Russia, Central Asia, and the Caspian: How Important is the Energy and Security Trade-off?

Martha Brill Olcott, Ph.D.
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By

Martha Brill Olcott, Ph.D.

Senior Associate
Russia and Eurasia Program
Carnegie Endowment for International Peace

Prepared in conjunction with an energy study sponsored by the James A. Baker III Institute for Public Policy and The Institute of Energy Economics, Japan

May 6, 2009
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ACKNOWLEDGMENTS

The Energy Forum of the James A. Baker III Institute for Public Policy would like to thank The Institute of Energy Economics, Japan, and the sponsors of the Baker Institute Energy Forum for their generous support of this program. The Energy Forum further acknowledges contributions by study researchers and writers.

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Russia’s position as a major energy supplier has great significance not only for its foreign policy but for its relationships with major energy-consuming countries. The nature of Russia’s future geopolitical role in world energy markets has become a major concern of international energy security with important implications for Europe, Japan, and the United States. Given a range of economic and geopolitical uncertainties, the fate of Russian and Caspian natural gas exports remains a major risk factor in global energy supply. For this study, researchers examined several scenarios for Russian and Caspian oil and natural gas production, possible export routes, and the geopolitics involved.

Study Authors

Joe Barnes
Stacy Closson
Jareer Elass
Peter R. Hartley
Amy Myers Jaffe
Kenneth B. Medlock III
Martha Brill Olcott
Nikolai Petrov
Lilia Shevtsova
Lauren Smulcer
Xiaojie Xu
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ABOUT THE AUTHOR

MARTHA BRILL OLCOTT, PH.D.
SENIOR ASSOCIATE
RUSSIA AND EURASIA PROGRAM
CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

Martha Brill Olcott is a senior associate with the Russia and Eurasia Program at the Carnegie Endowment for International Peace in Washington, D.C.

Olcott specializes in the problems of transitions in Central Asia and the Caucasus as well as the security challenges in the Caspian region more generally. She has followed interethnic relations in Russia and the states of the former Soviet Union for more than 25 years and has traveled extensively in these countries and in South Asia. Her book, Central Asia’s Second Chance, examines the economic and political development of this ethnically diverse and strategically vital region in the context of the changing security threats post 9/11.

In addition to her work in Washington, Olcott co-directs the Carnegie Moscow Center Project on Religion, Society, and Security in the former Soviet Union. She is professor emerita at Colgate University, having taught political science there from 1974 to 2002. Olcott served for five years as a director of the Central Asian American Enterprise Fund. Prior to her work at the Carnegie Endowment, Olcott served as a special consultant to former Secretary of State Lawrence Eagleburger.

Soon after 9/11, she was selected by Washingtonian magazine for its list of “71 People the President Should Listen To” about the war on terrorism.
Abstract

The current financial crisis and sinking oil prices have left Russia in a precarious position with depleted currency funds. At the same time, relations between Russia and the West have become tense over the Georgian conflict and the Ukrainian natural gas crises. Long-run implications of those events include increased liquefied natural gas (LNG) capacity in Europe, increased likelihood of new pipeline routes that bypass Russia, and significantly decreased value of Russian oil companies.

Given the reduced global demand for energy, Russia’s petro-state economy is projected to contract significantly this year. Major companies in the oil industry have debt issues, which will most likely curtail Russia’s oil production, despite Moscow’s decision to back several companies, because of the uncertainty of future investments in projects.

The financial crisis has also lost Russia some prestige on the international stage. Russia is no longer in a position to boldly challenge the leadership of Saudi Arabia in the oil market. On the domestic front, the loss of income from the oil and natural gas sector poses problems for those currently in power in Russia, potentially weakening the Dmitry Medvedev-Vladimir Putin power tandem and their political system. Russia now must focus on restoring domestic social welfare or rebuilding its international presence. Whatever Russia’s choice, it will have a great impact on the energy security of the rest of the world.

I. Introduction

This paper looks at the evolving relationship between Russia and its various Central Asian energy partners from independence to the present day. It explores the priority that Russia has given to creating a Russian monopoly on the transport of Caspian oil and natural gas resources, having been unable to create a dominant position for itself in the exploitation of these resources. The paper argues that Russia’s perception of its direct national interests has never wavered from the position that the “newly independent” post-Soviet states should and would naturally fall into a sphere of Russian interest; rather, the Kremlin’s means and capacities of implementing that
policy have evolved and strengthened over time. Although largely preoccupied with the challenge of holding Russia itself together, Moscow moved quickly and aggressively to maintain a monopoly over the existing export transport corridors, and then later to become stakeholder in exploitation projects on and offshore in the Caspian region. In recent years, when a more competitive environment has prevailed, the Kremlin has sought to retain control and acquire new assets through a combination of direct investment and, if necessary, linking energy policy to deliverables in the security sphere. However, unlike in the South Caucasus, where Russia is a stakeholder in the frozen conflicts that affect each state, Russia’s use in Central Asia of its security agenda to pursue energy sector goals has largely been achieved through promises of security assistance.

While the United States and European Union (EU) have been pressing for more than a decade to counter this Russian effort by opening alternative transport corridors for Caspian oil and natural gas to connect European markets, to date the only successes have been the BTE (Baku–Tbilisi–Erzurum) pipeline, which moves Azerbaijani natural gas to Europe but lacks the capacity to transport east Caspian natural gas, and the Baku–Ceyhan and Baku–Tbilisi oil pipelines, and whose operations are made vulnerable by Russia’s security standoff with Georgia. Small volumes of Turkmen natural gas can get through as a result of gas swaps across Iran. Russia is still transporting between 45–65 billion cubic meters (bcm)\(^1\) of gas annually, and is seeking to expand this capacity.

The only current challenge to Russia’s monopoly is China, which is developing a new trans-Central Asian pipeline system. The new Chinese pipeline network, originating in Turkmenistan and ending at the Chinese border, after crossing Uzbekistan and Kazakhstan, will initially move 10 bcm annually,\(^2\) expanding in stages up to 30 bcm,\(^3\) and potentially could move twice that capacity. Unlike Russia, China has succeeded, at least to some extent, in gaining guarantees of the output necessary to fill the new pipeline system. If the output from existing fields will not be sufficient to meet its purchase agreements, China has the right to develop greenfield projects as a joint license holder. Failing this, it could buy up existing output, further cutting back on gas

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\(^1\) This is equivalent to roughly 1,589–2,295 bcf.

\(^2\) This is 353.15 bcf.

\(^3\) This is 1,059.45 bcf.
targeted for Europe and giving the EU yet another reason to think about diversifying the group’s gas supplies.

While Russia retains a strong interest in monopolizing exploitation as well as transport of Caspian oil and gas reserves, to date Moscow has lacked the capital and at least initially the technology necessary to acquire a commanding position in the ownership of assets outside of Russia. However, at the same time, the Kremlin has secured majority control over every deposit of strategic importance in Russia itself. Russia has acquired some ownership of Caspian assets, particularly in Uzbekistan and Kazakhstan, albeit few major holdings in the former. Much like Russia, Kazakhstan has also been consolidating the position of its national oil company, which has been increasing its ownership stakes in that country’s strategic reserves. Kazakhstan’s three largest oil and gas projects, though, are under foreign control. To date, Turkmenistan’s assets are still almost entirely under state control, and Russia has only a small and indirectly held (through Lukoil) stake in Azerbaijan’s reserves and transport.

The large international oil companies still possess enormous cash reserves, and are interested in taking advantage of the currently depressed investment climate to cherry-pick assets of debt-ridden companies, be they private or national. However, as this paper details, it may be very difficult for the Western majors to increase their position in the Caspian region. Russia closely follows the evolving international relationships of the Caspian states, and Moscow has consistently sought to respond to each Western “incursion” as Russia would see it, with a response of its own. Many of Russia’s efforts have backfired and led the various Caspian countries to move closer to the United States and EU—though, for the countries of the eastern Caspian, the principle export routes for oil and natural gas still go through Russia. Russia has been a hard bargainer setting the terms of transport for both oil and natural gas, but over the last several years has been moving steadily to offering more of a market-based price structure.

Moreover, this change in relationship has occurred with very little use of threats from the Russian side. In the south Caucasus, Russia has used threats, and even a heavy military hand to deliver a message from Moscow. By contrast, in Central Asia, Moscow has used economic carrots and economic sticks. Unlike in the Caucasus, the way that the Central Asian states define
security threats has much in common with the definitions offered by the Kremlin. In almost all cases, the Central Asian states fear each other more than they do the Russians. For this reason, all the states but Turkmenistan, which continues to pursue a doctrine of “positive neutrality,” now are members of the Collective Security Treaty Organization (CSTO), the military alliance which Russia heads. This enables Russia to pursue a very different strategy in Central Asia than what has been applied in Georgia, or even in Azerbaijan. The worldview of these leaders is more in tune with that of the Russians, and the CSTO creates institutional guarantees for Russia’s exercise of soft power. Nonetheless, as the paper details, tradeoffs have sometimes been required between energy and security as Russia has pursued its desire to dominate the oil and natural gas trade in the Caspian region. In studying how the relationship between Russia and the Caspian has evolved in recent years, two important events must be taken into account: the death of Turkmen President Saparmurad Niyazov in December 2006, and Russia’s invasion of South Ossetia in Georgia in August 2008. The former provided an opportunity for Russia to see what it could get by offering carrots, and the latter made it obvious that the new political tandem of the Kremlin and the Russian White House (where the prime minister is located) was willing to apply the stick. This analysis ends with projections regarding how Moscow is likely to balance carrots and sticks in the coming year or two as both Russia and its Caspian and Central Asian neighbors try and manage the impact of the global economic crisis.

II. Background

The Russian leadership has always had a difficult time coping with the idea that the republics of the former Soviet Union (FSU) turned into independent and sovereign states. After the break up of the Union of Soviet Socialist Republics (USSR), the Central Asian republics were de jure free to choose their own fates with as little consultation with Moscow as their own leaders found desirable. Since the collapse of the Soviet Union, instead of accepting this new situation to be the future reality, the Kremlin has tried to convince these leaders, sometimes with carrots, and other times with sticks, that what Moscow wants for them is truly what they should want for themselves. And the Russian leadership has always enjoyed great support from the Russian public in this endeavor.
The peaceable breakup of the USSR was accepted by most Russian political insiders, as it brought with it the shift of power in the Kremlin from Mikhail Gorbachev, and his steadily diminishing coterie of associates, to Boris Yeltsin of the Russian Federation, then a subject of the USSR. By the time Yeltsin ascended to power in 1991 by dissolving the USSR to make the Russian Federation a sovereign state, his supporters included key elements in the military industrial establishment, who were a much more critical constituency than the young pro-reform democrats who were the public face that the maverick former communist from Sverdlovsk (Ekaterinburg) preferred. One of the relatively few ideas that these two groups agreed on was that all of the “newly independent” post-Soviet states, save the Baltic nations, should and would naturally fall into a sphere of Russian interest. All recognized (with varying degrees of anger) that the Baltic states, which had been late “acquisitions” by the Soviet authorities, enjoyed very strong international support in their desire to rapidly integrate with the rest of Europe.

However, in the early and mid-1990s the Russian leadership was relatively ineffectual in maintaining its sphere of influence beyond its borders. The one “success” story was that the post-Soviet republics and Caucasus countries joined the Commonwealth of Independent States (CIS). But, in effect, reformist elements inside the Russian government lobbied successfully for a policy that led to divorcing the post-Soviet states from the ruble zone, so that Russia could deal with its own economic problems without the burden of the debt and problems of the post-Soviet states. Although their economic fortunes varied, this meant that the Caspian states, once tethered to Moscow by a complex system of interlocking economic transactions, became disconnected from Russia and began to set up new foreign partnerships. Meanwhile, Russia was so mired down by its own growing economic and political problems that its leadership struggled to hold the Russian Federation together.

Yeltsin grew weaker with time, physically as well as politically, and became increasingly more dependent on Russian elites who had eschewed government service to soak up Russia’s vast economic wealth. This elite was a mix of new and older political actors (or their protégés), and their concern with the “Near Abroad” was to try and consolidate control over cheap assets there that might help solidify their newly found economic holdings in Russia.
Their ambitions fit well with the goals of Foreign Minister Andrei Kozyrev, who served between 1991 until 1996 and claimed Russia’s “Near Abroad” should be a sphere of Moscow’s influence. But despite some strong rhetoric, the policy was not well implemented, and Moscow did little to defend the sagging fortunes of the ethnic Russians living in many of these countries. The effectiveness of “Near Abroad” policy did not improve much under Yevgeny Primakov’s stewardship as foreign minister and prime minister (from 1996 to 1998 and 1998 to 1999, respectively), despite the fact that he was a strong supporter of the idea that Russia must be assertive about its own national interests.

In the 1990s, Russia’s state-dominated oil and gas companies had little prospect of amassing the capital to become majority investors in world-class development projects in Kazakhstan or Azerbaijan. Lukoil, Russia’s largest oil company, was able to acquire a small minority holding in several projects in these countries, but these were almost all legacies of its LUKArco joint venture.⁴ In the 1990s, Russia itself sought to attract foreign investors for prime onshore acreage, as well as soliciting foreign investment for the Sakhalin Island reserves.

During this period of relative weakness, the Russian government used a variety of means to control the flow of oil and natural gas westward from throughout the FSU. When the nationalist government of Abulfaz Elcibey refused to join the CIS, the Azerbaijani oil industry was effectively cut off from its access to the old Soviet pipeline system. This led Azerbaijan in 1992 to enter into discussions with Turkey for the construction of the Baku–Tbilisi–Ceyhan (BTC) pipeline. A letter of agreement between the two countries was signed in March 1993, shortly before Elcibey was ousted by Heydar Aliyev.

The Kazakhs ran into similar difficulties with the Russians early on as well, when the Kazakh government and Chevron tried to secure an agreement for the Caspian Pipeline Consortium (CPC) pipeline to move Tengiz oil to the port at Novorossiysk. It took from 1992 to 1996 to

reach a formal agreement, and then, until 1998, for the TEOC (technical evaluation) to be approved by Moscow. This was the first stage, without which this pipeline could not be constructed across Russian territory. Moscow’s continuing displeasure contributed to the slow implementation of the project, which was not completed until 2003. Russian interference in such projects was the driving force behind U.S. intervention to advocate for BTC and eventual Kazakh government interest in that pipeline route.

Turkmenistan initially had the smoothest relationship with Russia, given the carry-over of leadership. Starting in 1995, through the joint venture TurkmenRosGaz, the production of natural gas was effortlessly produced and marketed throughout the CIS through the trading firm ITERA. This agreement broke down in 1997, when Turkmen President Saparmurad Niyazov dissolved TurkmenRosGaz and Gazprom responded by refusing to purchase Turkmenistan’s natural gas. Sales were renewed in 1998, in a part-cash, part-barter arrangement directly between the Turkmen government and Gazprom. The management of the barter trade was of great personal benefit to some (reportedly Niyazov’s family among others) but certainly did not maximize earnings going to the state treasury. The Turkmen government routinely complained about how little cash they received, but President Niyazov would never fully commit to participating in a natural gas pipeline project to parallel the BTC line, to go from Baku to Erzerum via Tbilisi (known as BTE).

**III. Moscow Seeks a New Beginning**

When Vladimir Putin was handed the reins of power from Boris Yeltsin at the close of 1999, the state of Russian–Central Asian relations satisfied none of the major participants or key bystanders. The United States and Europe were making very slow progress—at best—toward accomplishing direct access to Caspian oil and natural gas reserves. Russia had a sense that it was soon going to be a question of now-or-never to maintain control over the transport of Caspian reserves. The Caspian states, meanwhile, were drawing closer to the EU, the North Atlantic Treaty Organization (NATO) and the United States—a development that was unacceptable from Moscow’s viewpoint.
Russia, Central Asia, and the Caspian

Russia was also pained by China’s increasing engagement and prospects that Central Asian oil and natural gas reserves might well be consolidated, at least in part, by China’s growing economy. The China National Petroleum Corporation (CNPC) secured assets in Aktobe, Kazakhstan, and appeared prepared to support the costly pipeline necessary to move the oil and gas eastward. But Moscow understood its options and knew that, while the export of Azerbaijani crude and natural gas appeared tied to BTC and BTE, the Central Asian export market was not yet lost.

Putin’s motivation to control the export and, if possible, the production chain of Central Asian assets was even stronger than that of Yeltsin and his team. Putin saw natural resources as a means of funding Russia’s own economic revival as well as its international resurgence. Central Asian reserves then provided Moscow with the cushion it would need to maintain its external market position while Russia’s energy industry was first reorganized and then new assets exploited in order to secure Russia’s position in the global energy market for the first half of the 21st century.

Putin’s first priority was securing Kremlin control over strategic decision-making in Russia’s own oil and natural gas sector, which he recognized as an enormous challenge. By contrast, the pathway to ensure long-term access to Central Asian reserves was less daunting, as it did not involve threatening the loss of licenses and trying to cajole or force private owners to turn over blocks of stock to state-owned oil and natural gas companies.

To consolidate control over Central Asian reserves, Putin initially used carrots—traveling to national capitals and generally striving to show respect toward the Central Asian leaders (all of whom were his chronological elders and, with the exception of Emomali Rahmon in Tajikistan, all had been in positions of responsibility decades longer than himself). Many of the Central Asian leaders took a personal liking to Putin, and all supported his take-charge attitude with regard to putting Russia’s own house in order.

Although there was no “harmony” on the energy front, things did improve from Moscow’s standpoint. A new marketing organization, KazRosGaz, was formed to move natural gas from
Karachaganak in Kazakhstan, creating the potential for securing a source of supply for Gazprom’s Orenburg refinery. The Kremlin also began strongly encouraging Russian firms to take equity stakes in projects in the Caspian states, with the implicit assumption that if these were not too commercially beneficial, they could expect to receive compensations elsewhere. In response, Rosneft increased its activity in the Caspian Shelf section, taking a 25 percent stake in a joint venture with KazMunaiGaz (Kazakhstan Oil and Gas, Kazakhstan’s state oil and gas company) to develop the Kurmangazy field in 2002, and originally setting the period for exploration from 2006 through 2011. Gazprom began to press more deeply into Uzbekistan, to help Tashkent ascertain the value of its unexplored assets and better utilize its aging fields. Gazprom also improved the terms of trade for transit of Turkmen natural gas across Uzbekistan in 2003.

While Moscow did not like the increased U.S. military presence in Central Asia, and especially the introduction of two U.S. bases that occurred in the aftermath of the September 11, 2001, terrorist attacks, the Kremlin made the best of the situation. Putin was able to press his Central Asian colleagues to make more concessions to Moscow in the name of balance and equity. Russia got a base in Kant, Kyrgyzstan, and some other smaller concessions from the Kazakhs and Uzbeks. This made deals like those described above easier to negotiate than would have been the case a few years previously, as the increasing Western presence made these states feel less vulnerable to Moscow’s pressure. Moscow was also quick to support Uzbekistan after U.S. and EU relations with the country soured following Tashkent’s brutal response in May 2005 to unrest in the city of Andijan. Not only was Moscow eager to capitalize upon the West’s disapproval, the Kremlin leadership also genuinely supported Tashkent’s actions against the armed (and unarmed) protesters, as did many of President Islam Karimov’s Central Asian colleagues. Moscow enticed Uzbekistan back into membership in the CSTO, and Gazprom signed an agreement on strategic cooperation with Uzneftegaz in December 2002. The agreement covers the purchase and transit of natural gas from 2003 to 2012 (the trade from which is purported to be at least partially under the control of Karimov’s daughter, Gulnara). A

2005 agreement covered transit of natural gas across Uzbekistan through 2010, a production-sharing agreement (PSA) for rehabilitating the Shakhpaty field and several other projects. Gazprom also reached agreements with Kyrgyzstan and Tajikistan to take controlling stakes in fields in both countries, which have natural gas reserves that are considerably smaller than elsewhere.

Kazakh–Russian energy relations remained mired over the issue of the expansion of the CPC pipeline, the only oil pipeline which crosses Russian territory that is not controlled by Transneft (the Russian state-owned oil transport company). As a result—and partly as a warning—the Kazakh oil and gas industry was moving toward closer integration with its Western oil and natural gas partners at an even more rapid rate, having finally signed a formal agreement in June 2006 with Azerbaijan to participate in the BTC pipeline project. In order to facilitate this, KazMunaiGaz in January 2007 entered an agreement with several international companies to construct the Kazakh Caspian Transport System, which would initially move 25 million tons of oil per year and eventually up to 38 million tons, first through a new pipeline to run from Eskene to Kuryk, then across the Caspian by rail from a new oil terminal, and then offloaded in Baku and sent through the BTC system.

So, the most important player for the success of Russia’s oil and natural gas sector strategy was Turkmenistan, which remained an erratic partner for Moscow. In 2003, Gazprom negotiated a 25-year natural gas purchase agreement with the Turkmen government in Ashgabat, which was designed to transform these transactions from part-barter, part-cash to cash-based commercial contracts, with provisions for periodic renegotiations of the purchase price. However, in 2005,

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Turkmenistan cut off deliveries for a few months in protest of what it described as unfair terms of trade.

Ironically, the West did no better with Ashgabat. There was some cooperation with NATO on transferring humanitarian assistance to Afghanistan and some limited posting of NATO personnel to handle emergency military landings, etc. But the combination of Niyazov’s increasingly erratic behavior and everyone’s uncertainty (including the Turkmen foreign minister) as to how to apply Turkmenistan’s doctrine of “positive neutrality” created serious constraints in the relationship. Niyazov continued to dither on the question of committing to an undersea TransCaspian pipeline to connect Turkmenistan’s (and through on overland link, Kazakhstan’s) gas to BTE. This, as well as the disorder of Turkmenistan’s own oil and natural gas industry, made Western investors reluctant to do more than offer periodic tepid feelers to Ashgabat. Lack of Western interest was one major reason why plans to revive the TAP (Turkmenistan–Afghanistan–Pakistan) natural gas pipeline project did not go anywhere, despite strong government support from all three parties.

Niyazov did behave decisively with regard to offers by Chinese oil and natural gas companies to buy and ship eastward 30 bcm\(^{12}\) of Turkmen natural gas annually through a pipeline that would potentially go across Uzbekistan and Kazakhstan—with the possible eventual doubling of that volume—and offered commitments to develop greenfield projects as necessary to meet this new capacity. Niyazov signed the protocols for the project in Beijing only weeks before his death in December 2006.

**IV. Exit Turkmenbashi**

Vladimir Putin quickly sought to take advantage of the potential opening created by Niyazov’s death. Putin did not attend Niyazov’s state funeral; instead, the Russian Federation was represented by the head of government, Prime Minister Mikhail Fradkov. Turkey, Pakistan, and Ukraine also were represented by their prime ministers; and the presidents of Kazakhstan, Afghanistan, and Tajikistan came. China sent the state counselor (and special presidential envoy),

\(^{12}\) This is equivalent to 1,059.45 bcf.
while Iran sent its foreign minister and vice president. The United States sent Richard Boucher, the assistant secretary of state for the region.

Putin held off meeting the new leader, Gurbanguly Berdymukhammedov, until after his formal election in late February 2007, seemingly allowing Turkmenistan’s elite to make their choice of who would succeed Niyazov before Moscow would choose to negotiate with him. Once accomplished, the Kremlin push began. Berdymukhammedov was received in Moscow in April, and this meeting was quickly followed by a one-week trip by Putin to Central Asia, which included visits to both Kazakhstan and Turkmenistan, and a summit for leaders of the three countries in Turkmenbashi on the Caspian.

Putin’s goals were to keep both Turkmenistan and Kazakhstan in the fold. Kazakhstan had been moving steadily forward in its plans to increase energy cooperation with both Azerbaijan and Georgia, and of course, the Kremlin was eager to have Turkmenistan’s new leader reaffirm his support for the 2003 natural gas purchase agreement and to set a firm price for the next year. Since the Ukrainian natural gas crisis of January 2006, both countries had been more actively pursued by the West.

The big news to come out of the May 2007 meeting was an agreement by Russia, Turkmenistan, and Kazakhstan to build a new pipeline to run along the Caspian coast, and to refurbish the smaller Soviet-era pipeline (no longer in use) that would lie alongside of it.13 The project, that is set to increase throughput capacity by some 12 bcm14 by 2012, is potentially inexpensive—especially if each partner funded its in-country construction costs. This is something that all of the Central Asian states have been reluctant to do because of the lack of guarantees that they will be offered commercially attractive prices from Russia long enough to get both payback and good profit. As a result, although various intergovernmental agreements to support the project have been signed, no firm commitments have been made on funding.

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14 This is 423.78 bcf.
Even before the international audit of Turkmenistan’s reserves was complete, accounts of newly discovered Turkmen deposits made it clear that there would be more than enough Turkmen natural gas to fill pipelines going north, south, east and west. In the short run, the announcement of this project took a little more air out of the balloon that the U.S.-backed TransCaspian pipeline might soon become a reality.

The Kazakh position had long been that it would likely support a land spur to join a pipeline originating in the Turkmen portion of the Caspian, and the hope of the United States was that Berdymukhammedov would support this idea. The Turkmen leader has been inching closer to this approach, maintaining that no options are foreclosed. Improved Turkmen–Azerbaijani relations made the prospect of creating a de facto undersea pipeline linking a number of Caspian shelf projects more plausible. The Turkmen–Azeri relationship improved steadily in 2008, with Berdymukhammedov making his first official visit to Azerbaijan in May of last year, foreshadowing a breakthrough on the disputed ownership of the Kapaz/Serdar offshore field, and increasing the likelihood that this project would be jointly developed by the two countries. Joint development of this project, which will be linked to Baku by a small offshore pipeline, would facilitate a small (8 bcm) pipeline linking offshore Turkmen and Azeri projects to each other, and then, in turn, to the BTE pipeline in Baku.

At the time of the Turkmenbashi meeting, the rapprochement between Turkmenistan and Azerbaijan was at its earliest stages, so the announcement of the new coastal pipeline—one which the Kazakhs seem to have worked hard to try to sell to the Turkmen as well—was viewed as at least a temporary blow to the United States and EU plans to supply not just BTE, but the Nabucco pipeline project as well, as the latter plan had been gaining momentum in Europe since January 2006, when supply to Europe was disrupted in a payment dispute between Russia and Ukraine.

On the eve of the Ashgabat meeting, Kazakh President Nursultan Nazarbayev agreed to Russia’s Bosporus pipeline bypass plans, which Moscow had set as a precondition for agreeing to CPC

16 This is 282.52 bcf.
expansion. Therefore, the Kazakh leader walked away from the Turkmenbashi summit thinking that now he was home free with this critical project, which, until the Kashagan field comes on-stream, is the single largest revenue producer for Kazakhstan’s oil sector.

However, shortly after the meeting, the Kremlin made quite clear that this was not the case, raising anew questions regarding future tariff and project debt. The Kremlin then added a tax claim against CPC. The end result was that the Kazakhs, remaining committed to the Caspian shore natural gas pipeline project, backed away from fast-tracking it. The Kazakhs have moved steadily forward with plans to substantially increase the freight capacity at the port of Aktau, a goal articulated in Kazmortransflot’s (Kazakhstan Maritime Transit Fleet) October 2008 publication of its 2008–2012 development plans, which call for the commissioning of five new 12,000-ton-plus oil freighters during 2009–2010.\footnote{17} And Chevron, as a major investor on both sides of the Caspian, is working with Azerbaijani authorities to improve port facilities on the Azeri side and then onward through BTC.\footnote{18}

The ball was then effectively left in Russia’s court, for now there was a risk that Moscow would lose the transit fees that CPC expansion would eventually produce. Conveniently for the Russians, the Omani put their 7 percent stake in the CPC pipeline up for sale in October 2008, which Moscow purchased, after having elbowed out the Kazakhs from a competing bid.\footnote{19} This left Russia as the largest single shareholder in the project, and, in December 2008, the Russians dropped their objections to CPC expansion, and expansion finally began moving forward in early 2009 with a target date of 2011 for its completion.\footnote{20} This occurred shortly after the CPC appointed a new board of directors.\footnote{21} Had the Russians not held this project up, BTC might have had trouble getting enough volume to justify its expansion, but now the project has commitments from both TengizChevrOil and Kashagan that at least part of their new production will be exported along this route.

\begin{itemize}
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Russia, though, has not been willing to take the same chances with its natural gas trade, and, for the last few years, the Kremlin has seen little alternative but to increase the income stream to the Caspian natural gas producers. Gazprom believes that by offering commercially attractive pricing, Turkmenistan’s natural gas will continue to flow through Russia, and that the Kazakh natural gas trade with Russia can be maintained as well. Moreover, Moscow holds out hope that attractive pricing might also get them part of the Azerbaijani natural gas trade.

While Moscow fears the long-term threat that direct sale of Caspian natural gas to Europe might pose to its position in that market, for now, its first priority is to counter the competition posed by China, which has offered long-term purchase agreements for Turkmen natural gas with a commercial formula that was initially pegged at just under $200 per thousand cubic meters (tcm)\(^22\) plus a transit allowance. This price will facilitate the flow of natural gas into a pipeline whose construction is in process. The “Chinese factor” is why the Russians offered the Kazakhs, Turkmen, and Uzbeks a new pricing formula in March 2008, which promised “European” prices for 2009, with a complicated averaging of Russian, CIS and European pricing, allegedly to compensate for transport costs that is intended to be in effect until 2028.

Originally, the three Central Asian countries had expectations of receiving upwards of $350 to $400 per tcm\(^23\) given what were then soaring European natural gas prices.\(^24\) But regardless, given the terms of the pricing formula, which Moscow continues to honor, their payments for the first half of 2009 will be much higher than the current wholesale purchase price of natural gas in many of the consuming countries.

It has been reported that the Uzbeks are being paid $305 per 1000 cubic meters,\(^25\) and that the higher purchase price for Uzbek natural gas appears to apply for all of 2009.\(^26\) Most of Uzbekistan’s natural gas is sold in-region at much lower prices than Russia offers. A bonanza for Tashkent is a fitting reward for its September 2008 agreement with Gazprom to cost-share

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\(^{22}\) This is $200 per 35,315 cubic feet.

\(^{23}\) $350 to $400 per 35,315 cubic feet.


\(^{25}\) $305 per 35,315 cubic feet.

repairs on parts of the existing Central Asia–Center natural gas pipeline network that was constructed in 1974, as well as a new parallel pipeline to supplement parts of it—a project that, should it be completed in full, would expand capacity through Uzbekistan from 45 bcm per year to between 80 and 90 bcm per year. Tashkent’s portion of the cost will be met by forward-sale of Uzbek natural gas, a model Moscow would like to see introduced elsewhere in the region. While Gazprom’s relationship to Uzbekneftegaz may be the closest of any with a Central Asian partner, the Uzbeks still periodically show displeasure with the pace of Russian investment in their gas industry. Gazprom complains about the dry wells it keeps coming up with in Uzbekistan, and Tashkent is at best an unpredictable ally of the Kremlin.

For example, several weeks after the agreement in Tashkent, the Uzbeks dropped out of the Russian-dominated EurAsEC (Eurasian Economic Community), which it had joined after Andijan. But, this not withstanding, Russian President Dmitry Medvedev came courting to Tashkent in January 2009, taking its side in a long-time dispute over Tajikistan’s plans to construct the Rogun hydroelectric station, much to its leadership in Dushanbe’s ire. This is a project that Russia’s RUSAL (Oleg Deripaska’s aluminum company) had been pushed out of in 2007. During the Medvedev visit, Karimov also offered to increase deliveries of gas to Russia, to send 16 bcm in 2009, and then to raise its exports to 31 bcm per year. For Uzbekistan to meet this latter figure, Uzbek production, now at roughly 60 bcm per year, would have to increase considerably, and most of the increased production would come from Uzbek–Russian joint ventures. Since 2006 Uzbekistan has been diverting more supply to Russia, but even the 16

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32 Sixteen bcm is roughly equivalent to 565 bcf and 31 bcm is roughly equivalent to 1,095 bcf.
33 This is about 2,119 bcf.
bcm can only be achieved by Uzbekistan reducing supply to its traditional Central Asian clients, most of whom are balking at paying more than $150 per 1000 cubic meters.³⁴

While Uzbekistan is important to the Kremlin, as the region’s largest and most strategically located state (bordering on all four of the other Central Asian states as well as Afghanistan), Tashkent’s importance to Gazprom is as much a pressure point for leverage on Ashgabat as it is a source. Tashkent has committed to export its gas exclusively through Russia, and the volumes of both oil and gas controlled by Lukoil from the Gissar and Kandim mean that Russia will increasingly share in the ownership of Uzbek assets as well.³⁵

Turkmenistan still remains the real prize. Ashgabat continues to upgrade its total reserves, buoyed by new fields that have been discovered in southeastern Turkmenistan,³⁶ which include the South Iolathan–Osman gas field, a field confirmed as one of the world’s top five deposits in an independent audit by Gaffney, Cline and Associates. This field is said to be able to gradually build to 70 bcm per year in production.³⁷ While Turkmenistan continues to talk with Western “majors” about the development of both onshore and offshore parcels,³⁸ Ashgabat has not been willing to offer these companies ownership rights or PSAs for those choice parcels which are located on land.

Moscow continues to hold out hope that it will be able to secure development rights to some of these deposits, which Ashgabat continues to withhold, announcing after a March 25, 2009, Kremlin meeting between Medvedev and Berdymukhammedov that the signing of such agreements was imminent.⁴⁰ Some of these deposits are to support the planned gas pipeline that

³⁴ $150 per 35,315 cubic feet.
³⁷ This is about 2,472 bcf per year.
is to run along the Caspian coast and that Moscow now terms the “East–West” pipeline. This pipeline is expected to cost between $1.2 and $1.5 billion to complete, making it the cheapest of the proposed new pipelines. It may also be the least necessary, needed only if Russia secures exploitation rights for gas deposits near its route. Economic cooperation between the two countries has deepened since Niyazov’s death, and Moscow is now training Turkmenistan’s gas and oil specialists in both Moscow and in country through programs designed by Russia’s prestigious Gubkin Institute of Oil and Gas. Yet it would be hard to describe the relationship as warm, particularly since a visa regime remains in place between the two countries and this is the only visa regime that exists between Russia and a Central Asian state.

While negotiating with Europe to ship gas through Iran (by swaps) and keeping open a conversation on Nabucco, Ashgabat seems to recognize that Turkmenistan’s short- and medium-term interest still lay more with Moscow than with any other country. The Turkmen leadership has done its bit to keep discussions on the Caspian coastal pipeline alive, offering in a January 2009 tripartite meeting that Ashgabat will even increase its planned contribution to the project.

V. Georgia and Beyond

It is interesting that Russia’s hand-holding exercise with Tashkent came after the events in Georgia in August 2008, and after Moscow pressed hard for the Central Asian states to fully back its actions, first at the Shanghai Cooperation Organization (SCO) meeting in August, and then a few weeks later at the CSTO summit. The Central Asian states, much to the displeasure of some in Astana, and probably most other national capitals as well, endorsed statements that lay all the blame on the Georgian side—although none would adopt Russia’s “support” of the independence of both South Ossetia and Abkhazia.

The Russo–Georgian war was the Kremlin’s indication that it was going to dominate the security relations in the “former Soviet space,” leaving unclear whether this would apply to Ukraine, Moldova, and Belarus. The signal to the three Caucasus countries, as well as throughout Central Asia, was unmistakable. Russia appears to recognize that all NATO member states are outside of its direct sphere of influence, but the Kremlin seems to reserve the right to be particularly sensitive to perceived threats coming from the “new NATO” states.

The Central Asian states appear, more or less grudgingly, to accept this new status quo. In the case of Kyrgyzstan, the fragile government of Kurmanbek Bakiyev was quite enthusiastic about throwing out the United States in return for increased assistance from Russia. In fact, the increasingly more unpopular Bakiyev may have seen the promised aid and lines of credit as the answer to a dream rather than neo-imperialist meddling on Moscow’s part. This would certainly be the case if the Russian offer included guarantees that Moscow would help keep Bakiyev in power.

The question of Azerbaijan is a more interesting one, and it seems that its president, Ilham Aliyev, is willing to receive all courters before he makes up his mind as to what the new Russian assertiveness could mean for him or for Azerbaijan’s national interest. Like Georgia, Azerbaijan has a frozen conflict of its own, in this case with a long-time Russian client state, Armenia. A cynical observer would say that Moscow’s actions “unfroze” the Georgian conflicts, for it is hard to imagine a short- or even medium-term scenario in which Russia withdraws and these territories are subsumed back into Georgia, even if all but nominally independent.

Now, in the Azerbaijani and Armenian conflict over Karabakh, it is Azerbaijan (like Georgia) that is struggling to regain its territorial integrity. So, theoretically, Moscow should—for consistency sake—continue to back Armenia. But one of the “niceties” of the Russian “school” of conflict resolution is that consistency is not as important a predictor of behavior as perceived national interest. It is clear that it would be in Russia’s national interest to secure Azerbaijan as a friend, and a good enough friend for Russia to pursue a coordinated energy strategy with the country. Some asset swaps between the two countries would be better still.
It might be pointed out that Heydar Aliyev, and now Ilham Aliyev, have been good friends to the West for over a dozen years, and have as their reward BTC, BTE, and a great deal of Western-funded infrastructure development. But the geopolitical winds can change, rulers can be fickle and friendships can form and reform to lead to intriguing combinations. Take for example, NATO member Turkey’s increasing closeness with Russia, which has gone so far that Turkey is now moving towards establishing normal diplomatic relations with Armenia (just as the United States seems on the verge of declaring the Armenian holocaust a form of genocide). This creates a new form of pressure on Azerbaijan to accept a settlement, and one in which any breakthrough seems likely to come from Turkey and Russia acting in concert, rather than from The Organization for Security and Co-operation in Europe (OSCE) Minsk group to which both are party. However, after accounts surfaced in the international press regarding Russia’s sale of some $800 million of arms to Armenia in 2008, Russia’s chance of substantial improvements in its relationship with Azerbaijan took a real hit.45

Russia’s policies in Azerbaijan highlight the “one Russia” problem that those writing inside of Russia point to more frequently than those outside of the country. Sometimes, Russia simply does not speak with one voice. This was the case before the emergence of a political tandem—in which Vladimir Putin took over as prime minister, a post in which he technically answers to Dmitry Medvedev, his protégé, who has now replaced Putin as president.

Even during the Putin administration—when power was more centralized—military and security forces often acted in ways that were to the detriment of Russia’s commercial interests, including its interests in the oil and natural gas sector. While it is fair to say that Gazprom does not act on issues that have national security implications without checking with the Kremlin, and with the president or the prime minister in particular, the chain of upward flow of decisions by Russia’s senior military people, and the heads of Russia’s almost entirely state-owned arms industry, is really quite different. They would not run purchases of tens or even a few hundred million dollars of weapons through Gazprom, and they would almost undoubtedly not run these

purchases individually through the Kremlin (especially if they were part of earlier drawn-up plans that went through the Ministry of Defense).

Now what does this mean for Central Asia’s oil and natural gas producers in the future? The question is whether or not Russia will continue to use a commercial carrot to obtain Caspian oil or natural gas, or—in a world where Moscow is not afraid to show force when it believes its vital interests are at stake—resort to sticks in the future?

This author contends that Russia’s invasion of South Ossetia changes very little for Moscow. Only Uzbekistan was willing to flaunt before the Kremlin its independence in the security sector, and now Gazprom is too important of a source of income for Tashkent for Karimov to do much flaunting. This does not guarantee that he might now offer a U.S. base in the future, but, if Karimov does, he would offer one to Moscow as well—and as that is the only way Moscow is likely to get a base in Uzbekistan, such an arrangement might be acceptable to both Moscow and Tashkent. The United States, though, does not appear interested in acquiring full basing rights in Uzbekistan, given the potential reaction in Washington to renewing close ties with its autocratic regime. Kazakhstan will not offer a base—as it would never agree to a Russian base on its territory—and Turkmenistan would not put its commercial relationship with Russia at risk any time soon (even if for improved security relations with the United States). Tajikistan is difficult to predict, and irrelevant to Russia’s oil and natural gas calculations.

Moscow will have very little motivation to use the stick in its energy relations in Central Asia. Unlike Georgia or even Azerbaijan, these states share a security agenda with Russia. The problems they have are usually commercial, and are caused by the fact that Russia needs to sell Central Asian natural gas to satisfy Russian commitments in the European market. Coming up on 20 years of independence for these states, Russian companies own very little of the current output of these countries, and efforts by Russian firms to increase their equity holdings will not gain them much more guaranteed supply for several more years. Even then, theirs will be a minority interest in projects. Therefore, Russia can only secure this supply through its purchase and transit.
In the past year, Russia has shown a willingness to pay higher prices for Central Asian natural gas, and increasingly Moscow controls both the prices for natural gas exported from the region, as well as much of Uzbekistan’s sales within the region. Because Russia will have even more difficulty doing its own large projects (since currently falling prices make it far too costly to develop many of the permafrost area natural gas projects that are slated to move into the exploitation phase in Russia proper), it will be even more dependent on Central Asian natural gas. This would be true even if Gazprom and Rosneft had a surplus of credit, which neither has due to the current financial crisis.

The good news, from Russia’s point of view, is that, while energy prices are low and Europe and the United States are in the midst of major economic crises of their own, the Central Asian countries may have little choice but to sell their natural gas to Russia. The United States and the EU may keep talking about new pipelines, but for the moment no one seems ready to allocate funds to build them (witness how the funds for exploratory technical work on Nabucco have already been spent on more pressing needs—most of them in the area of energy conservation and the development of renewable energy sources). Even the Chinese, with the pipeline from Turkmenistan already partly constructed, could decide to slow down these high-cost projects if Chinese internal demand drops as a result of the global crisis. The pipeline to China is estimated to cost $7.3 billion. It is being constructed by Gazprom subsidiary Stroytransgaz, and financed by China National Petroleum Corporation (CNPC) as well as by Uzbekneftegaz and Kazmunaigaz, and will not be ready to transport gas in 2009 as originally planned.

46 Since Gazprom’s purchase of a 75 percent stake of Kyrgyzgaz, the Uzbeks must deal directly with the Russians for sales to Kyrgyzstan, and Gazprom also helps set pricing in Kazakhstan. Bruce Pannier, “Gazprom Works to Advance Russia’s Interests in Central Asia,” Radio Free Europe Radio Liberty, October 19, 2008. http://www.rferl.org/content/Gazprom_Advances_Russias_Interests_In_Central_Asia/1331056.html.


49 Stroytransgaz does not appear to be responsible for this delay, which appears to be the result of the fact that construction on the 525 kilometer Uzbek section did not begin until June 2008, and that of the 4860 km Kazakh section until July 2008. The Turkmen section is only 188 km, and its construction began in August 2007. “Turkmenistan: Ashgabat Reveals That Gas Won’t Start Flowing to China in 2009,” Eurasianet, January 5, 2009, http://www.eurasianet.org/departments/briefs/010509b.shtml.
While most of the Central Asian world-class oil and natural gas projects are cheaper than those in Russia, they are not truly cheap, and a prolonged economic crisis (that might keep oil in the $20–$40 a barrel range) will certainly delay many of these projects, and leave the Russians in a better competitive position to buy the Central Asian natural gas than they have been for several years. In fact, for all intents and purposes, Russia is now subsidizing the purchase of Central Asian natural gas, meeting its 2009 purchase pricing agreements, even though this is seriously cutting into Russia’s margin in natural gas sales to Europe. Moscow is doing this, both to secure long-term access to these reserves, and equally importantly, to use the current phase of the financial crisis to deepen the dependence of the Central Asian states on Russia, and to create an interdependent economic space out of the FSU (excluding the Baltic nations).

While Russia may not ultimately have the financial resources to succeed, it is also the case that the United States and EU are very likely to find that their priorities lay elsewhere during the next few years at least, in Afghanistan and in securing the economies of the EU members and aspirants, respectively. So, if oil and gas prices sharply increase in the next few years, then many of the planned gas pipelines included in the appendix to this paper may well be built. For now though, the Central Asians have only one real outlet for their natural gas, through Russia, and the near certainty of China as the alternative, offering transport for relatively small volumes to start. For the other routes, the current planned opening dates are highly unlikely, as each planned pipeline lacks either funding for construction, an assured market, or natural gas to fill it. For now the question is not just when the market will change to create economic incentives for the development of these assets, but also when it does, whose capital will get to develop it—local capital, investment from the West or some sort of Central Asian partnership with Russia?

Appendix

<table>
<thead>
<tr>
<th>Proposed Pipeline</th>
<th>Export Capacity</th>
<th>Completion Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nabucco: Turkey-Bulgaria-Romania-Hungary-Austria</td>
<td>31 bcm/year</td>
<td>2015</td>
</tr>
<tr>
<td>Prikaspiisky: Turkmenistan-Kazakhstan-Russia</td>
<td>30 bcm/year</td>
<td>2015</td>
</tr>
<tr>
<td>Trans-Caspian: Turkmenistan-Caspian Sea- Azerbaijan</td>
<td>30 bcm/year</td>
<td>2015</td>
</tr>
<tr>
<td>Turkmenistan-Afghanistan-Pakistan-India (TAPI)</td>
<td>30 bcm/year</td>
<td>Not Announced</td>
</tr>
<tr>
<td>Expansion of Central Asia Center: Turkmenistan-Uzbekistan-Kazakhstan</td>
<td>80-100.2 bcm/year</td>
<td>2015</td>
</tr>
<tr>
<td>Turkmenistan- Uzbekistan-Kazakhstan-China Pipeline</td>
<td>40 bcm/year</td>
<td>2013</td>
</tr>
<tr>
<td><strong>Total (using upper limit of CAC)</strong></td>
<td>261.2 bcm/year</td>
<td></td>
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References


