

The Southern Corridor and Nabucco – A Promising Challenge for Caspian Countries

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1. Introduction

The hydrocarbon-rich post-Soviet countries of the Caspian Sea basin, such as Azerbaijan, Kazakhstan and Turkmenistan, as well as Uzbekistan, are facing a difficult choice: where should they direct the major streams of their hydrocarbon exports?

All four directions are at stake: the North, the traditional Russian route, which has gone awry lately with regard to some countries; the South, namely Iran, which historically, as a »hydrocarbon country«, has all the necessary infrastructure and offers attractive rates for hydrocarbon transit to world markets; China, which is rapidly conquering key positions in Central Asia and already importing gas from Turkmenistan via a newly built pipeline; and finally, Europe, an immense and, what is more, reliable market, which by any estimation is profitable and alluring.

It is always the case that the wider the choice the more difficult it is to make the correct decision. That is why almost all of the abovementioned countries presently find themselves at a »crossroads« and have not yet decided on which principal route to opt for to sell their main natural resources. It is therefore fairly likely that we will see the Caspian countries develop all four options. Another reason for this is that they do not want to put all their eggs in one basket – as they had to do in the past with Russia – even a new basket, such as the European Union (EU). Indeed, each of these routes is problematic, and it seems that some of them currently present insurmountable challenges, which presumably will have to be solved by politicians of the next generation.

In this chapter, I shall explore the advantages and limitations of the European option for Azerbaijan and Turkmenistan. For these two countries, gas deliveries to EU customers are especially promising – due to their relative geographic proximity and huge reserves (see Table 1) – whereas they are less realistic for Kazakhstan and Uzbekistan. To enable Azeri and Turkmen deliveries is, however, also challenging since a number of hurdles have to be cleared from the path before gas can start flowing westwards.

2. Choosing the EU as a Customer?

Naturally, when a western orientation for Caspian gas deliveries to Europe is considered it is primarily the much-talked-of Nabucco gas pipeline that is meant (see also Brendan Devlin's and Katrin Heer's chapter in this volume). What, therefore, are the advantages and limitations of the western direction for gas transportation from the Caspian countries?

First of all, it should be mentioned that, historically and traditionally, Europe is the largest market in terms of demand for hydrocarbons, especially for natural gas. It is not by chance that all gas pipelines running through the territory of the former Soviet Union and contemporary Russia are directed from east to west towards Europe. Forecasts for the EU also confirm fast-growing demand for additional natural gas in both the short and long terms. Moreover, it should be noted that the countries of the European Union and Europe as a whole are likely to be the most reliable business partners of all possible consumers of natural gas from the Caspian Sea basin coun-

Table 1: Proven Reserves and Production of Natural Gas in the Caspian Countries¹

Natural gas	Azerbaijan	Kazakhstan	Turkmenistan	Uzbekistan
Proven reserves (2009) in trillion cubic metres	1.31	1.82	8.10	1.68
Share of world total in per cent	0.7	1.0	4.3	0.9
Production (2009) in billion cubic metres	14.8	32.2	36.4	64.4
Share of world total in per cent	0.5	1.1	1.2	2.2

1. BP (2010), Statistical Review of World Energy, p. 22, 24. Available at: http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/reports_and_publications/statistical_energy_review_2008/STAGING/local_assets/2010_downloads/statistical_review_of_world_energy_full_report_2010.pdf (accessed on 27 September 2010).

tries. This is especially noticeable when the new partners for purchasing of natural gas from Central Asia, such as Iran, China and Russia, periodically change contractual terms and even annul contracts, unilaterally suggesting alternative payment options, such as barter. European countries, most of which are members of the OECD, as a rule meet high standards of accountability and transparency and, in these terms, are reliable and, most importantly, predictable partners.

Also important is the attraction of European values for most countries of the East. They have become the key driving force in efforts to join the European Union in the aftermath of the disintegration of the Soviet Union. Although there is no intention on the part of the Caspian countries to become members of the European Union, the EU is regarded as an attractive institution. Public opinion in all of the abovementioned countries unambiguously favours the EU and European values. In this sense, considering the EU as a business partner always triggers a positive reaction among the majority of members of the national elite and civic representatives.

At the same time, the European route of natural gas delivery entails a number of limitations for the Caspian countries. First of all, there is a considerable geographical distance between the EU and the Caspian countries, especially the countries of Central Asia. Obviously, this circumstance makes the European route fairly unpredictable and high-cost. The unresolved issue of the Caspian Sea's status should also be taken into account. Given the uncompromising position of Iran above all, the project of a Trans-Caspian – that is, sub-sea – gas pipeline making it possible to deliver natural gas from Central Asia via Azerbaijan to the EU seems rather vague. In addition, there are some inconveniences due to the Nabucco pipeline's own architecture. Sometimes it seems that the European Union has not clearly decided on the importance of this project. The large number of countries which are to be connected by the Nabucco gas pipeline is a hindrance to obtaining a firm political decision on it. It seems that various EU countries have different attitudes towards the project. For some of them, such as the East European countries, it seems more important than for others (particularly France, Italy and some other older member states), which consider it to be non-essential. A lot depended on Germany's position, which only recently declared itself a strong supporter of Nabucco. As a result, a political decision on the Nabucco pipeline and a mech-

anism for its financing look unconvincing and even nebulous.

On the other hand, it is evident that some so-called authoritarian Caspian countries are not particularly eager to enter into negotiations on gas supplies to Europe, being aware of possible consequences with regard to human rights, freedom of speech and democracy, which will have to be met as counter-obligations. In this sense, it is much easier to cooperate with Russia, Iran and China, countries which are absolutely indifferent towards such values, considering them to be the internal affair of individual states. It is well known that human rights, freedom of speech and democracy are particularly burning issues in Turkmenistan and Uzbekistan, although Kazakhstan and Azerbaijan also face a number of problems in those areas.

The importance of the Nabucco gas pipeline varies in relation to different Caspian countries. Let us consider the motivating and obstructive factors for Azerbaijan and Turkmenistan.

3. Weaknesses of the Nabucco Project from Azerbaijan's Perspective

The Nabucco gas pipeline project was initiated not by the supply side, but rather by the demand side; more precisely, by a group of gas importing countries. This involvement on the demand side of financially stable importing countries can certainly be regarded as positive. However, although the importing countries can provide flawless gas delivery and guarantees for gas purchase at the terminal point, the gas necessary to fill the pipeline may be lacking. The quantity of gas needed to fill the Nabucco pipeline to full capacity is currently still lacking, despite numerous agreements and assurances on the part of the producers. The construction of the Baku-Tbilisi-Ceyhan crude oil pipeline in 2003 comes to mind, successful implementation of which is linked to the fact that it was initialised by an oil producing country – Azerbaijan – which proved able to complete construction rapidly due to support from the West, above all, the United States.

Another weakness of the Nabucco gas pipeline project is the special role played by Turkey, which is gradually becoming the energy hub of the region. A friendly and strategic relationship between Azerbaijan and Turkey is cer-

tainly beneficial for mutual understanding between these countries and clearly account for the interest of each of these countries in this project. However, something else is at stake. Due to the Nabucco pipeline project and the other transit projects of the Southern Corridor Turkey has an obvious advantage in setting the terms of hydrocarbon transit through its territory. Needless to say, such terms may not always suit other partners, including Azerbaijan and the countries of Central Asia. The disagreement and protracted negotiations on the price for gas from the Azerbaijani natural gas field Shah Deniz and the rates for gas transit through the territory of Turkey illustrate this. Fortunately, all these issues were successfully resolved in early May 2010. Now it can be hoped that the commercial relationship between the two countries will become a success. However, Turkey's competitive advantages with regard to gas transit to Europe and additional opportunities to participate in the Russian South Stream pipeline project further underpin its ability to dictate the terms of gas transit to Europe.

The third weakness of the Nabucco pipeline project is the rivalry it represents with regard to Russia. As the biggest natural gas producer in the world, Russia has its own interests in the region. Having used its »energy weapon« in the region as a club to beat Ukraine with in 2004, Russia obviously has a vital interest in securing its monopoly of natural gas supplies to Europe. In this respect, other players and alternative pipelines going to Europe collide with Russia's plans. That is why Russia is actively cooperating with the leaders of Azerbaijan on the maximum accumulation of Azerbaijani gas in the northern direction, offering attractive conditions to purchase all available gas. The fact that Russia is presently buying Azerbaijani gas at the highest price in the world of 244 US dollars per 1,000 cubic metres serves as proof positive of this.² Although the amount of gas being bought remains small, at 500 million cubic metres per year, Russia keeps urging Azerbaijan to increase it in order to minimise the amount of gas that Azerbaijan is able to ship to the EU.

2. RBK (2010), Dlya loyaly'nykh RF stran Gazprom snizil tseny na gaz, 3 June 2010. Available at: <http://top.rbc.ru/economics/03/06/2010/415719.shtml> (accessed on 27 September 2010).

4. Nabucco as a Stimulus to Azerbaijan

Europe remains the most reliable and commercially attractive destination for selling natural gas in the long run. Cooperation with the European Union has always been part of Azerbaijani policy. The natural gas business is no exception.

Azerbaijan is already in possession of an infrastructure for gas delivery to Turkey: the Baku-Tbilisi-Erzurum pipeline has been operating since 2007, and 9.1 billion cubic metres (bcm) of gas had already been pumped through by early 2010.³ The capacity of the pipeline (41 inches in diameter) is certainly not enough to meet the needs of the Nabucco project to its full extent, but, provided a successful solution can be found to all issues, beginning with pipeline construction within the framework of the Nabucco project using the existing infrastructure, the gas passage capacity of this corridor can be extended with much greater benefits and efficiency.

Azerbaijan's gas export policy can be expressed as follows: »diversify the diversification«. To put it another way, the Azerbaijani authorities have adopted and are successfully implementing the policy of securing maximum diversity of gas delivery routes. Consequently, nowadays Azerbaijan possesses four pipelines and exports gas in all directions: to the west, using the Baku-Tbilisi-Erzurum pipeline (5.2 bcm in 2009) and the Baku-Gardabani pipeline (less than 0.5 bcm per year); to the south, namely to Iran via the Hajigabul-Astara pipeline (0.5 bcm per year); and to the north, to Russia via the Hajigabul-Mozdok pipeline (0.5 bcm per year).⁴ Nevertheless, it is obvious that by creating a diversity of gas delivery routes the government initiates competition between potential buyers and gives preference to the most profitable direction. In this respect, the Nabucco pipeline project fits well into the abovementioned policy and participating in this project would benefit Azerbaijan. On the flip-side, however, this means that Azerbaijan will never wish to dedicate all of its gas to a single customer, including the EU.

Certainly, the recent package agreement with Turkey on gas gives Azerbaijan a mighty »carte blanche« for more active cooperation with the Nabucco project partners.

3. SOCAR presentation during the 17th Caspian International Oil & Gas Conference in Baku on 3 June 2010.

4. »Turan« and »Trend« information agencies.

5. Weaknesses of the Nabucco Project from Turkmenistan's Perspective

The fairly long distance between Turkmenistan and Europe is clearly a problem. Furthermore, the main Turkmen gas reserves are located in the east of the country, 1,000 km away from the Caspian Sea. A gas pipeline connecting the east to the rest of the country needs to be built on land in order to deliver Turkmen gas to western destinations. The recent decision by the Turkmen authorities to build such a pipeline without outside participation is controversial. Nobody knows the terminal point of delivery of the gas or its buyer, as the western border of Turkmenistan is not a point of sale, but rather an intermediate point of the gas transportation route. If this is a signal regarding the onshore route of gas transportation to Russia, why cannot the traditional Central Asia-Centre pipeline also be used successfully? At the same time, no positive signs can be discerned so far in the actions of Turkmenistan's political leadership with regard to the future Trans-Caspian route.

Another weakness of the Nabucco pipeline project is the continuing tension between Turkmenistan and neighbouring Azerbaijan which, ironically, is primarily the result of energy issues. The controversy over the Kyapaz field (in Turkmenistan this small oil and gas field right in the middle of the Caspian Sea is referred to as the Sardar field) is still not settled, and the undefined legal status of the Caspian Sea merely aggravates these antagonisms. Judging by the pace of the negotiation process and Iran's uncompromising stance, this stalemate is unlikely to be broken in the foreseeable future.

A third weakness of the Nabucco pipeline project, from Turkmenistan's perspective, is the low attractiveness of hydrocarbon-rich Azerbaijan as a transit country. It is common knowledge that the poorer a transit country is in hydrocarbon resources the more attractive it is for producers of raw materials to try to pump as much resources as possible over the territory of this transit country. The availability of natural resources in a transit country puts up »natural barriers« by creating competition for pumping hydrocarbons over its territory. Naturally, Azerbaijan, with large reserves of natural gas, is interested in pumping its own gas through the pipeline, and plans to export a total annual amount of 13 to 15 bcm of natural gas by

2025, during the second stage of the Shah Deniz project.⁵ Most of that volume could be provided to Nabucco. But does that mean that the most attractive time for Turkmenistan to join the Nabucco pipeline project will be after 2020, when Azeri gas supply is expected to start to fall?

6. Nabucco's Incentives to Turkmenistan

As for Azerbaijan, Europe is a very reliable and profitable long-term market for Turkmenistan. The Turkmen authorities understand this very well and are aware that being cut off from this large market is likely to mean remaining behind while the world progresses. Despite the long distance and some obstacles to the delivery of Turkmen gas to Europe this market seems very alluring.

Turkmenistan is also interested in diversifying its gas delivery routes to consumers. Turkmenistan's natural gas reserves are considered to be the fourth largest in the world. The entire gas transportation system of the country used to be linked to Russia via the Central Asia-Centre pipeline system. That is why even after independence Turkmenistan was dependent on Russia, which bought Turkmen gas at low prices and resold it on European markets at higher rates. In 1997, Turkmenistan built its first export gas pipeline, to Iran. However, despite the capacity of this pipeline – 8 billion cubic metres per year – Iran has never imported more than 6.5 bcm of the »blue fuel« from Turkmenistan.⁶

The highest level of gas production was achieved in Turkmenistan in 1989 (89.9 bcm). In subsequent years, natural gas production fell fairly rapidly. In the mid-1990s, annual gas production dropped to some 30 bcm. Natural gas production has gradually increased since then, however, reaching 70.5 bcm in 2008.⁷

5. SOCAR presentation during the 16th Caspian International Oil & Gas Conference in Baku on 4 June 2009.

6. Tehran Times (2009), Iran-Turkmenistan gas pipeline inauguration slated for late Dec., 15 August 2009. Available at: http://www.tehran-times.com/index_View.asp?code=200961 (accessed on 27 September 2010).

7. Natal'ya Grib (2010), Turkmeniya predpochla evropejskuyu cenu ob'emam eksporta gaza v Rossiyu, 11 January 2010. Available at: <http://www.kommersant.ru/doc.aspx?DocsID=1301816&ThemesID=188> (accessed on 27 September 2010); Nezavisimoe neftyanoe obozrenie Skvazhina, Neft' v mire – Turkmenistan. Available at: <http://www.nefte.ru/oilworld/s2.htm> (accessed on 27 September 2010).

This was linked to the fact that Gazprom was rapidly increasing its gas imports from Turkmenistan due to skyrocketing gas prices on European markets. However, the price fall of early 2009 resulted in the annual amounts of gas imported by Gazprom from Turkmenistan falling to around 10–11 bcm in 2010. It is widely believed that Gazprom, in order to avoid importing the promised annual 50 bcm at the agreed high prices or paying the penalty, induced the explosion in the Central Asia-Centre gas pipeline in April 2009. As a result, Turkmenistan's annual natural gas production fell by an unprecedented 44.8 per cent in comparison to 2008, totalling a mere 36.4 bcm.⁸

At the end of 2009, the Turkmen government managed to put into operation an export gas pipeline Turkmenistan-China. The second stage of this gas pipeline is currently under construction. However, the projected gas pipeline capacity of 40 bcm a year will not be realised before 2015. That is why Turkmenistan will scarcely achieve the production level of 2008 in the years to come. Turkmenistan is moving slowly but steadily towards multi-vector gas transportation, with a view to reducing its dependence on Russia. In this respect, the Nabucco pipeline project would fit perfectly into the geostrategic policy of the Turkmen authorities.

where needed in order to win over the Caspian countries from other competitors for gas resources. The EU should enter into an active and committed engagement with Turkmenistan as the long-term prospects of the Nabucco pipeline project look extremely vague without Turkmen participation. The European Union has considered Turkmenistan one of the major suppliers of hydrocarbons for Nabucco since the project's inception in 2002. However, the EU has so far failed to come up with concrete proposals, such as initiating financial support for infrastructural development, support for economic and legal reforms and other relevant programmes for the Turkmen side.

At present, Turkmenistan is steadily moving towards determining its external economic and energy benchmarks. The events of recent years demonstrate that, overall, they do not favour the EU. China is positioning itself in the energy area with more and more confidence, and natural gas is being supplied to three destinations: China, Russia and Iran. Turkmenistan is drifting further away from the western course. The EU is constantly losing leverage. Despite these difficulties, the EU has a real opportunity to get a foothold in Turkmenistan and to guarantee its own energy security by diversifying large gas supplies to the European market.

7. Conclusion

The examples of Azerbaijan and Turkmenistan show that, despite a number of problems, the Caspian countries are very interested in the Nabucco pipeline project in general. Given these circumstances, the EU has the task of creating competitive opportunities for these gas producing countries. Aiming at the maximum acceleration of these processes, ending the doubts of the gas producing countries and persuading them to develop the western hydrocarbon delivery routes, the European Union could take the following action.

First of all, the EU should demonstrate a united stand on the Nabucco pipeline project and its unanimous interest in this momentous project on the legislative, financial and political levels. This will inevitably give new impetus to potential gas suppliers and business partners in general. The EU should also clearly separate commercial interests from politics and offer a more competitive price

8. BP (2010), *Statistical Review of World Energy* (see footnote 1), p. 24.