



# LINKING THE CASPIAN TO EUROPE: REPERCUSSIONS OF THE TRANS-ANATOLIAN PIPELINE

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RETHINK  
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## Abbreviations

bcm	<i>Billion Cubic Meters of Natural Gas</i>
BOTAŞ	<i>Petroleum Pipeline Corporation of Republic of Turkey</i>
BTC	<i>Baku-Tbilisi-Ceyhan Oil Pipeline</i>
EITI	<i>Extractive Industries Transparency Initiative</i>
HGA	<i>Host Government Agreement</i>
IGA	<i>Intergovernmental Agreement</i>
kWh	<i>Kilowatt hour</i>
mtoe	<i>Million Tons of Oil Equivalent</i>
PSA	<i>Production Sharing Agreement</i>
ROW	<i>Right of Way</i>
SOCAR	<i>State Oil Company of Azerbaijan Republic</i>
TANAP	<i>Trans-Anatolian Natural Gas Pipeline</i>
tcm	<i>Thousand Cubic Meters of Natural Gas</i>

## Summary

The intergovernmental agreement recently signed between the governments of Azerbaijan and Turkey begins the next phase of the Trans-Anatolian natural gas pipeline project (TANAP). The pipeline, which is estimated to cost \$7 billion, will transport 16 billion cubic meters of gas each year from Azerbaijan through Georgia to Turkey, with most of the gas volumes going to Europe. Deliveries of Azerbaijani gas are expected to begin in 2017, while project planning starts in 2013.

Although the volumes of gas reaching Europe are relatively small compared with the original Nabucco project, TANAP officially opens the coveted “southern gas corridor” to EU states. This corridor will provide Caspian gas directly to European markets not controlled by Moscow or Tehran. The Nabucco pipeline project would have delivered more gas from Central Asia across the Caspian Sea and Turkey into the heart of Central Europe, somewhere between 45-90 billion cubic meters (bcm) per year to Europe. Although the construction of the Nabucco pipeline would not have eliminated European dependence on Russian gas supplies, it would have undoubtedly weakened the Russian gas pricing monopoly and possibly contributed to greater political independence of Eastern European and Black Sea littoral states from direct Russian foreign policy interventions.

Despite the strong backing of the United States for Nabucco across several US administrations, the European goal of weakening Moscow’s resource influence on the economies of the European Union remains a distant dream. Considerations of power politics notwithstanding, European, US and Russian power probably did not ultimately determine Nabucco’s fate. Realist power politics had little role to play. Instead regional political and commercial considerations associated with the smaller TANAP project sealed Nabucco’s fate. TANAP emerged as the preferred pipeline to Europe from the Caspian, because of its local political and economic appeal. This suggests an important lesson for international relations in the 21<sup>st</sup> century—that regional politics when combined with commercial interests and local market development can trump geopolitical resource competition.

Why did realist politics among the great powers give way to the local interests of smaller regional states? This paper identifies several key internal domestic drivers of TANAP for both Azerbaijan and Turkey to better understand why TANAP prevailed over the much heralded, Western backed Nabucco pipeline project. These domestic factors illustrate how exploiting natural resources and geographic comparative advantages translate into increased political power for each state. The

paper also shows how the construction and operation of TANAP will likely accelerate the economic integration of Caspian states while strengthening the economic and political linkages of Azerbaijan, Turkey and Georgia to Europe.

## The Political Landscape for TANAP

Policy discussions of European Union (EU) dependence on Russian gas have focused mainly on geopolitical considerations and realist perspectives of power politics.<sup>1</sup> The accepted narrative of many policy makers and policy analysts was that building Nabucco would simultaneously increase European political power, while weakening Russian influence in the Caucasus and Eastern Europe.<sup>2</sup> Geopolitical considerations, regardless of their theoretical attraction, had a much smaller role in the Azerbaijani-Turkish decision to abandon Nabucco and back TANAP. Instead, domestic political goals along with regional commercial interest contributed to the selection of TANAP.

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International political considerations certainly played *some* secondary role in Azerbaijan's decision-making on how to exploit its hydrocarbon potential. For example, although Baku never signaled its desire to join the two quintessential Western European clubs—NATO or the EU—it has indeed pursued a commercial strategy that may be interpreted as pro-Western or consistent with Western goals of

market development.<sup>3</sup> This strategy has allowed Azerbaijan and its neighbor Georgia to gain additional autonomy from Russia. However it has accomplished this goal not through political confrontation or overt military alliances but rather through exploiting its commercial interests in hydrocarbons to its long-term political advantage. All in all, Azerbaijan has hedged its bets: it has appeased Russia with increased gas exports, enticed the EU with the prospects of greater gas volumes to their markets, while inviting US multinational firms to develop off shore reserves.

Turkey has pursued a similar strategy, although with slightly different intentions. Unlike Azerbaijan, Turkey is already a member of NATO and

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<sup>1</sup> Goldman, Marshall I., *Petrostate: Putin, Power and the New Russia*. Oxford University Press, 2010; Souleimanov, Emil And Josef Kraus, "Turkey: An Important East-West Energy Hub," *Middle East Policy*, Vol. XIX, No.2, Summer 2012.

<sup>2</sup> Rzayeva, Gulmira and Theodoros G.R. Tsakiris, *Strategic Imperative: Azerbaijani Gas Strategy and the EU's Southern Corridor*, Center for Strategic Studies, Baku, 2012, p.9.

<sup>3</sup> Rzayeva and Tsakiris, *Strategic Imperative*, p. 11



has walked quite far along the EU accession road.<sup>4</sup> Like Azerbaijan, Turkey is explicitly attempting to leverage its strategic location, although without the benefit of domestic hydrocarbon reserves. Turkey's proximity to large gas supplies in the Middle East along with its crucial location to gas supplies in the Caspian region, make Turkey an important strategic partner for the EU to achieve greater energy security. Yet Turkey, too, was cognizant of Russian concerns. Shortly before signing TANAP, Turkey agreed to the Russian South Stream pipeline project across the Black Sea. A project that many analysts believe may not be built.<sup>5</sup>

These background conditions for the political landscape of the region, however, predate the TANAP agreement; of course, these conditions were also present for the Nabucco negotiations. Although these conditions helped frame the decision-making process on TANAP, they did not factor greatly into the intergovernmental agreement (IGA) struck between Azerbaijan and Turkey. To understand the attraction of TANAP to each country, it is necessary to analyze more local interests in the region.

## Economic and Commercial Interests of Azerbaijan

It turns out that other reasons, rather than geostrategic power politics, were more crucial for achieving the IGA. Although there are regional political advantages to other recent agreements between Azerbaijan and Turkey, the decision to pursue TANAP was based on more prosaic economic considerations. Azerbaijan's long-term goal to diversify its petrochemical industry and market its large natural gas reserves to multiple Western countries made TANAP an attractive investment vehicle. There was no need to wait for the large Nabucco coalition to agree on details. With the operation of TANAP expected in 2017, Azerbaijan will be directly connected to Europe's lucrative gas markets sooner rather than later. Azerbaijan is also less dependent on its larger neighbors, such as Russia and Iran, to market its gas; instead it can now diversify its transport routes for the export of natural gas. This expands the geography of Azerbaijan economic relations into the Balkans and the Black Sea region.

TANAP also has long-term commercial value to Azerbaijan. Because TANAP is scalable, it provides the potential to transport increased volumes of gas supplies should they become available. Azerbaijan will be well positioned to take full advantage of this with majority ownership

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<sup>4</sup> European Commission, *Turkey Progress Report*, SEC 1201 Final, Brussels, 2011.

<sup>5</sup> Lamiya Adilgizi, "Energy policy caught between Russian, Western interests," *Today's Zaman*, April 22, 2012.

stakes in TANAP. Apart from Shah Deniz gas field, Azerbaijan has confirmed off shore reserves such as Absheron, Umid and Babak. The total volume of proven gas reserves is estimated to be about 2 trillion cubic meters. This provides Azerbaijan with options in the long term to provide additional gas through TANAP. TANAP provides a more flexible investment vehicle for Azerbaijan than Nabucco.

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The construction of TANAP also provides Azerbaijan with a solution to projected reductions in oil exports. Since 2011, reduced production from the Azeri-Chirag-Guneshli oil field has occurred. In 2010 Azerbaijan's oil production was 50 million tons; in 2012, oil production is expected to decrease to 42 million tons. TANAP will allow Azerbaijan to substitute new gas revenues for reduced oil export revenues. This will allow the Azerbaijani government to maintain

higher levels of economic growth, while diversifying its hydrocarbon portfolio of product offerings. Understood from these perspectives, TANAP for Azerbaijan was an important economic investment as well as an important strategic option to diversify export income. Nabucco was a much too uncertain proposition for Azerbaijan to depend upon, given known revenue declines.

Several additional factors, unconnected to Nabucco negotiations, influenced Azerbaijan's decision-making to sign the IGA for TANAP. First, although pricing of gas volumes was no doubt important to Azerbaijan and its commercial partners, pricing was not the deciding factor in the agreement. According to the Turkish newspaper Hurriyet, Azerbaijan will sell its gas at \$320 per 1,000 cubic meters (tcm) to Turkey, while other reports suggest that Azerbaijan could easily get upwards of \$350 tcm from Russia.<sup>6</sup> Although Azerbaijan may have agreed to a lower price, TANAP has allowed it to diversify its transport routes thereby increasing its consumer base. This suggests that other

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<sup>6</sup> *RIA Novosti* reported on June 30, 2009 that Russia agreed to purchase 0.5 bcm of Azerbaijani natural gas at \$350 tcm. In January 23, 2012, Reuters reported that Russia renegotiated contract volumes to deliver 2 bcm to Russia although discussion of pricing was not revealed. Gazprom Chief Executive Alexei Miller suggested, "[W]e can offer a very comfortable price for our Azerbaijani colleagues. According to our estimate, Gazprom's price is more than competitive than the possible offers by European consumers". Gazprom says there is no contractual limit on Azerbaijani deliveries to Russia.

considerations were more important than price alone. Second, TANAP's financing structure will allow 80% stake by the State Oil Company of Azerbaijan Republic (SOCAR). This will allow SOCAR to retain considerable downstream infrastructure ownership and management in the future.<sup>7</sup> This is consistent with Azerbaijani economic development goals to actively participate in downstream investment opportunities whether they are in Turkey or Europe.

In summary, for Azerbaijan, the IGA on TANAP permitted them to gain direct access to new customers, acquire new revenue streams relatively quickly to replace other anticipated revenue declines, while retaining majority ownership over infrastructure. All this was done in a way that did not provoke strong Russian reactions, while allowing Azerbaijan considerable control over the project timetable. For Azerbaijan TANAP presented considerable upsides, with few downside risks compared to Nabucco.

## **The Clash of Turkish Economic and Political Priorities**

The decision by Azerbaijan to back TANAP over Nabucco was, in many respects, relatively straightforward, with multiple goals satisfied by TANAP—goals that would have been more difficult to realize had Nabucco prevailed. However the stakes associated with the TANAP agreement are probably greater for Turkey than Azerbaijan: Turkey needs greater access to gas supplies to fuel its domestic growth while achieving its international aims in energy transportation and distribution. Those considerations also make the issue more complex for Turkey compared to Azerbaijan. Turkey faces a clash of economic and political priorities: the need to secure greater volumes of gas, the desire to become an energy corridor and energy hub for South East Europe and the hope to continue strong domestic economic growth—these goals may be difficult to achieve simultaneously. Although TANAP contributes to each, the new IGA with Azerbaijan should be viewed as only one part of a more complex energy future for Turkey.

### ***Advantages of TANAP over Nabucco***

A scaled-up Nabucco pipeline may have delivered greater volumes of gas to Europe compared to TANAP, but the current IGA provides Turkey with greater amounts of gas in the short run. With the operation of TANAP, Turkey will be able to purchase an additional 6.6 bcm of gas

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<sup>7</sup> According to the EU Gas Directive, (Directive 2009/73/EC), there may be limitations on the ownership interests of SOCAR in the production and distribution of gas in Europe.

from Azerbaijan beginning in 2017, making Azerbaijan an even more crucial energy supplier to Turkey. This is probably more gas than Turkey would have received in the first phase of any Nabucco project.

TANAP also improves Turkey's security of supply and lessens risks associated with potentially less reliable gas partners. Azerbaijan has

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proven to be a reliable supplier of gas to Turkey and the operation of TANAP will strengthen their existing commercial partnership. Without Azerbaijani gas deliveries, Turkey would have certainly faced increasing dependence on Russia and Iran for satisfying its short-term domestic gas needs. This dependence comes with economic and political risks.

On the one hand, Russia has frequently signaled its intentions to use gas exports as a tool to achieve foreign policy goals<sup>8</sup> that both destabilize markets<sup>9</sup> and reinforce its regional influence in Europe.<sup>10</sup> On the other hand, Iran's pariah position in the international community presents Turkey with possible future supply disruptions.<sup>11</sup>

Although security of supply was probably one consideration, another factor certainly influenced Turkey's decision to sign the IGA: the price of Shah Deniz I and II gas is considerably less than Gazprom or Iranian supplies. According to Hurriyet, Azerbaijani gas exported to Turkey during the second phase of Shah Deniz field development will be 12% less than the imports from Russia. Gas imported from Russia currently costs Turkey \$460 tcm. Iranian imports are even more expensive than Russian gas because of a take-or-pay pricing clause.<sup>12</sup> Shah Deniz gas is approximately 20% cheaper than current Iranian imports.

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<sup>8</sup> Goldman, *Petrostate*.

<sup>9</sup> Chow, Edward and Jonathan Elkind, "Where East Meets West: European Gas and Ukrainian Reality," *The Washington Quarterly*, Vol 32, No.1 January 2009, p. 84

<sup>10</sup> Ratner, Michael, Paul Belkin, Jim Nichol and Steven Woehrel, *Europe's Energy Security: Options and Challenges to Natural Gas Supply Diversification*, the Congressional Research Service, March 13, 2012, p.11-12.

<sup>11</sup> In perhaps the most striking example, Russia and Ukraine agreed to extend the stay of the Russian Black Sea Fleet in Crimea until 2042, from the original withdrawal date of 2017. In exchange, Russia pledged to provide Ukraine with a discount of two-thirds from Russia standard oil-linked contract price for natural gas supplies for 10 years. See Ratner et al, *Europe's Energy Security*.

<sup>12</sup> Take or pay pricing requires the consumer to purchase a pre-established quantity of gas whether or not this quantity is used by the consumer.

Domestic economic considerations were key factors in this agreement, but Turkey’s international aspirations also played a role. The operation of TANAP will help Turkey realize its long-term international strategy to become an energy corridor for Europe. TANAP contributes to this goal by leveraging its geographical proximity to Europe and delivering hydrocarbons from the Caspian.

**Turkey’s import of natural gas by country of origin (bcm, 2011)**

Russia	25.4
Iran	8.2
Algeria	4.2
Azerbaijan	3.8
Nigeria	1.2
Spot LNG	1.0
<b>TOTAL</b>	<b>43.9</b>

Source: Republic of Turkey, Energy Market Regulatory Authority

However Turkey did not get everything it initially wanted in the IGA with Azerbaijan. Turkey’s original hope was to purchase all Azerbaijani gas at the border and then resell it to European markets. This would have allowed Turkey to begin implementing its long-term strategy to become an energy hub in the region through buying and selling large quantities of oil and gas. Azerbaijan was not satisfied with this arrangement. Disagreements between Turkey and Azerbaijan began in 2008 and continued through to the end of 2011 until Turkey relented on the issue of market access for Azerbaijan. Much of the agreement then fell into place. Azerbaijan was granted direct access to European markets via Turkish territory, while Turkey would receive transit earnings from gas distributed to Europe along with an agreed price formula for its gas deliveries.

Economic considerations drove Turkey’s bargaining position. Yet Turkey’s international desire to become an energy hub for South East Europe did not stand in the way of the TANAP agreement. Instead the TANAP project along with the Baku-Tbilisi-Ceyhan oil pipeline (BTC) increases the importance of Turkey to Europe’s overall energy portfolio and strengthens both Azerbaijani and Turkish economic links to South East Europe. TANAP holds great promise for both economies.

**Turkey’s Relentless Energy Needs**

The operation of TANAP in 2017 will indeed help Turkey meet its rapidly increasing domestic demand for natural gas. However signing the IGA has also sharpened policy issues related to Turkish aspirations to become an energy hub for Europe. How can Turkey realize this goal in the face of daunting domestic social and economic forces? Turkey’s economy has grown continuously for 19 consecutive quarters, with its economic growth second only to China in 2011. This growth requires ever-greater amounts of energy to power its economy. Depending on

near term Turkish policy choices, Turkey's energy consumption patterns, if left unchanged, could undermine its long-term international energy aspirations.

To better understand Turkey's domestic energy constraints, consider several aspects of Turkey's recent energy growth. According to Turkish Ministry of Energy, primary energy demand across the entire Turkish economy is expected to almost double from approximately 100 million tons of oil equivalent (mtoe) to over 200 mtoe by 2020. Despite hopes to the contrary, only a small portion of this increased demand can be provided from strictly domestic energy sources;<sup>13</sup> instead, much of this growth must be fueled by imported hydrocarbons.

What are the main energy needs for Turkey? A great deal of growth in Turkish energy demand comes from increasing demand for electricity. The share of electricity in final energy consumption surged between 1990 and 2009, from 9.5 percent to above 20 percent in 2009. Since 2000, electricity consumption has increased around 5% a year. In the

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next ten years, estimates for electricity demand suggest an increase in production somewhere between 25-75% from 2010 levels.<sup>14</sup> Fossil fuels and natural gas will meet most of Turkey's increasing electricity demands. Natural gas represents almost half of Turkey's current energy import expenditures and natural gas has become the main energy source in power generation. Its market share in electricity production soared from 18% in 1990 to almost 50% in 2010. Coal and

lignite represent 25% of total electricity production. Fossil fuels thus accounted for 75% of total power generation in 2010, with most of these fuels imported.<sup>15</sup>

<sup>13</sup> The Ministry of Energy and Natural Resources of the Republic of Turkey, "Strategic Plan, 2010-2014," Ankara, 2009; Yigitguden, Yurdakul, "The Future Prospects of Turkish Energy Policy," paper presented at South East Europe Energy Dialogue, Thessaloniki, Greece, June 2-3, 2011.

<sup>14</sup> Base year 2010 = 210.2 TWh (Teias) (Deloitte, *Turkish Electricity Market: Developments and Expectations 2010-2011*, Deloitte, Turkey, 2010; Dilaver, Zafer and Lester C. Hunt, "Turkish Aggregate Electricity Demand: An Outlook To 2020," Surrey Energy Economics Centre (SEEC) Department of Economics University of Surrey SEEDS, 2011).

<sup>15</sup> According Turkey's Ministry of Industry (2011) total Turkish energy imports were \$54 billion out of a total of \$240.8 billion in imports. For every \$10 per barrel oil price increase, Turkey needs to pay an additional \$4 billion, illustrating the dependence of the Turkish economy on oil price changes abroad.

Securing greater volumes of gas is therefore central to Turkey's ability to maintain near term growth prospects, because so much of Turkey's electricity generation is tied to natural gas. TANAP clearly assists Turkey to meet this growing demand in the short run. However, Turkey's natural gas consumption has tripled in the last two decades. In 2011, Turkey consumed over 43 bcm of natural gas. Based on conservative estimates, natural gas demand in Turkey can be expected to grow almost 50% in the next ten years,<sup>16</sup> with no new gas production expected within the country.<sup>17</sup> These are daunting numbers for any country to manage.

Increasing electricity demands are directly related to increased demand for natural gas, and this raises several important policy issues for Turkey. With no changes in its domestic energy policies, Turkey can attempt to meet increasing demand by consuming greater amounts of imported gas from Azerbaijan, Iraq or Russia. Since it lies near large oil deposits, there are numerous possibilities to meet demand, although each comes with its own set of challenges. Of course, this strategy may undermine its long-term aspirations to become an energy hub for the region because it may not be able to transport increasing gas volumes to Europe as they become available. For these reasons there is a clash between the economic demands within Turkey and its geostrategic aspirations to become an energy hub for the region.

### ***How to Bend the Demand Curve: Liberalization, Green Energy and Energy Efficiency***

Therein lies the conundrum for Turkey. Turkey's demand for energy will increase considerably in the next decade. Without the ability to decrease the rate of energy consumption, Turkey may be unable to fully capitalize on its geographic potential to become a critical supplier of energy to Europe. How can Turkey bend the upward sloping demand curve for gas and electricity to assist with achieving its long-term strategic goals to become an energy corridor and energy hub for Europe?

Reducing domestic energy consumption while increasing GDP, is extremely difficult for many countries. However for Turkey, a middle-income country seeking to become a high income OECD country, the

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<sup>16</sup> Yigitguden, "Future Prospects"

<sup>17</sup> For a discussion of potential off shore gas fields see International Crisis Group, "Aphrodite's Gift: Can Cypriot Gas Power a New Dialogue?" *Europe Report No. 216*, April, 2012.

situation is even more difficult.<sup>18</sup> Reducing domestic energy consumption requires a host of domestic policy changes across both energy and non-energy sectors, while reforming different institutions. Nothing about these reforms is simple or easily to implement.

Several general recommendations need to be further pursued and implemented if Turkey is to decrease the rate of energy consumption:

- (1) Turkey needs to continue the implementation of energy sector reforms, especially in the gas and electricity sectors.
- (2) Turkey should implement additional requirements of the energy chapter of the *acqui*, liberalizing domestic energy prices while pursuing renewable and alternative energy investments.
- (3) Turkey must invest in domestic energy efficiency across different sectors of the economy.
- (4) Turkey needs to eliminate subsidies in different energy sectors.<sup>19</sup>

According to reports sponsored by the EU, liberalization of Turkey's domestic energy markets needs to continue. Greater liberalization of the energy sector will allow for greater regional integration and improved market functioning. This component of domestic reform involves public sector laws and regulations that allow for stable and transparent market operations to lower investor risk, and introduce fair market pricing for residential and commercial consumers, while eliminating state run energy monopolies. These kinds of reforms will enhance regional energy trade and competition. Such actions are the cornerstone for EU and Energy Community policies in the region.

Turkey and other Energy Community contracting parties have made considerable progress along several dimensions of energy liberalization, but important institutional and policy issues remain to be addressed in both gas and electricity sectors. Two reforms stand out as most pressing. First, the development of private domestic energy producers and suppliers that provides energy to customers on the basis of liberal

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<sup>18</sup> Felipe, Jesus, Arnelyn Abdon, and Utsav Kumar, "Tracking the Middle-income trap: What Is It, Who Is in It, and Why?" *Working Paper No: 175*, Levy Economics Institute of Bard College, April 2012.

<sup>19</sup> According to a recent report Turkey estimates that its exemption for diesel used by fisheries and shipping represents a tax expenditure of 0.03% of GDP (IEA, OPEC, OECD, WORLD BANK, "Analysis Of The Scope Of Energy Subsidies And Suggestions For The G-20 Initiative Joint Report," Prepared for submission to the G-20 Summit Meeting Toronto (Canada), 26-27 June 2010.



market pricing mechanisms. This includes the reform of the state run BOTAŞ gas monopoly.

The second, and perhaps the most difficult domestic reform to achieve, is increasing the price of energy for residential consumers. For Turkey this would require increases in both natural gas and electricity prices. Increasing prices would stimulate greater demand for energy efficiency technologies while assisting the transformation to green energy alternatives. Increasing energy prices would facilitate economic development and permit Turkey to continue economic growth, perhaps breaking into the club of high-income countries within the next decade.<sup>20</sup>

On April 1, 2012, the government hiked domestic gas prices by 18.7%, with electricity prices increasing 9.3%. However, Turkey like other recent EU member states has relatively low electricity and gas prices. Compared to EU average of 0.184 € per kWh for residential electricity, Turkey's residential electricity price is 0.115 € per kWh (2011).

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Turkey's residential electricity prices are similar to average electricity prices in Romania. For natural gas, residential prices are similarly low compared to EU averages. For Turkey average natural gas prices per kwh are 0.029 € compared to 0.064 € for the EU.<sup>21</sup>

Experience with other states in the region show just how difficult increases in energy prices can be.

Increasing electricity prices requires the removal of existing energy price subsidies. When universal subsidies for energy are removed, they pose challenges for elected officials because of associated changes in household welfare, the economy, and changes in government expenditures associated with rising energy costs. The cost of removal of energy benefits is often concentrated on specific groups, while the benefits of subsidy removal are diffused throughout the society. As a result, powerful interest groups often emerge to block reforms.<sup>22</sup>

Increasing electricity prices requires

<sup>20</sup> Felipe et al., "The Middle-income Trap."

<sup>21</sup> Eurostat 2011.

<sup>22</sup> Although high-income households receive the greatest benefit from universal energy subsidies, it is lower income households that face the greatest risks from subsidy removal. Studies indicate that the proportional welfare impact of subsidy removal is often greatest for low-income households, resulting in increasing energy burdens and increasing poverty, Yemtsov, Ruslan "Developing Effective Reform Strategies: Safety Nets to Protect the poor and vulnerable groups," World Bank Presentation, WTO-WB

The withdrawal of untargeted universal energy subsidies requires an efficient social safety net that targets energy benefits to poor households to lessen energy burdens posed by increasing prices. All of these reforms require time, institutional capacity and a strong commitment by the government. For these reasons, bending the energy demand curve is extremely challenging to most developing states, including Turkey.

## The Role of TANAP in Regional Integration and Market Development

Regardless of Turkey's domestic situation, the TANAP IGA is an important milestone for the region. The TANAP project is expected to be approximately 2,000 km in length and cost over \$7 billion. It is, by almost any measure, an ambitious infrastructure project—even larger than the Baku-Tbilisi-Ceyhan (BTC) oil pipeline project completed in 2005. It will span three countries traversing very different climatic and geological zones, some of them known for their seismic instability. There are engineering precedents for this project, not only in each of the three countries, but elsewhere in the world. What promises to make this project important, therefore, is not so much the technical engineering associated with TANAP, but the domestic and international implications of the project for each country and the region.<sup>23</sup>

The construction of a new pipeline from Azerbaijan through Georgia and Turkey to Europe will have significant economic, social and institutional implications for each country:

- (1) For the region, the construction of TANAP can be expected to deepen the economic and institutional links of these three countries to one another.
- (2) By linking the Caspian to Europe, TANAP can be expected to further deepen the social, economic and political links of the region and to European markets and Western institutions. The Azerbaijani economy will become further integrated with Turkish markets

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Joint Conference, Geneva, October 14-15, 2010. For these reasons, the removal of universal subsidies must be implemented with corresponding social protection measures for poor citizens (International Energy Agency, *World Energy Outlook*, 2010).

<sup>23</sup> TANAP will end at the Turkish-Bulgarian border. There are two proposed projects for the continuation of the pipeline to Europe. First is Trans-Adriatic Pipeline, which will end in Italy after traversing Greece, Albania, and the Adriatic Sea. Second is Nabucco-West, an abridged version of Nabucco, which will begin from Turkish-Bulgarian border, pass through Bulgaria, Romania, Hungary, and end at Austrian Baumgarten hub. Experts contend that countries on the Nabucco-West route may need more Caspian gas than Italy, which has alternative sources of gas.

through its infrastructure investments and business interests. TANAP path through Turkey will assist Azerbaijani's business interests in Europe while allowing Turkey to advance its status as an energy bridge to Europe.

(3) TANAP will hasten the mutual attraction occurring between Azerbaijan, Georgia and Turkey to Europe. The IGAs and Host Government Agreements (HGA) will further solidify the market destinies of Azerbaijan, Turkey and Europe. All three countries will have greater access to European institutions, but without European accession. These implications will no doubt have profound implications for power, politics and markets for years to come.

### ***Domestic Implications: Economic, Social and Institutional Development***

The construction of TANAP will have implications for economic development and civil society development in each of the three states. The most immediate to be felt will be the economic influence of TANAP. During the construction of TANAP, all three countries will employ thousands of workers to complete the project by 2017. Most of these workers will come from the region in the construction and petrochemical industries. Foreign direct investments in both Georgia and Turkey from pipeline construction will have immediate economic effects, along with longer term effects associated with maintenance and operation of the pipeline across their territories.<sup>24</sup>

For Azerbaijan it will also expand relations with dependable, energy consumer countries in the EU. But it will also open new commercial opportunities to Azerbaijani companies. Azerbaijan is not only interested in the export of natural gas and oil to Europe, but it is also interested in new investment opportunities. For example SOCAR will likely become more assertive in the acquisition and purchase of energy infrastructure beyond Turkey. It already has petrol stations operating in Ukraine, Romania and Georgia under the SOCAR brand. TANAP stands to assist Azerbaijan and Turkey realize greater economic opportunities with South East European nations.

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<sup>24</sup> For the BTC, transit fees were estimated to be between \$200-\$300 million per year for Turkey (Baran, Zeyno, "The Baku-Tbilisi-Ceyhan Pipeline: Implications for Turkey" in Starr and Cornell, eds., *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West*, Central Asia-Caucasus Institute & Silk Road Studies Program, 2005, p. 108).

However TANAP can be expected to further the development of government institutions within each host country and facilitate the interactions of government with civil society. These kinds of effects are less discussed by policy analysts but quite possibly the most important long-term domestic consequences of the construction of TANAP. The BTC pipeline provides considerable evidence for this prediction.

As the BTC pipeline project illustrated, the implications of construction on each society is enormous.<sup>25</sup> For the BTC pipeline construction, the Right of Way (ROW) affected approximately 4,100 households in Azerbaijan and 1,800 in Georgia. In Turkey the ROW affected more than 13,000 parcels of land, with as many as 62,000 households affected.<sup>26</sup>

***Western guidelines such as EU environmental rules and the Extractive Industries Transparency Initiative (EITI) will provide the framework for environmental, social and construction requirements in each of the states. It is likely that some of the same standards used to build the BTC pipeline project will be used to guide TANAP construction.***

All construction in each country required land acquisition and compensation plans, grievance dispute mechanisms and resettlement action plans that were consistent with local law and in conformity with all aspects of the HGAs and contractor control plans. This required governments to build capacity to verify construction plans, implement construction and social agreements, and settle disputes while better protecting the environment. Construction

for TANAP will be no different except the scope for all of these plans and mechanisms will be greater than BTC pipeline construction.

Western guidelines such as EU environmental rules and the Extractive Industries Transparency Initiative (EITI) will provide the framework for environmental, social and construction requirements in each of the states. It is likely that some of the same standards used to build the BTC pipeline project will be used to guide TANAP construction. This means that the HGAs will include provisions to abide by “[i]nternational standards and practices that are not less stringent than those generally applied in the European Union.”<sup>27</sup> As the BTC project showed,

<sup>25</sup> Starr, Frederick S, “The Baku-Tbilisi-Ceyhan Pipeline: School of Modernity,” in Starr and Cornell, eds., *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West*, Central Asia-Caucasus Institute & Silk Road Studies Program, 2005, pp. 7-16.

<sup>26</sup> Blatchford, David. “Environmental and Social Aspects of the Baku-Tbilisi-Ceyhan Pipeline,” in Starr and Cornell, eds., *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West*, Central Asia-Caucasus Institute & Silk Road Studies Program, 2005, p. 126.

<sup>27</sup> BTC pipeline project IGA. See [http://www.ifc.org/ifcext/btc.nsf/Content/Legal\\_Regime](http://www.ifc.org/ifcext/btc.nsf/Content/Legal_Regime).

environmental policies and governmental oversight improved considerably as a result of the construction compliance measures in place.<sup>28</sup>

### ***Regional Implications: Shared Azerbaijani-Turkish Infrastructures***

The IGA between Azerbaijan and Turkey on TANAP is part of a continuing trend between these countries for increasing economic interdependencies. TANAP will add to infrastructure investments between countries and further consolidate and structure their common commercial interests, while ultimately influencing longer-term political relations. The successful implementation of TANAP can be expected to further align the interests of Azerbaijan and Turkey.

Because of its geography and its economic development, Turkey has been able to attract large investments from Azerbaijan. The IGA on TANAP has occurred when SOCAR has become the biggest FDI investor in the Turkish economy. Most recently SOCAR has increased its shares in Petkim, Turkey's formerly state owned petrochemical company. SOCAR now controls a majority interest in Petkim which has provided it with additional market opportunities within Turkey. Petkim holds a 26 percent share in the Turkish petrochemical market. By late 2017, SOCAR's investments in Turkey are expected to reach \$17 billion, including the new investments in TANAP.

TANAP, however, is only one of many infrastructure projects implemented by each country. In 2011, SOCAR started the construction of the refinery in Izmir, Turkey. Other existing projects include the BTC oil pipeline, mentioned earlier, and the Baku-Tbilisi-Erzurum gas pipeline. In addition to these projects, by the end of 2012 it is expected that construction on the Baku-Tbilisi-Kars railroad will be completed. These projects, together with the operation of TANAP, create a complex commercial hydrocarbon network, based on market principles and commercial interests, that will connect not only two countries, but also help integrate the Caspian and Mediterranean regions to Europe. The construction of TANAP will strengthen the strategic relationship between Azerbaijan and Turkey by further developing market integration between them, creating much stronger links in mutually owned infrastructure and deepening their connections to Europe.

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<sup>28</sup> In particular waste management practices improved in Turkey (European Commission, *Turkey*, p. 100) as well as improved waste management infrastructure in Georgia and Azerbaijan (Blatchford, "Environmental and Social," p. 142).

### ***International Implications: Caspian-Turkish Relations with Europe***

The construction and operation of TANAP will allow Azerbaijan to have direct access to European energy markets and allow Turkey to play an even greater role in European energy policy. However as the previous section suggests, it can also be expected to further increase the influence of Western governance models in the Caspian region. Why should this be expected? Associated with TANAP are crucial legal, regulatory and pricing agreements. All three states have entered Western legal regimes by subordinating the construction and operation of their infrastructure to Western regulatory norms. Although the IGA struck by Azerbaijan

***The construction and operation of TANAP will have several implications on the region, some of these similar to the implications from the BTC. Commercial interests are helping develop capacity by prompting Azerbaijan, Georgia and Turkey to coordinate on best practices governing contracts, financing, construction and operations.***

and Turkey will contribute to each country's economic development, the framework for the IGA is largely based on Western legal and regulatory principles. In this sense decisions made by Azerbaijan and Turkey illustrates how mutual influences between the regions are reciprocal. The construction and operation of TANAP will have several implications on the region, some of these similar to the implications from the BTC. Commercial interests are helping develop capacity by prompting Azerbaijan, Georgia and Turkey to coordinate on best practices governing contracts, financing, construction and operations. These best practices involve informal business norms (EITI), EU compatible regulatory frameworks, and dispute resolution and construction practices. All these will influence government capacity in the region.

prompting Azerbaijan, Georgia and Turkey to coordinate on best practices governing contracts, financing, construction and operations. These best practices involve informal business norms (EITI), EU compatible regulatory frameworks, and dispute resolution and construction practices. All these will influence government capacity in the region. These institutional implications are particularly important when contrasted with other states in Eurasia.<sup>29</sup> As the BTC proved, bilateral state actions were developed with a view to market rules and market actors. Market factors conditioned planning, construction and implementation of BTC. This permitted private actors and international actors to become part of the process and invest in the outcomes. During BTC planning, the Azerbaijani's were willing to relinquish unilateral market power by agreeing to EU legal and regulatory regimes though

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<sup>29</sup> For the contrasting cases see Jones-Luong, Pauline and Erika Weinthal, *Oil is not a Curse*. Cambridge: University Press, 2010.

their respective HGA. This allowed a larger coalition of business interests, international financial actors, government agencies and social groups to participate in final decision-making processes.

TANAP will not only have economic consequences for the region. The commercial interests of both Azerbaijan and Turkey, and the paths they have chosen, are gradually integrating each country within Western political and economic arrangements. Commercial interests in each state have increased the number of international (coalitional) actors directly interested in TANAP's financing, construction and operation. Commercial interests are resulting in a natural mutual attraction between countries on regulatory and legal regimes that will likely result in coordination on economic and social dispute resolution frameworks. These will very likely strengthen regional political relations. This integration illustrates how commercial interests exploit resource and geographic advantages and turn these advantages into political power for governments.

This agreement further solidifies the market destinies of Turkey, Azerbaijan and Europe. Securing gas contracts within Western legal and regulatory institutions not only draws Azerbaijan and Turkey closer to the West, but it also promises to help insure the security of supply to several European nations.

## European and EU Implications of TANAP

The Turkish-European gas demand curve will increase dramatically in the near term. TANAP will therefore not end European and Turkish resource dependence on Russia. For this reason alone, the TANAP project must be perceived as less threatening to Russia compared with the Nabucco project. The success of Nabucco would have represented a direct challenge to Russian natural gas pricing and its monopoly supply to Eastern European countries. Russia was opposed to its implementation, and even offered South Stream pipeline as an alternative to the Nabucco project. But Nabucco had the potential to lessen Russian power in a very public way and therefore Russia probably could not ignore Nabucco or treat it as merely a 'commercial investment'. Because TANAP will provide considerably less gas in the near term to Europe, it can be seen as representing a more practical, but quieter step toward opening a southern gas corridor that is independent of Russian control.

Although the amount of gas delivered to the EU is not considerable and will not eliminate dependence on Russian gas supplies, the introduction of gas supplies from TANAP can be expected to have several

implications. First, by delivering crucial supplies to South East Europe, it allows greater volumes of imported energy to be supplied under market-based, contractual arrangements. The volumes are regulated by production sharing agreements (PSA) that fall under Western regulatory regimes. This means that Western market rules on construction, operation and ownership will guide competition and distribution and generally set the rules for the market. This will likely influence the social, economic and political development of institutions in participating states.

The progressive evolution of hydrocarbon transportation through the southern corridor to Europe and elsewhere is likely to diminish Russian

***The progressive evolution of hydrocarbon transportation through the southern corridor to Europe and elsewhere is likely to diminish Russian influence among Caspian and Mediterranean states. As economic development increases in all three states, Azerbaijani, Georgian and Turkish interdependencies will likely strengthen, along with their participation in Western legal and regulatory regimes.***

influence among Caspian and Mediterranean states. As economic development increases in all three states, Azerbaijani, Georgian and Turkish interdependencies will likely strengthen, along with their participation in Western legal and regulatory regimes. The introduction of these regimes through infrastructure development, as illustrated by the BTC, is causing a pro-Western institutional bias within each of the participating countries. As a result, these smaller nations, by successfully leveraging their own domestic comparative advantages in the marketplace, have

contributed to their own autonomy from Russia. It represents integration without accession through regulatory coordination and market based competition.

Although the volumes of gas reaching Europe are relatively small compared with the original Nabucco project, TANAP for the European Union officially opens the coveted “southern gas corridor” to EU states. This corridor will provide Caspian gas directly to European markets not controlled by Moscow or Tehran. It also meets several EU conditions considered crucial to building a reliable gas supply, the most important being scalability. TANAP will be scalable with capacity reaching up to 60 bcm. This suggests the possibility of additional gas supplies in the future. For these reasons, TANAP is an important first step in developing the southern gas corridor.



Finally, the delivery of natural gas to European countries may contribute to changes in pricing mechanisms for natural gas, accelerating the two-tiered pricing of natural gas that has already emerged in the EU. The contribution of non-Russian gas supplies, along with future increases in the availability of LNG supplies, may well weaken the predominant pricing mechanism preferred by Gazprom that indexes the price of natural gas to oil.

Although TANAP is probably only a very small step toward the realization of EU energy goals, it illustrates how Western legal regimes associated with the marketplace and EU regulatory norms have begun to expand to the Caspian. TANAP will likely accelerate integration to Europe, without necessarily leading to accession.

## **Conclusion: Resource Politics and Repercussions of TANAP**

When using realist perspectives on resource competition between states, there is a tendency to focus on the geopolitical dependencies of smaller states and the power of larger states to determine economic and political outcomes.<sup>30</sup> Realist resource competition emphasizes the zero sum nature of resource acquisition and the power of large states to unilaterally determine the distribution of resource outcomes. When considering the Nabucco pipeline project, this was the preferred theoretical perspective assumed in many policy circles in Washington, Moscow and Brussels. According to one version of the argument, building Nabucco would simultaneously increase European political power, while weakening Russian influence in the Caucasus and Eastern Europe; for this reason, it was imperative for US and EU policymakers to implement Nabucco. Yet Nabucco did not happen and Russia did not kill it. Instead, it was smaller regional states that determined Nabucco's ultimate fate.

How could this happen? The realist perspective emphasized by many policy analysts tends to ignore diverse actors and complex regulatory regimes that contribute to international outcomes on the provision of resources among developing and advanced democracies. To better understand why TANAP prevailed and its significance to the region, this paper suggested that smaller state actors pursuing market interests consistent with local political goals, determine the distribution of resource outcomes. This is exactly what happened in the case of TANAP.

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<sup>30</sup> Goldman, *Petrostate*; Rzayeva and Tsakiris, *Strategic Imperative*.

To better understand this perspective on resource competition, consider the international provision of hydrocarbons among OECD nations. When considering costly infrastructure to support the transportation of hydrocarbons, there are complex sets of rules that must be satisfied and multiple domestic and international actors that must be included in any successful project. When implemented well, the regulatory regimes tend to protect actors associated with the project, while further strengthening local economic development goals and regional market outcomes. In OECD nations, resource outcomes not only need to be political feasible but also market conforming. Although this perspective acknowledges a crucial role for the state, it tends to focus on the distributed commercial and political benefits to diverse actors and the crucial role they play in the determination of resource outcomes. This contrasts greatly with organizations such as Gazprom.

In our analysis of TANAP, we instead focused on how diverse domestic and regional actors assessed their interests. Azerbaijan's long-term goal to diversify its petrochemical industry and market its large natural gas reserves to multiple Western countries made TANAP an attractive investment vehicle. There was no need to wait for Nabucco. With the operation of TANAP, Azerbaijan will be directly connected to Europe's lucrative gas markets. All this was done in a way that did not provoke strong Russian reactions, while allowing Azerbaijan considerable control over the project timetable.

Turkey needs greater access to gas supplies to fuel its domestic growth. TANAP would likely meet this need better than Nabucco. TANAP also improves Turkey's security of supply and lessens risks associated with potentially less reliable gas partners. Finally the operation of TANAP will help Turkey realize long-term international strategy to become an energy corridor for Europe. TANAP assists with this goal by leveraging its geographical proximity to Europe and delivering hydrocarbons from the Caspian.

When considering the successful implementation of the 2,000 km pipeline project and its expected outcomes, we also attempted to sketch the outlines of the political and economic shifts occurring in the Caspian and Mediterranean regions. In its current form, TANAP will supply only a small amount of gas to Europe. Yet TANAP meets several EU conditions considered crucial to building a reliable gas supply including scalability and market based pricing. For these reasons, TANAP is indeed a crucial step in developing the southern gas corridor and putting in place infrastructure and trade that is in conformity with EU energy market planning. Although it may not provide the volumes of gas originally hoped for in Nabucco, TANAP will likely provide more reliable gas supplies to Europe. TANAP, however small a step it may be, can

therefore be expected to contribute the future energy security of the EU. Whether or not TANAP or other gas pipelines from the Caspian ultimately influence the gas pricing structure in Europe will no doubt depend on many other factors. In the meantime, Russia will continue to be the dominant natural gas supplier to the EU and several other Eastern European and Mediterranean states.

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# LINKING THE CASPIAN TO EUROPE: NATURAL GAS & OIL PIPELINE SYSTEM



Entry Point to Turkish National Gas Grid



Planned Pipeline




Existing Pipeline (2012)





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