-Western policy given the geopolitical imperatives of living in between these two strong neighbors. Consequently, the Kazakhstan government is likely to continue its strategy of inclusion of Russia and China in energy cooperation.

There are also plans to connect Turkmen gas into the Azerbaijan-Turkey gas pipeline (South Caucasus –Shah Deniz- gas pipeline, SCP), if the Turkmen-Azeri dispute over the legal status of the Caspian Sea is resolved. At present, Turkmenistan is bound to export most of its gas through the Russian pipeline system. While Turkmen leadership is becoming frustrated with the given price far below world market levels, the international crisis about the nuclear proliferation in Iran does not help to increase the capacity of Korpezhe-Kurt Kui pipeline as a way to create another export outlet for the huge gas reserves of Turkmenistan.[21]

Despite the slow-paced political and economic reforms under President Niyazov's authoritarian rule, which made the majority of the multinational oil companies withdraw their investment from Turkmenistan,

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[18] I. Gorst and E. Tsui, "Kazakhstan flexes muscles over PetroKaz," *Financial Times*, 4 October 2005.

[19] Eventually, a sixth of Kazakhstan's total production could flow to China. However, the Kazakh government ensured that control remains with the state national oil company, KazMunaigaz, by increasing the stakes of this company in the PetroKazakhstan agreement with CNPC. For details see S. Blank, "PetroKaz: China's Difficult Search for Central Asian Energy," *China Brief*, 5, 23, 8 November 2005, pp. 5-7.

[20] In 2002 Kazakhstan joined the PfP Planning and Review Process (PARP).

[21] The Korpezhe-Kurt Kui natural gas pipeline, completed in 1997, was the first one to follow a non-Russian route from a Newly Independent State, Turkmenistan, to Iran. Turkmenistan has been able to supply Iran less than the capacity of the pipeline.

the heightened fears about energy security in the global energy market could create incentives to develop huge Turkmen gas fields and to extend the Azerbaijan-Turkey gas pipeline (SCP) to Turkmenistan.

Nevertheless, the demarcation of the Caspian Sea is crucial to bring Turkmen gas and Kazakh oil to the EU energy market independently from the Russian controlled pipeline network. Russia and Iran have contended that the Caspian is actually an inland lake and thus subject to joint control by all the littoral states. Azerbaijan, Kazakhstan, and Turkmenistan, however, have argued that the Caspian is a sea that should be divided into national sectors over which each state has exclusive sovereignty. [22] Nevertheless, all littoral states now favor sectoral division of the Caspian Sea. The issue is no longer whether the seabed should be divided but how that division might be accomplished.

In May 2003 Azerbaijan, Kazakhstan, and Russia concluded bilateral agreements with each other based on a Russian-developed principle known as the "modified median line."[23] Turkmenistan and Iran, meanwhile, refused to sign the May 2003 agreement. Iranian officials argued that the southern end of the Caspian constitutes a natural bay so a different baseline should be used.[24] Azerbaijan fiercely contests the concept of such a baseline and related claims on the offshore fields. Moreover, the differences between Turkmenistan and Azerbaijan remain unsettled.[25] Therefore, while the projects in the northern Caspian Sea are likely to move forward despite the lack of a comprehensive regional consensus, the extension of the SCP gas pipeline to Turkmenistan and the trans-Caspian oil pipeline project have been halted for the foreseeable future.

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[22] For the legal history of the Caspian Sea before 1991 and the positions of the littoral states between 1991-1999 see K. Mehdiyoun, "Ownership of oil and gas resources in the Caspian Sea," *American Journal of International Law*, January 2000, Vol. 94, No. 1, pp. 179-190; and C. M. Croissant, M. P. Croissant, "The Legal Status of the Caspian Sea: Conflict and Compromise," in M. P. Croissant, B. Aras (eds.), *Oil and Geopolitics in the Caspian Sea Region*, Praeger Publications, Westport, 1999, pp. 21-42.

[23] These three littoral states divided the northern 64% of the Caspian Sea into three unequal parts, giving Kazakhstan 27%, Russia 19%, and Azerbaijan 18%. US Department of Energy, EIA, *Country Analysis Briefs, Caspian Sea,* September 2005. <http://www.eia.doe.gov/emeu/cabs/Caspian/Background.html> (access date: July 2006).

[24] Iran, for instance, has set claim over the Araz-Sharg-Alov field in the Southwestern Caspian Sea. Since Iran threatened to use force in 2001 to evict BP-owned exploration vessels from the Araz-Sharg-Alov offshore fields, the beginning work on the field has been halted for now.

[25] For example, the lack of an agreement on maritime borders between the two countries has kept the Serdar/Kyapaz field from being developed.

Increasing turbulence in the Middle East

The progress on Iraq-Turkey and Egypt-Turkey natural gas pipeline projects are strictly dependent on the stability in the Middle East region. The historical case studies of cross-border natural gas pipelines demonstrate that it would be a mistake to expect a peace dividend from cross-border pipelines.[26] In other words, there is no evidence to support the analogy that a peaceful integration could be achieved in the region as it could in Europe starting from the European Coal and Steel Community and the Treaty of Rome in 1957. Prior to any interdependence via cross-border energy pipelines, peace and supportive democratic institutions must be in place in the Middle East countries.

Policy Implications

Overall, the prospects for overcoming the challenges should create neither euphoria nor despair. The completion of the trans-Caspian pipeline projects depends strictly on the development of long-term contracts and the pace of new infrastructure investment in the EU energy markets. Thus, the creation of an integrated internal energy market and a coherent external energy policy in the EU are vital steps to identify buyers before the Caspian region gas resources are extracted and pipelines are constructed.

Today some parts of the EU gas market are competitive and market driven, while other parts are regulated or contain significant monopoly or oligopoly elements.[27] Nevertheless, there is a need for political will beyond market incentives to complete a fully integrated internal market with the required new infrastructure and financing. For example, in order to foster investment in new transit routes, such as the trans-Caspian pipelines, long-term gas contracts with former incumbents must be regulated to achieve interconnectedness and third party access to pipelines.

A strong political will is also required in the European Council and the European Parliament to create a coherent external energy policy. Such a will is essential in enabling a coordinated approach to new investments in

[26] For a discussion see M. H. Hayes D. G. Victor, "Politics, markets, and shift to gas: insights from the seven historical case studies," in D. G. Victor, A. M. Jaffe, and M. H. Hayes (eds.), *Natural Gas and Geopolitics: From 1970 to 2040*, Cambridge University Press, 2006, pp. 319-356.
[27] For details see CERA (Cambridge Energy Research Associates), *Long-term Outlook for European Gas*, CERA Special Report: Cambridge, Massachusetts, July 2005.

infrastructure, in gas markets particularly. Rather than the EU members' individual initiatives, an external energy policy should be in place to carry out the planning and the financing of the required gas infrastructure in coordination with the on-going projects for an energy hub in Turkey.

Accordingly, the EU-Russia energy dialogue, the Euro-Mediterranean Energy Forum, and the South East Europe Regional Energy Market are the key policy instruments to facilitate an integrated internal market and a coherent external energy policy. However, the EU-Russia energy dialogue, which was launched in October 2000, deserves special attention, since Russia is a major gas supplier to the EU energy markets.[28] Following the agreement in March 2006 between Russia and China to build a gas pipeline and the continuing talks to build a pipeline carrying oil from Siberia to China, there were concerns raised by energy analysts whether enough gas capacity and oil exists in Russian fields to satisfy both Chinese and European gas markets and Chinese and Japanese oil pipelines.[29]

Thus, the major rivalry remains in the question of whether Kashagan's oil will completely feed into BTC, and whether Turkmen gas will be transported independently from Gazprom, the Russian state monopoly. Russia wants to ensure its strategic partnership with Kazakhstan not only to increase energy cooperation between Kazakhstan-Russia-China, but also to secure more gas from Central Asia to the Russian-controlled pipeline system.[30]

However, a true partnership between Russia and the EU should offer security paving the way for the necessary long-term investments required for new capacity and independent transit routes from the Caspian region. Furthermore, there is much needed collaboration between the EU and multinational firms to overcome market failures and monopoly of a Russian-controlled pipeline system since there is significant investment of European firms in the Caspian region.[31] The presence of Agip/ENI (Italy)

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[28] Russia provides 26% of the EU's natural gas demand, while the share of Russian gas in the EU's total natural gas import is 42 %.

[29] P. S. Goodman and E. Cody, "Russia Plays Gas Line to Feed China; But Fate Still Unsettled for Desired Crude Pipeline," *Washington Post*, 22 March 2006, p. D1.

[30] The two branches of the Central Asia-Center (CAC) gas pipeline, the main gas export pipeline from Central Asia, particularly from Turkmenistan meet in the southwestern Kazakh city of Beyneu before crossing into Russia at Alexandrov Gay and feeding into Russian pipeline system.

[31] For a discussion of the monopolistic nature of the energy sector and supply of energy as a public good with the consequence of the "free rider problem" that creates market failures see Yelena Kalyuzhnova, "The EU and the Caspian region: An energy partnership?" *Economic Systems*, Vol.29, No. 1, March 2005, pp. 68-69.

as an operator in the Kashagan project in Kazakhstan is particularly important to facilitate such collaboration. ENI's strategic partnership with Gazprom to develop joint projects in third countries and to conduct joint activities for the gas transportation system may have profound implications for decisions about spreading the economic risks and the choice of pipeline route.[32] It is also important to note that Russia has been reluctant to ratify the Energy Charter Treaty and the Transit Protocol, which entered into force in 1998, since it will allow the Caspian countries to use Gazprom's gas transit network to export their energy resources directly to the EU energy markets. Consequently, a new energy partnership between Russia and the EU should address a coordinated approach enabling the construction of new independent transit routes as well as access to existing Russian controlled transit routes to secure, stabilize, and diversify energy supplies for the EU energy markets.

On the other hand, the geopolitics of Kazakh oil and Turkmen gas highlights the importance of the political leadership in Kazakhstan and Turkmenistan and the discourse of their foreign policy. Although the immediate implications of Kazakhstan's participation in the BTC project, such as cementing a strategic partnership between Kazakhstan, Azerbaijan, Georgia, and Turkey, present an optimistic picture for strengthening the east-west energy corridor, there are unanswered questions about the trans-Caspian pipeline projects.

Despite the agreement of the Kazakh government, a construction of a trans-Caspian oil pipeline is not included in the agreement. Increasing production in the Kashagan project is decisive for building the pipeline. However, Kazakhstan's new tax regime and regulations for foreign direct investment, aiming to increase national control and revenues from larger oil output, accelerated the unwillingness of firms in the project to increase oil production.[33] Thus, slow progress and disagreements in the Kashagan

[32] Eni and Gazprom signed an agreement for their strategic alliance in February 1998. In the context of this strategic alliance, Gazprom and Eni have together developed the Blue Stream gas pipeline to transport natural gas from Russia to Turkey. The pipeline, completed in 2002, is made up of two pipelines each 385 km long and carries at full capacity, 16 billion cubic meters/year of natural gas, that cross the Black Sea from Dzhubga, Russia to Samsun, Turkey. Although the official inauguration ceremony was on 17 November 2005, the supplies of natural gas to Turkey started in February 2003. Eni also holds a 2% stake in the Caspian Pipeline Consortium (CPC), which owns and operates a pipeline to transport oil from the Tenghiz field, in Kazakhstan, to Novorossiysk, Russia on the Black Sea.

[33] For example, KazMunaiGaz must now own at least half of any production sharing agreement (PSA) and will act as contractor in all new offshore PSAs in Kazakhstan. Also, the introduction of a new tax structure in January 2004 included a so-called 'rent tax' on exports, a progressive tax that increases as oil prices grow. The new amendment to Kazakhstan's tax law has raised the government's share of oil income to a range of 65 to 85%, and

project make Kazakh political leadership reluctant to start building a trans-Caspian pipeline.

Nevertheless, a closer partnership between Kazakhstan and China should not be interpreted as a significant shift in Kazakhstan's foreign policy, but simply as a skillful diplomatic tactic of the Kazakh government to attract new investment into the economy as well as to increase oil production. President Nazarbayev opted for the Kazakhstan-China pipeline as an extra oil export route to reduce its dependence on Russia. Kazakhstan's geopolitical imperatives force the country to keep good relations with Russia and China as well as with the US and the EU, as counter balancing partners.

The investment of European and American companies in the Kashagan project, in fact, might represent an opportunity to facilitate a coordinated approach to carry out the planning and the financing of the trans-Caspian oil pipeline. Facing Chinese competition, the Western companies in the project and the US government already demonstrated a strong commitment to the east to west energy corridor. Thus, a coherent policy between multinational oil firms, the EU, the US, and the key transit country of Turkey should support the trans-Caspian projects. However, despite the European Commission's declaration pledging to work to "successfully complete" the Nabucco project, the commission does not perceive the opposition of Russia[34] to the project as a threat but as a useful alternative.[35] Consequently, there is an urgent need for political will in the European Council and the European Parliament to create a coherent external energy policy and to complete a fully integrated internal market with the required new infrastructure and financing.

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it has removed a clause guaranteeing investors a static tax rate throughout the duration of the contract. The new structure includes an excess profit tax, and limits foreign participation to 50% in each offshore project with no guarantees of operatorship. The other 50% will belong to KazMunaiGaz.

[34] Russian state owned gas monopoly Gazprom has been strongly opposing the Nabucco project. Gazprom competes with a planned extension of the Blue Stream gas pipeline under the Black Sea to Turkey. The extension would take Central Asian and Russian gas to Austria via Turkey and will allow Russia to supply Europe via an alternative to Russian supply network crossing Ukraine. In this case, Turkey will be a natural bridge between Russia and EU to transport more Russian gas into the EU energy markets. However, this will not achieve the diversification of energy supply sources but diversification of the Russian supply routes. In fact, Hungary's MOL and Gazprom signed a deal on June 21, 2006 to form a company to study the proposed extension of the Blue Stream gas pipeline. *Turkish Daily News*, "Hungary MOL, Gazprom agree to extend Blue Stream gas pipeline," 22 June 2006.

[35] S. Wagstyl, "EU blessing for 3300km gas pipeline Dollars 5.8bn –Caspian project."

Although Turkey is defined as "strategic importance to the EU" in the Green Paper, the lack of political determination undermines the EU energy security strategy and the planned energy hub in Turkey. Based on the extension of the relevant EU acquis, the Treaty establishing an Energy Community was signed in October 2005 by all the Balkan countries and the European Community. Turkey actively supported the Athens process leading up to the Energy Community Treaty. However, the adhesion of Turkey to this treaty and the application of normal transit conditions, in particular for gas, are dependent on the EU-Turkey accession process.

Lastly, the long-standing authoritarian rule of the leaders in Kazakhstan, Azerbaijan, and Turkmenistan, in addition to nepotism and corruption, could complicate the prospects for completing the east-west energy corridor. The re-elected or life-time presidents have all the means to consolidate their power. For example, the leaders take advantage of the geopolitical rivalry in pipeline routing, the strategic location of the region to fight the global war on terror, and the distributive nature of their state-building practices given the oil/gas led development in their countries. However, their failure to fulfill domestic economic and political expectations may result in instability in the region.[36]

The degree of authoritarianism and the influence of opposition parties, as well as the popular support the leaders receive from the public, vary between Turkmenistan, Kazakhstan, and Azerbaijan. While the leaders of Kazakhstan and Azerbaijan seem to be allowing slow and gradual democratic changes under their authoritarian rule, President Niyazov of Turkmenistan starkly differs from other leaders in Central Asia with a dictatorship cult that goes beyond any authoritarian rule.[37] Thus, connecting Turkmen gas into Turkey's energy hub is vulnerable to the unpredictable policy environment in Turkmenistan.

The existing relations between Turkey, the EU, the US and the Caspian countries include a constructive dialogue for democratization

[36] For a discussion see P. Ipek, "Challenges for Democratization in Central Asia: What Can The United States Do?" *Middle East Policy*, 14, 1, Spring 2007, pp. 95-106.
[37] OSCE/International Election Observation Mission (IEOM), *Presidential Election, Republic of Kazakhstan, 4 December 2005: Statement of Preliminary Findings and Conclusions*, Astana, 5 December 2005; OSCE/ IEOM, *Parliamentary Election, Republic of Azerbaijan, 6 November 2005: Statement of Preliminary Findings and Conclusions*, Baku, 7 November 2005; OSCE/ODIHR, *Republic of Azerbaijan, Presidential Election 15 October 2003OSCE/ODIHR Election Observation Mission Report*, Warsaw, 12 November 2003; OSCE/ODIHR, *OSCE Rappetour's Report on Turkmenistan* , Warsaw, 12 March 2003.

process and sustained economic growth. However, these issues require a long-term strategic agenda not limited to energy security and terrorism.[38]

Conclusions

It would be wiser for Turkey and the EU to engage the energy rich countries of the Caspian region in the emerging framework for energy security by recognizing two critical dimensions. First, not only Turkey and the EU but also Russia should recognize that the value of having regional network of trade and investment in energy markets is greater than what can be gained in a mercantilist race to access and transport energy supplies. Second, all countries should acknowledge the emerging concept of energy security to protect the entire energy supply chain and infrastructure rather than the old system, which focuses on how to handle any disruption of oil and gas supplies from producing countries.

Today, long-distance, cross-border pipelines are gaining importance in global energy trade. There are also many chokepoints along transportation routes of oil and LNG tankers that create particular vulnerabilities. Thus, terrorist threats and extreme weather conditions underline the emerging concept of energy security by demonstrating the need for collaboration among companies and governments, including energy, environmental, law enforcement, military, and intelligence agencies.

Consequently, Turkey's role as an energy hub is important for the emerging concept of energy security not only to secure new energy supplies but also to diversify long-distance, cross-border pipelines. It is time for the EU to demonstrate effective international leadership in tackling the common problems of energy security in partnership with Turkey. Additionally, the Caspian countries must take the necessary steps to facilitate a strategic partnership with the EU (i.e. an EU-Caspian Energy Dialogue Directorate) paving the way towards open and transparent energy markets in the region.

[38] For example, despite an increase in funding from the US for democracy assistance, the highest increase has been in the areas of security and in the economic and social (For details see Ipek, "Challenges for Democratization in Central Asia: What Can The United States Do?"). The EU's contribution to the social and economic development in the Caspian countries is undertaken by Tacis and Inogate programs.