SAM Center for Strategic Studies

Strategic Imperative:

Azerbaijani Gas Strategy and the EU's Southern Corridor

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BAKU-2012

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By Gulmira Rzayeva & Dr. Theodoros G.R. Tsakiris[1]

1 IMPORTANT NOTE: Ms. Rzayeva prepared the chapter of the paper analyzing Azerbaijan's diplomatic and energy strategy, including the chapters on TANAP, SCP and Nabucco. Dr. Tsakiris prepared the chapters of the paper that focus on the Western perspectives vis-à-vis the EU's Southern Gas Corridor Strategy, as well as the chapters on the Trans Caspian Pipeline (TCP), SEEP (South East European Pipeline) and the Trans Adriatic Pipeline (TAP). The paper's Final Selection chapter as well as the paper's conclusions were written jointly.

INTRODUCTION

Europe's Southern Gas Corridor Strategy is founded on the necessity to maximize the imports of non-Russian gas via non-Russian controlled territory, so as to establish a fourth route of supply diversification following Russia, Norway and Northern Africa. The European Commission has recognized as potential sources of supply for the Southern Gas Corridor not only Caspian (Azerbaijan) and Central Asian (Uzbekistan, Kazakhstan and primarily Turkmenistan) but also Middle Eastern gas from Iraq's and even Egypt's future production. Any serious discussion on the feasibility of the two remaining Southern Gas Corridor Strategy pipeline projects, namely Nabucco West and Trans Adriatic Pipeline (TAP) that vie for the transportation of Azerbaijani gas to Europe via Turkey, requires an examination of the geopolitical environment which will, along with competing corporate strategies, determine the optimal option for SOCAR and its Shah Deniz (SD) partners.

AZERBAIJAN & TURKMENISTAN: WESTWARD GAS PIPELINE OPTIONS

This paper will first analyze the geopolitical context of Europe's Southern Gas Corridor Strategy (hereafter SCGS) and then present the competing interests of regional state players as well as SD members in the South Caucasus component of the transportation chain up to the entrance of Azerbaijani gas to the Turkish national grid in Erzurum via the SCP (South Caucasus Pipeline). The paper will then make a specific reference to the emergence of the TANAP (Trans Anatolian Project) pipeline that effectively replaces Nabucco's route through Turkey.

The authors will then discuss the prospects of the Trans-Caspian Gas Pipeline and its relation with the demise of the original Nabucco project. The paper will also analyze the different corporate perspectives focusing on SOCAR's strategic goals as well as the pros and cons of the two remaining pipeline projects. The authors believe that both TAP and Nabucco West offer significant value to Azerbaijan and SOCAR. TAP is perceived as more commercially antagonistic project, which nevertheless lacks the solid political support that Nabucco West enjoys not only from the states it transits through but also from the European Commission itself.

The Geopolitical Context: the U.S. & EU Perspectives

The European Commission and the pro-Atlanticist member-states of the EU who are either not dependent on Russian natural gas (UK) or over-dependent on Russian gas imports (Poland, Baltics, Bulgaria, Central Europeans) are in complete agreement with the general political motivation driving U.S. and EC (European Commission) energy policy in the Caspian Sea region. This has been the case since the early 1990s and the completion of the Baku-Tbilisi-Ceyhan oil pipeline (BTC) that aspired to consolidate the geopolitical independence of the former Soviet states by giving their hydrocarbon resources not only export markets but also transit routes that would both bypass Russia.[2]

Russian gas to Europe routes

Azerbaijan was the first and so far the most successful "case study" of this strategy that clearly antagonizes Russian efforts to establish a hegemonic post-colonial "sphere of influence" along the southern tier of the entire former Soviet frontier in the Caucasus and Central Asia. The rationale of the U.S. strategy was that the elimination of the Russian monopoly on the export pipeline network of those four states (Azerbaijan, Kazakhstan, Turkmenistan,

2 As former U.S. Energy Secretary Bill Richardson noted in 2005, "I have seen energy advance U.S. geopolitical interests, as the nation did in pressing successfully for the construction of east-west oil and gas pipelines in Central Asia, securing political autonomy for the newly independent states of the former Soviet Union". Bill Richardson, "Foreword", in Jan Kalicki & David Goldwyn (eds.), Energy & Security: Toward a New Foreign Policy.

Uzbekistan), and the emergence of Europe as an alternative export market, would seriously curtail Moscow's ability to neutralize any serious pro-western/pro-U.S. orientation on the part of these states.[3]

This of course was only half the answer from the U.S. and EU perspective. The other half was supposed to be given by "conflict resolution" in ways that would drastically diminish Russia's "meddling" in a series of so-called "frozen conflicts" which span the former southern Soviet periphery and are "literally" in the middle of SCP's, TANAP's and TCP's (Trans-Caspian Pipeline) way, from the Turkmen-Azerbaijani dispute over the boundaries of their Exclusive Economic Zones (EEZ) zones and the sovereignty of the Kyapaz/Serdar field in the Caspian Sea to the Nagorno Karabakh conflict between Armenia and Azerbaijan, the Russia-Georgian War and the Kurdish guerilla movement of S.E. Turkey.

If the construction of any gas pipeline –or for that matter any energy project -could motivate these states to resolve their bilateral disputes, then it would not only help the West to limit Russia's geopolitical influence but it would provide the EU with access to the gas resources of Turkmenistan and potentially other Central Asian states. According to U.S. strategic perception, the majority of national income for the four abovementioned states – with the partial exception of Uzbekistan and Kazakhstan where oil and gas revenues account for less than 40% of GDP - emanates from hydrocarbon exports.

Therefore he, who bought and simultaneously controlled the routes of these exports, would be able to exercise a predominant influence over their foreign and security policy. The original Nabucco plan was supposed to do for the U.S. in the 2010s what BTC did in the 1990s: drive a hole in Russia's ability to dominate the post-soviet economies of its hydrocarbon-rich "comrade" colonies. Yet the original Nabucco project was and remains even more dangerous from a Russian point of view.

Compared to BTC, Nabucco's original strategy would deliver an even harder blow on Russia's geostrategic ambitions, since, due to its size, it would not only "open up" Turkmenistan to Western influence, but also allow Ukraine to limit its dependence on Russian gas imports thereby facili-

3 Strategy, Woodrow Wilson Center Press, (Washington D.C.: 2005), p.xvii. Jan Kalicki who served during the 1990s as the U.S. Ombudsman for Energy & Commercial Cooperation with the Newly Independent States notes that "Moscow recognized that alternative oil route would give the Caspian states a measure of independence never before enjoyed since at least the Bolshevik Revolution. The U.S. government played a critical role in countering this opposition –recognizing the stakes involved for the future independence of the Caspian States", in Kalicki & Goldwyn, ibid, p.162.

For the strategic rationale behind U.S. Caspian policy see, Strobe Talbot, The Russia Hand: A Memoir of Presidential Diplomacy, (Random House: 2002), pp.91-94, Zbigniew Brzezinski, The Grand Chessboard: American Primacy and Its Geostrategic Imperatives, (Harper Collins: 1997), pp.128-130 & Barnes Joe, "U.S. National Interests: Getting Beyond the Hype", in Yelena Kalyuzhnova, Amy Myers Jaffe & Dov Lynch (eds.), Energy in the Caspian Region: Present and Future, London, (Palgrave: 2002), pp.215-216.

tating a more pro-western orientation of Kiev's foreign and defence policy that could even allow its eventual inclusion into NATO. Ukraine was refused to join the Organization. This is not a far-fetched scenario. This nearly happened in April 2008 and constituted one of the main underlying causes for the Russian-Ukrainian gas crisis of January 2009. *Russia did not hesitate to remind the "Atlanticist" Europeans and the pro-western Ukrainians that it could "gladly freeze" Europe and lose billions of dollars in revenue in order to keep Ukraine out of NATO.*

At the same time Russia's ambassador to NATO indirectly threatened Ukraine with the possibility of Crimea's separation.[4] No one should ignore that one of the fundamental motivations behind the Kremlin's determination to scuttle Nabucco, is to pre-empt any possibility for the diversification of Ukrainian gas imports from Azerbaijan and more importantly Turkmenistan. Such an eventuality would allow Kiev to resist Russian demands on the security of its European-oriented gas exports, while resisting Moscow's continued long-term military presence in the Crimea. *This presence is a propos one of the stronger guarantees that Ukraine will stay out of NATO.*[5]

For "Atlanticist" Europe the diminishment of Russia's control over its "Near Abroad" was a welcoming development especially if it was accompanied by the means of limiting their overwhelming dependence on Russian gas imports. The announcement in March 2011 that Nabucco was planning to extend its reach by another 60 km to the Czech hub of Lanzhot so as to be able to penetrate the Slovakian, Czech and Polish markets,[6] may make little sense for a project that had no gas contract whatsoever, but it attested to the geostrategic rationale which has been driving Nabucco for the better part of decade. This is not to say that other EU member-states like Greece, Italy, Germany and France would not want to diversify –to various degrees - from Russian gas imports. Their main differences with "Atlanticist" Europe and the Nabucco lobby is that:

(a) they are more worried that a lessening of Russian influence in the post-Soviet space will make Russian gas exports to Europe *less, not more, secure* and that is part of the reason why they support the *bypassing of Ukraine, Belarus and Poland via the construction of the Nord & South Stream projects without refraining from participating in the smaller Caspian-originated*

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4 More analytically See Theodoros Tsakiris, The Blue Gold: Russo-Ukrainian Relations and Europe's Natural Gas Strategy, Hellenic Center for European Studies, (Papazisis Publications: 2011), (in Greek), pp.108-112.

5 Ukraine wanted to join Nabucco as early as 2006 and was among the first to welcome the pipeline's relative progress during 2009 especially after the signing (13 July 2009) of the pipeline's Intergovernmental Agreement (IGA) in Ankara. See Simon Pirani, Jonathan Stern, & Katja Yafimava, The Russo-Ukrainian Gas Dispute, ibid, pp.52-53, "Ukraine Welcomes Nabucco Gas Pipe, Ready to Join", DowJones, 14/7/2009 & "Ukraine Interested in Joining Nabucco Consortium, Considering LNG Imports", Middle East Economic Survey, 27/07/2009.

6 "Deadline Set for Competing Gas Corridor Projects, Nabucco Plans Extension", Middle East Economic Survey, 28/03/2011, pp.8-10.

pipelines like ITGI (Interconnector Turkey-Greece-Italy), SEEP (South East European Pipeline) or TAP that would inflict minimal damage on Russia's regional power position while at the same time strengthening Azerbaijan's regional role.[7] *This position is evidently enhanced by the nearly complete absence of any European Major in the natural gas upstream sector of (primarily) Turkmenistan and (secondarily) Uzbekistan:*[8]

(b) they believe that any form of diversification away from Russian gas imports does not have to come primarily from the Caspian Sea, as opposed to greater Arab LNG imports (from Qatar) and the development of Eastern Mediterranean (Israel / Cyprus) and North African (Libya, Egypt, Algeria) gas resources, which are perceived to be far more transit-risk free compared to South Caucasus and Turkey.

(c) they also believe that any form of Caspian gas that bypasses Russia should inflict *–at least for the time being*- a minimal not a maximal geostrategic damage on Moscow's relative power position vis-à-vis the U.S. in the post-Soviet space and particularly in Central Asia, even though this position seems to be under review after the expansion of Turkmen gas deposits in South Yolotan and

(d) incidentally, these four states are neither part of the Nabucco project nor of the Nabucco lobby, even though France initially attempted to join the Nabucco consortium in 2008 via GdF only to be vetoed by Turkey due to France's decision to introduce legislation that criminalized the denial of the Armenian massacre of 1915 as genocide, as well as French skepticism regarding not only the progress but also the desirability of Ankara's integration into the EU.[9]

As we have already presented the implementation of the Southern Gas Corridor Strategy is literally plagued by geopolitical traps and sources of risk that are related to security problems both between and within regional states. One of the major deficiencies in the planning of the Nabucco project was that it overemphasized the benefits the project would offer to the European part of the transportation chain while underestimating the changes in the regional

7 Greek policy never accepted the premise that Nabucco and South Stream are mutually exclusive opting instead for a far more balanced approach that simultaneously promoted both the ITGI and South Stream projects, a policy that was more close to the general opinion of the European Council rather than the European Commission bureaucracy. See, Elisabeth Loverdos & Theodore Tsakiris, "Greece's Role in Europe's Energy Security Policy for Natural Gas", Evropeon Politeia, 03/2009, p.625. Jozias Van Aartsen, the former Dutch Foreign Minister and the first European Council appointed Southern Gas Corridor Coordinator specifically notes in his first report that "projects such as Nabucco and South Stream are compatible", Jozias Van Aartsen, Activity Report: September 2007-February 2009 / Project of European Interest no NG3, Brussels, (4 February 20009), p.3. By upstream gas presence we mean the production and export of natural gas and not gas condensates

8 The only exception is the development of Turkmenistan's Caspian Block 23 which is still in the early exploration stage. The field was awarded in 2009. First seismic were shot in April 2012.

9 "Franco-Turkish Dispute Overshadows Nabucco Project", Euractiv, 20/02/2008, http://www.euractiv.com/en/energy/franco-turkish-dispute-overshadows-nabucco-project/ article-170424

balance of power and the way they influenced the cost/benefit analysis of Baku, which is the irreplaceable linchpin of the entire Southern Gas Corridor Strategy and (most likely) its principal (if not sole) gas provider for the next 10-15 years.[10]

The Geopolitical Context: the Azerbaijani and Turkish Perspectives

From Azerbaijan's point of view the utilization of its hydrocarbon resources as a means of national empowerment was always at the epicentre of the country's strategic orientation towards the Euro-Atlantic Area and its post Cold-War security architecture. Even though Baku does not aspire to join either NATO or the EU, it does want a closer structural relationship with both organizations as a counterbalance to a potential resurgence of Russian regional hegemony and perceives its hydrocarbon exports as a powerful diplomatic "weapon" in this regard. The strategic goals Azerbaijan aspired to achieve through the signing of major PSA (Production Sharing Agreement) with international oil companies back in the mid-1990s, did not merely relate to the understanding that the development of SD and ACG[11] fields would bring huge economic benefits to Azerbaijan.

Even though these benefits have been and will continue to be very considerable in terms of foreign direct investments, hard currency accumulation, energy self-suf-

Shah Deniz. (Source: BP)

10 On 17 November 2010, the European Commission adopted the Communication "Energy infrastructure priorities for 2020 and beyond - A Blueprint for an integrated European energy network." This document says that the strategic objective of the Southern Corridor is to achieve a supply route to the EU of roughly 10-20% of EU gas demand by 2020, equivalent roughly to 45-90 bcm/year.

11 Azeri-Chirag-Guneshli

ficiency, the application of new technologies and the construction of new infrastructure, Azerbaijani oil and gas revenues also serve a major geopolitical imperative: The consolidation of Azerbaijan's geopolitical and geoeconomic independence, the expansion of its regional influence throughout Transcaucasia and the establishment of a ever stronger energy partnership with Europe and the U.S.

From Azerbaijan's point of view the development of SD serves, through the abovementioned PSAs, the need to provide affordable, secure and sustainable energy to Azerbaijan, Turkey and Europe while in the process establishing a new Southern Corridor for the gas supply from the Caspian Sea that puts Azerbaijan in the role of the prominent supplier and long-term transit state. Every country that has been directly or indirectly involved in the SD Project apart from commercial interests had political and strategic interests towards not only Azerbaijan but the whole region. In the 1990s when the ACG (1994) and SD (1997)[12] PSAs were signed a few years after most regional states regained their independence, the entire Caspian and South Caucasus Region was extremely volatile and vulnerable to a strong Russian influence. The rules of the game were basically set by a regional superpower, Russia.

During the 1990s Russia's role, which claimed to prefer to "find regional solutions to regional problems", including the conflicts of Georgia and Nagorno-Karabakh, (although it is not clear how it is possible to find a solution to the conflict while keeping the external players out of the region), was perceived by the other regional states as a hidden attempt at establishing hegemony in the vast area Russia considers "its near abroad". As a result counterbalancing Russia, which itself looks to counterbalance the U.S. (and the EU in general) became a strategic priority for Azerbaijan and for most of the Caspian states.

Despite its continuing conflict with Armenia over Nagorno-Karabakh, Azerbaijan was courageous enough to sign the two historic PSA and invite the International Oil and Gas Majors to develop its vast hydrocarbon resources. If Azerbaijan had not taken that decision at the time it would simply be unable to cope with the repercussions of the Nagorno-Karabakh conflict without the intervention of several western countries and international institutions.

The development of SD would help Azerbaijan emerge as a major gas exporter in the EU context thereby complementing and further enhancing its oil export strategy. The opening of the Southern Corridor and the completion of its associated export/transit infrastructure will also enhance, in the long-term, Azerbaijan's potential role as a crucial transit state for the export of Central Asian oil and gas resources to Europe. Geopolitically speaking the development of SD would also help Azerbaijan to establish closer security cooperation with the U.S., the EU and NATO, which could in turn be instrumental for balancing the regional influence of Russia and Iran.

12 "A new drilling contract for development and exploration projects", http://www.bp.com/genericarticle.do?categoryId=9006615&contentId=7054365

Another important political benefit for Azerbaijan would be the enhancement of its strategy regarding the utilization of its growing energy power in its attempts to resolve the Nagorno-Karabakh conflict. Baku tries to benefit from these energy projects politically by simply securing more votes and influence in various international organizations while also accumulating diplomatic capital in the U.S. and several EU states, whose support is crucial for the resolution of the decades-long conflict between Armenia and Azerbaijan. Yet Azerbaijan is still uncertain about the selection of the most commercially viable evacuation route to the European market, thereby leaving the door open for further political bargaining.

Azerbaijan is also interested in benefiting from the SD project in order to keep Georgia as a close ally and an important regional partner. Azerbaijan has already helped Georgia annul its oil and gas dependence on Russia. State Oil Company of Azerbaijan (SOCAR) controls the port facilities in the Kulevi harbor, a significant portion of Georgia's gasoline retail network and the Baku-Supsa oil pipeline. There is no doubt that Baku is among the country's top foreign investors and its most important commercial partner. A recent practical example of the Baku-Tbilisi nexus is the publicly discussed prospects of SOCAR purchasing the Georgian portion of the gas pipeline connecting Russia and Armenia, which may be interpreted as an explicitly political move against Yerevan.

In addition to the above, the completion of the SD project would further enhance Azerbaijan's "special relationship" with Turkey that Azerbaijan has traditionally tried to maintain, by facilitating the participation of Turkish companies, such as Botas and TPAO in Caspian energy projects. Turkey's greater involvement would make Ankara more self-assertive in the regional political scene and increase its negotiating power vis-à-vis the EU and its accession talks which have fallen behind since Turkey became an EU candidate in 2004. Azerbaijan's official position puts all the emphasis on economics and non on politics. But even if politics matters, it is very hard to claim that SD related decisions were not the most optimal in terms of pure economics.

Turkey has its own ambitions to become an energy hub not only regionally but also internationally, transforming itself into a strategic bridge between Eastern hydrocarbon resources and Western lucrative markets. Ankara is trying to increase its stake in the entire transportation chain, and especially the component of the project, namely TANAP, that will cross through Turkish territory by replacing Nabucco. Two reasons explain Turkey's behavior. First, Turkey wants to utilize its pressure on the EU companies that participate in SD in order to increase its chances of progressing with its accession talks since the integration of Turkey in the EU is the country's most significant strategic priority. Secondly, Turkey wants to maximize its negotiating power vis-à-vis SOCAR and the SD partners in order to secure better prices for the purchasing of the 6 bcm/y of SD II production, including of course a favorable transportation tariff for these volumes through TANAP.

Analyzing the Value Chain: The South Caucasus Pipeline

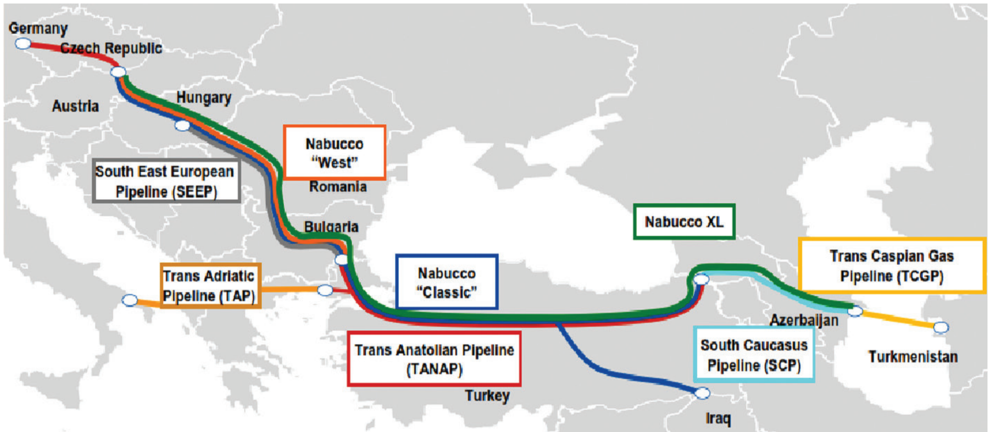
Since 1997 when the original PSA on SD was signed fifteen years have passed. During this 1 ½ decades many things have changed for Azerbaijan as it has managed to accumulate unprecedented wealth, stabilize its political system, and increase the welfare of its citizens and the cohesiveness of its society. SOCAR, the national oil and gas company (NOC) has emerged as one of the largest NOCs in the world employing almost 80,000 people. SOCAR has been the main driving force behind Azerbaijan's economic and financial booming as it emerged into a position of regional prominence and international excellence with offices, representatives and a marketing network that extends from Switzerland and Austria to the U.A.E. and Singapore.

Since 1994 SOCAR has signed over 25 major PSA worth tens of billions of USD while also attracting tens of billions USD in Foreign Direct Investment. Only the upstream component of SD II, which will increase its production by 17 bcm/y by 2017/2018 is expected to cost around $22 billion or more. Thanks to its wise energy policy and smart management the company was able to position Azerbaijan as a very strategically important energy player in the Black Sea/Caspian region which is now able to expand internationally. Today the company has strong financial assets that allow it to invest in various downstream projects not only in the region but also outside the region. Thanks to its vast financial resources SOCAR is expanding its investment in strategic projects not only in the wider Black Sea Region but in Europe and the Middle East.

As a consequence of SOCAR's increased dynamism and the strategic decision of Azerbaijan to have an ever expanding participation in the production and export of its own hydrocarbon resources, SOCAR has decided to claim a major share of the export infrastructure that will be servicing SD exports along the entire value chain from the Sangachal terminal to Austria (Baumgartner) or Italy. *Since SOCAR cannot force a redistribution of the shareholders structure in the SD consortium for the next 24 years, until the concession license expires in 2036, Azerbaijan is determined to acquire more assets along the value chain and the infrastructure through which its gas will be transported. Consequently the company and Azerbaijan would not be satisfied with only a 10 percent stake along the entire value chain.*

Azerbaijan needs to buy more assets in the midstream and downstream projects in order to maximize its revenues and in the long-run acquire more political and strategic influence over the involved regional players. Given the fact that Azerbaijan has succeeded in the core goal of its oil export strategy through the development of the ACG resources –Azerbaijan is set to collect 80% of the $130 billion expected to be "produced" during the 30 years lifetime of the AIOC contract.[13] Baku can now focus on the second component of its energy grand strategy: its emergence as a major gas exporter to the European Union by the year 2025 when Azerbaijani production and

13 "Caspian Oil Windfalls: Who Will Benefit?", http://caspianrevenuewatch.org/news/publications/051203.pdf



Source: RWE

exports will respectively reach 50 bcm/y and 20 bcm/y (most of the rest volume will be re-injected into the ground for oil extraction).

Not being satisfied with its 10 percent stake in the South Caspian Pipeline (SCP), SOCAR with the strong support of the Azerbaijani government has proposed to its SD partners a radical new approach with regards to the construction of a second SCP line that would have more export capacity than the existing SCP pipeline namely 16 bcm/y. Even if the new SCP line would be scalable –through additional compressors- to 22 bcm/y, as it is BP's current development proposal, it would still not be enough to cover SD II volumes as well as the additional exports of gas Azerbaijan would produce by 2025 from several of its recently discovered offshore fields such as Shafag-Asiman, Umid/Babek, Absheron and ACG Deep.

In case a Trans-Caspian Pipeline also materializes then the combined transportation capacity of the SCP/TANAP system must be significantly higher than what is envisioned in BP's existing strategy. That is exactly why SOCAR has proposed to BP and its SD partners, the construction of a second SCP pipeline which will be scalable up to 60 bcm/y and under its majority control. The Azerbaijani NOC would also become the operator of the second SCP line. By having a majority stake in the Caucasus and Turkish component of the whole value chain, Azerbaijan will be able to operate and control part of the strategic project and thus, increase its leverage towards all the players including the EU. It goes without saying that the SOCAR proposal has created significant friction with BP since in this instance corporate interests are obviously diverging.[14]

On the one hand BP is mostly interested in small scale, low fixed infrastructure with minimum investment and maximum pay back within a short period of time. On the other hand Azerbaijan is interested in scalable projects

14 Interviews of Gulmira Rzayeva with senior officials based on Chatham House Rule

since it expects to produce and export far larger gas volumes over the next two decades. BP has already suggested as a second SCP the construction of a 42 inch line, with a transportation capacity between 16-22 bcm. This capacity is the same with the current SCP pipeline. Yet SOCAR and Azerbaijan believe that such an expansion of the pipeline would not make a sense, considering the possible future volume of gas that can be exported from the region. *Baku would be better off if a 56 inch pipeline with a maximum throughput capacity of 60 bcm that would be fully consistent with the TANAP pipeline is constructed.*

In this case the 56 inch pipeline would extend to the Azerbaijani-Georgian border and subsequently be sized down because of Georgia's complex landscape. With the help of two compressor stations in Georgia the new pipeline would be scaled to its maximum capacity, even though additional alternative techniques including looping are being examined in order to maximize the export potential.[15]

Having said that, SOCAR and BP should agreed on, first, the capacity and size of the pipeline, and second, on the allocation of its shares and the role of the operator. It is highly likely that BP might not want to relinquish its favorable position in the existing value chain that gives it a controlling stake in the SCP and SD consortia equal to 25.5%. Arguably BP may seek something in return from Baku. That might be issuing new licenses in virgin offshore territories in addition to BP's existing PSAs in the ACG Deep and the Shafag-Ashiman fields. It would be quite logical to expect BP, Total and Statoil to display a cooperative attitude vis-à-vis SOCAR.

15 Interviews of Gulmira Rzayeva based on Chatham House Rule

Analyzing the Value Chain: TANAP: A Strategic Game Changer?

With the construction of a second SOCAR-operated SCP line that could reach a net throughput capacity of up to 60 bcm/y, Azerbaijan would be able to secure its interests and control the potential volume of gas from the wellhead to the end users (Turkey) in 1/3 of the entire value chain from the Shangachal terminal to Erzurum. However with this arrangement the overall strategy of becoming an influential gas exporter country would not be satisfied. Azerbaijani government as an owner of the gas would not want to transport its gas via the pipeline that belongs to the consortium representing the interest of the consumer countries and be thereof dependent on such an infrastructure where its interests are not represented. That was essentially why SOCAR along with its SD partners were opposed to the original version of the Nabucco project (hereafter Nabucco Classic) since the JVC did not include any of the upstream components of the SD consortium.

It was only logical that SOCAR and its SD partners would want to build a dedicated, standalone pipeline, which would deliver huge volumes of Azerbaijani and in the future Central Asian gas and thus, replace *Nabucco Classic* in the entirety of its Turkish route from Erzurum to European Turkey. The divergence of interests between the SD and Nabucco shareholders on the latter's crossing through Turkey was further intensified by SD's lack of belief in the ability of Nabucco's planners to secure gas from non-Azerbaijani gas sources in Turkmenistan and Iraq (See Nabucco Classic chapter analysis).

This rift, which had been simmering for years, appeared in the public eye in November 2011. Azerbaijan's Energy Minister Mr. Natiq Aliyev openly expressed his doubts over the viability of the Nabucco pipeline project during a press conference held on the sidelines of an energy summit held on 18 November 2011 in Istanbul. Aliyev underlined the absence of available gas sources as a primary concern for Nabucco's short-to-medium term viability noting that "Nabucco's time will come he said "once all of Azerbaijan's gas production projects, including SD II and Absheron, are fully launched…as well as gas from third countries such as Turkmenistan comes on stream". Then, Aliyev emphasized "Nabucco could be the best option".[16]

This was the first time a key Azerbaijani decision maker openly acknowledged the shortcomings of the Nabucco project thereby making direct reference to the comparative profitability of Nabucco's competitors. Aliyev also said that "we believe that apart from Nabucco, which has certain elements of uncertainty about the timeline of its development, there are other projects that can be seen as attractive. First of all these are the Trans Adriatic Pipeline and the Intercon-

16 "Prospects Appear to Dim for EU-Backed Gas Pipeline", http://online.wsj.com/article/SB10001424052970204517204577046131042602316.html

nector Turkey Greece Italy pipeline and other projects of more local character (namely BP's SEEP gas project)".[17] Most importantly the previous day, Natiq Aliyev announced that Turkey and Azerbaijan decided to construct a new pipeline project that will replace Nabucco and have an initial transit capacity of 16 bcm/y that would be progressively expanded to reach up to 60 bcm/y.

This new transportation system whose existence was initially alluded to by SOCAR President Rovnag Abdullayev in late October 2011 and was confirmed on 17 November 2011 by SOCAR VP Elshad Nassirov, and effectively delivered Nabucco's final death blow since it rendered useless the project's major comparative advantage, a single regulated transportation system from Erzurum in north-eastern Turkey to Baumgarten. The solution to this dilemma was given through the announcement of the Trans-Anatolian Gas Pipeline or TANAP which will replace Nabucco on Turkish soil. The pipeline's construction is expected to begin in 2014 and end by 2018 when the production of SD II is expected to begin.

Contrary to what many experts predicted the legal regulatory framework governing the operation of the TANAP pipeline was not a big issue in the negotiations between Turkey and Azerbaijan. It was one of the main problems when BOTAS-SOCAR negotiated their transit agreement which lasted for two years and was finally signed on 25 October, 2011[18] when both sides agreed that the IGA/HGA[19] on the transit of Azerbaijani gas to Europe will be based on Swiss Law. The same provisions were made in the negotiations over the TANAP pipeline; negotiations that were concluded on 26 June 2012.

The TANAP pipeline, is expected to cost around $7bn for the original 31 bcm/y capacity but would be scalable up to 60 bcm/y. Turkey's Botas and TPAO and Azerbaijan's SOCAR are the initial shareholders, with respective stakes of 5%, 15% and 80%.[20] SOCAR has invited all of its SD partners to participate in TANAP, which it sees as meeting Azerbaijan's gas export requirements for the next 15-20 years, including projected volumes from fields which are currently at different stages of development such as Shafag-Asiman, Absheron and Umid/Babek.[21]

It was important for SOCAR to include in the terms of the TANAP agreement the transportation of 6 bcm of gas for export to the Turkish market. Without this 6 bcm of gas, TANAP was not perceived to be financially viable due to the fact that its 56 inch and 31 bcm capacity pipeline will not be

17 "Prospects Appear to Dim for EU-Backed Gas Pipeline", http://online.wsj.com/article/SB10001424052970204517204577046131042602316.html

18 "Turkey, Azerbaijan Sign Landmark Transit Agreement", M.E.E.S., 31/10/2011, pp.9-10.

19 IGA: Intergovernmental Agreement, HGA: Host Government Agreement

20 Interviews by Gulmira Rzayeva based on Chatham House Rule

21 "TANAP Framework Agreement Signed By Turkey And Azerbaijan", Middle East Economic Survey, 02/07/2012, pp.14-15.

economically sustainable with only 10 bcm startup volume. That is why both SOCAR insisted on including this particular provision in the TANAP negotiations and have it respected by the other SD members who will also join in the pipeline's construction.

The transit fee will be charged according to the transit agreement between Azerbaijan and Turkey and other SD shareholders that will join TANAP will pay their transit fees according to the existing transit agreements which will be based on non-discriminatory principles. TANAP is fully supported by both the Azerbaijani and Turkish governments. It is also supported by the UK, the USA and the EU, as well as the TAP and Nabucco consortia. SOCAR would want to hold at least 50 percent but it needs to be mentioned that it will not be easy for SOCAR to keep a 50 percent stake in TANAP. The reason is that the other players of the SD Consortium such as BP, Statoil and Total are also invited to join the project.[22]

However there is a completely different approach from the consumer side at the other end of the network namely the EU, which differs from the position of the upstream players. From the European perspective a free market creates actionable alternatives. According to the EU third party access law no one company or consortium can own assets more than 50 percent in the upstream, midstream and downstream projects of a gas value chain. It is obvious that due to its anti-monopoly rationale the EU will not give the third party exemption permit to the SD Consortium shareholders. Regardless which of the II remaining pipeline options is selected (TAP or Nabucco West) the SD consortium shareholders cannot own more than 50 percent stake in total along the value chain.

Even if the all of the SD consortium shareholder companies will not be able to have a direct access to the end users and distribution network in the markets where SD gas will be sold, it would still be profitable and lucrative for them to sell gas in the supply chain to European consumers. They will not lose anything because the price in the market is high enough. *As it is already mentioned SOCAR may be willing to keep as much as 50% of the TANAP shares but could limit its demands to as low as 40%, provided that it would retain the operatorship and align its percentages in the SCP pipelines with those in TANAP so as to maximize its midstream and downstream influence.*

Turkey's Prime Minister Recep Tayyip Erdogan observed at the signing ceremony of the Turkish-Azerbaijani agreement that TANAP "would be a significant contribution to ensuring Europe's energy security," which would not only cover Turkey's needs but also "create the possibility of transporta-

22 Interviews by Gulmira Rzayeva based on Chatham House Rule

tion through TANAP for Turkmen gas."[23] The reference to Turkmenistan is seen as part of Turkey's support for European Commission plans for the construction of a 30 bcm/y Trans-Caspian Gas Pipeline (TCGP), which Russia and Iran oppose. Azerbaijan is also sceptical about TCGP's prospects and is reluctant to commit capacity for Turkmen gas in its own pipeline system, including SCP and TANAP sections through Georgia and Turkey.

The implementation of the TANAP project will also have important geopolitical implications for all interested parties. Already both Russia and Iran have shown their implicit concern with regards to the possible materialization of the project. Turkey via TANAP is aiming to lessen its dependence on Russian and Iran gas import by importing the additional 6 bcm/y of gas from SD II. For Turkey it is unacceptable to increase the gas import volume from Russia and Iran simply because Iran sells its gas to Turkey for $585/1.000 cubic meters (c/m), thereby increasing Turkey's natural gas bill by an extra $800 million every year.

Moreover, much of the problem in the gas trade between Tehran and Ankara derives from a "take or pay" condition put in the contract. Following the agreement on TANAP, Iran increased the gas price for Turkey from 505$ per thousand cubic meter to 585$[24] the most expensive price Turkey pays for gas. Russia has also reacted and has warned Ankara that it will not supply additional volumes of gas to Turkey in case of emergency during the winter peak demand season. Although Turkey has recently secured a price discount from Gazprom it still pays the average European price of approximately 400$/1.000 c/m.

The cheapest and most commercially attractive price for Turkish gas imports is of course the one from neighboring Azerbaijan at a rate of $330/1.000 c/m.[25] It should not come as a surprise that Ankara is more interested in increasing the gas export volume from SD in long run. Russia has also reacted on the political level. The recent announcement from Ashgabat in June 2012 that it will take the disputed Kyapaz/Serdar field case to the International Court of Justice and, more importantly, will sue the Azerbaijani officials for their statements on the field, is not coincidental.[26] Russia has political and economic leverage over Ashgabat. It should not be excluded that Turkmenistan is making such a move with the silent consent of Russia.

23 "Erdogan: Azerbaijan, Turkey will make significant contribution to ensuring Europe's energy security", http://en.trend.az/capital/energy/2040720.html

24 http://www.byegm.gov.tr/yabanci-ultenler.aspx?d=15.03.2012&pg=2&ahid=50189&act=3

25 http://www.todayszaman.com/news-270575-turkey-eyes-solution-as-iran-insists-on-unfair-gas-price.html

26 "Turkmenistan threaten international legal action against Azerbaijan over disputed oil fields", http://www.edmonton-journal.com/technology/Turkmenistan+threaten+international+legal+action+against+Azerbaijan/6867280/story.html

The Collapse of Nabucco Classic and the Elusive "Turkmen Connection"

The inability –primarily due to U.S. diplomatic opposition- of Nabucco's planners to secure any realistic prospect of gas supplies from Iran and (Kurdish) Iraq, so as to make their original plan viable to the eyes of the SD consortium, resulted in a major push on the part of the U.S. and the European Commission that focused on the resolution of the Azerbaijani-Turkmen maritime disputes in the Caspian Sea. The potential demarcation of the respective sector borders and territorial waters between the two littoral states would nullify the political risk associated with the construction of a TCGP which would in turn make the original Nabucco project bankable.

In effect, the European Commission's efforts to resolve the Kyapaz/Serdar dispute were not only another direct attempt to boost the chances of the faltering Nabucco project. The involvement of the European Commission was also the EU's first foreign energy policy initiative that aspired to neutralize a key source of regional instability, a potential flash point that lies, literally, in the middle of the TCGP route. It should be noted though that even if the Kyapaz/Serdar dispute were to be resolved, Turkmenistan would still be unable to meet the timetable of the SD partners given the fact that Ashgabat does not allow any access to International Oil Companies in the lucrative onshore acreage of its eastern and central regions that are so far exclusively dedicated to the service of Turkmen exports to China from CNPC's investment in the Turkmen South Yolotan/Yarshlar fields and (secondarily) Iran, which is dependent on imports from the Dauletabad field.

Bridge Over the Caspian: Turkmenistan to the Rescue?

The publication on 7 September 2011 of what would constitute the European Commission's proposal of a foreign energy policy for the EU was a long-awaited document that –if implemented- could have far reaching implication in the conduct of national energy diplomacy among the member-states. The policy paper titled, On security of energy supply and international cooperation - *"The EU Energy Policy: Engaging with Partners beyond Our Borders"*[27] basically argued that the powers of the Commission should be expanded to the degree of allowing it:

27 European Commission, COM(2011) 539 final, COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS, On security of energy supply and international cooperation - "The EU Energy Policy: Engaging with Partners beyond Our Borders", (Brussels: 07/09/2011). (Hereafter: Engaging with Partners)

(a) not only to establish so cohesive an internal energy market so as to create a unified energy importer that would stop the conduct of bilateral energy import agreements between member-states and third-parties, such as the ones between i.e. EDF, Wintershall, ENI and Gazprom,[28] but also (b) the ability to negotiate *on behalf of member-states major foreign energy agreements regarding the import of energy resources and the construction/financing of associated infrastructure*. The case *par excellence* that the Commission would try to use as an example to persuade the European Union on the necessity of its request for more leverage vis-à-vis the Member-States is of course the "opening" of a Western Trans-Caspian route for the export of Turkmen gas to Europe, which is mentioned four times in the proposed policy framework as an issue of major priority if not *necessity.*

The Commission officials who drafted this policy document spared no efforts to underline their perception of how significant the Trans-Caspian Pipeline or TCP option is for their own understanding of a more unified EU External Energy Policy.[29] For the Commission "Negotiating mandates for the EU may be necessary where agreements have a large bearing on the EU energy policy objectives and where there is a clear common EU added-value. The recent adoption by Council of a mandate to authorise the Commission to negotiate an agreement for the legal framework with Azerbaijan and Turkmenistan for a TCGP system offers an immediate example of the benefits of EU-level action for energy security".[30]

Apart from the fact that the Commission appeared to pre-judge the benefits of a negotiation it had not even begun,[31] what is important to underline is that the speed through which the Commission wanted to acquire the above-mentioned mandate may be misinterpreted as a sign of indirect favouritism for only one (Nabucco) of the three contestants of the Southern Gas Corridor who at the time were vying for the SD II contract and needed the opening of Turkmen exports before SOCAR and the other SD II partners decided to close the first tendering round on 1st October 2011.

28 The Commission is currently introducing legislation that would oblige the member-states to inform the Commission before signing any major national energy agreement with non-EU member states whereas until now the member-states had no such obligation and would communicate intergovernmental energy import or infrastructure agreements ex post facto to Brussels. The Commission demanded this notification in order to determine their conformity with the regulation of EC Competition Law and the function of the Internal Energy Market. European Commission COM (2011) 540 final 2011/0238 (COD), *Proposal for a DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL setting up an information exchange mechanism with regard to Intergovernmental agreements between Member States and third countries in the field of energy, (Brussels: 07/09/2011).*

29 It goes without saying that any generalization of the EC's proposal on the Trans-Caspian pipeline will effectively limit the flexibility of national energy diplomacy, an issue that could also infringe on the prerogatives of the Lisbon Treaty where it is clearly stated that any new powers of coordination the Commission may acquire will not interfere with the ability of the member-states to source their foreign energy imports as they *choose.*

30 European Commission, *Engaging with Partners,* ibid, p.4.

31 The Council approved the mandate on 12 September 2011.

The drafters of this policy document, which guided EC policy in the Caspian Sea, are also trying to create the impression of an absolute necessity behind their (and Nabucco's) need for speed on the TCP. For anyone who is even faintly familiar with EC documents, the Commission very rarely used the word must in its formal communications. When it came to the TCP the word must appeared three times in two paragraphs "The EU must demonstrate that it is prepared to engage with the Caspian and the Middle East regions on a long term basis, both politically and economically. It must also assist main supplier countries like Azerbaijan, Turkmenistan, Iraq and others, notably in the Central Asian region, in developing their energy sectors in an efficient and sustainable way and related trade and investment patterns with the EU. As part of the Southern Corridor, the proposed agreement on Trans-Caspian Gas Transmission and Infrastructure between the EU, Azerbaijan and Turkmenistan must pave a way for the construction of physical infrastructure for the supply of Turkmen natural gas across the Caspian Sea".[32]

On 12 September 2011 the European Council decided to grant an unprecedented mandate to the European Commission allowing it to negotiate a legally binding agreement for the construction of a TCGP between Azerbaijan and Turkmenistan. This is the first time the Commission's bureaucrats have been given the authority to negotiate a prospectively major energy import agreement, such as the sourcing of Turkmen gas to Europe instead of the Union's Member-States. Mikolaj Dowgielewicz, Poland's EU Minister, who was holding the rotating six-months Presidency of the European Council, noted that "This is very significant in terms of strengthening our leverage vis-à-vis key suppliers and partners in energy".[33] Dowgielewicz also announced that "negotiations would start in September [2011]. That is currently the plan". Nabucco's CEO Reinhard Mitschek applauded the Commission's decision as he tried to underplay Turkmenistan's significance as a "make or break" deal for Nabucco's viability, noting in a press release that "This groundbreaking initiative taken by the European commission matches the aim of the Nabucco project to enable the transportation of a broad diversified gas portfolio. Following a multi sourcing approach, Nabucco will not be dependent on the construction of a potential Trans-Caspian pipeline. Nevertheless, it is a fact that the big potential for gas exports on both sides of the Caspian Sea is vital for the future of the European and Turkish gas markets".[34]

Leonhard Birnbaum, RWE's Head of Strategic Planning, told during a press conference in the sidelines of an energy conference organized in Mu-

32 European Commission, *Engaging with Partners,* ibid, p.5.

33 "EU Member States Give Commission Mandate To Negotiate Caspian Pipeline", http://www.downstreamtoday.com/news/article.aspx?a_id=27848&AspxAutoDetectCookieSupport=1

34 "Nabucco welcomes EU initiative towards Turkmenistan", http://www.europeanenergyreview.eu/site/pagina.php?id=3208

nich on 13 September 2011, that Nabucco "is making good progress" following the EC's Turkmen mandate, noting that "If the talks are successful there will be enough gas (for Nabucco) even without (gas from) North Iraq".[35] The news was not welcome in Russia, who on 16 September 2011 oversaw the finalization of South Stream's main shareholders structure during a ceremony in Sochi. On 13 September 2011 Russia's Foreign Ministry issued a statement that did not mince its words with regards to Moscow's opposition vis-à-vis Europe's "intervention" in the Caspian Sea. The statement noted Moscow's "surprise" on the decision of the EU Council underlining that it "regretted the EU's decision which by all appearances, ignores the current international, legal and geopolitical situation in the Caspian basin".[36]

The statement also noted that the construction of a Trans-Caspian pipeline would be very challenging since the project would be crossing a region of "high seismic activity". "As we know" the Russian Foreign Ministry said, building such a project "is a first experience for the European Union too, and we are surprised that it is in the Caspian Sea, which does not border any of the European Union members".[37] Finally the Russian communiqué warned that "all attempts to intervene in the Caspian deal could seriously complicate the situation in the region and negatively affect talks on the status of the Caspian Sea. EU Energy Commissioner Gunter Oettinger did not mince his words either, noting, with phenomenally un-diplomatic clarity during an interview with Deutsche Welle on 14 September 2011, that Russia should not use its gas exports to politically pressure Europe and that the South Stream project is obstructing Nabucco. "If the Russians try to hinder Nabucco both technically, by constructing South Stream, and politically, by pressuring Ashgabat and Baku, I personally will have less confidence in numerous gas contracts with Russia and believe less that gas is not a political instrument for Russia".[38]

Why this urgency? The first obvious reason related to the October 1st, 2011 deadline set up by the SD consortium for the submission of the finalized transportation proposals for the transit of the 10 bcm/y. The second less obvious reason is that the momentum which was built around a statement made by Turkmen President Gurbanguly Berdymukhamedov in November 2010[39] regarding the de-linking of the TCGP from the Azerbaijani/Turkmen dispute over the sovereignty of the Kyapaz/Serdar fields has all but evaporated, despite the first ever visit by an EC President to Turkmenistan in January 2011.

35 *DowJones*, 13/09/2011

36 "Russia issues warning after EU decision on trans-Caspian pipeline", http://www.azernews.az/oil_and_gas/36150.html

37 *Middle East Economic Survey*, 19/09/2011

38 *Deutsche Welle*, 14/09/2011

39 The Turkmen President said he was "firmly convinced that laying an underwater pipeline in the Caspian Sea may be carried out only with the consent of those countries, the sections of which it will cross", the *Azeri Press* Agency reported on 19 November 2010.

Yet, since January 2011,[40] Berdymukhamedov has confirmed his willingness to support a TCP option, but has refused to put his money (or more accurately his gas) where his mouth is. He has remained as elusive as ever and has been able to procrastinate by literally "cashing in" on the drastically expanding Chinese interest over the vast resources of the South Yolotan reserves. This interest has been translated into a $18 billion investment in the form of soft loans extended to Turkmenistan by the Chinese Development Bank over a period of two years from 2009 to 2010.

In May 2011 China has succeeded in further expanding its strategic presence in Turkmenistan by extending another major financial package agreement of $4.1 billion that would be translated by 2020 into the export of about 20 additional bcm/y of South Yolotan gas to China via an extended Central-Asia to China (CACN) gas pipeline system. This was the third such loan China's Development Bank has extended to Turkmenistan for the development of South Yolotan in less than two years, following a $4 billion soft loan to Turkmengaz for the initial development of South Yolotan in June 2009 and a another $9.7 billion financial "assistance package" that was given to Ashgabat in December 2009.

China wants to import around 60 bcm/y of Turkmen gas by 2020 a volume equal to its entire final consumption in 2010. More recently CNPC decided to push the 2020 deadline by five years to 2015, by announcing on 26 August 2011 that it has order its Central Asian affiliate, the Central Asia Gas Co. to start laying two new pipelines parallel to the existing system before the end of this year in order to complete the doubling of the system's transportation capacity to 55-60 bcm by 2015 from an original estimate of 30 bcm/y. According to the China Petroleum Daily, CNPC "has set a goal of running nearly 7,000 km of gas pipelines through central Asian countries with 55-60 bcm of annual transportation capacity by 2015".[41]

Despite the most earnest efforts of *some* European Commission officials, as long as China subsidizes Turkmenistan's financial needs, Mr. Berdymukhamedov has no immediate need to call his bluff on Russia and seriously consider promoting the TCGP option which could have saved Nabucco's life in late 2011-early 2012.

Moreover there is always the possibility that Russia may step in and repurchase a significant portion of Turkmenistan's idle 40-50 bcm export capacity that Moscow shut down since April 2009, if only to serve the purpose of killing Nabucco; a prospect that has increased especially after Gazprom's

40 "Is Turkmenistan Again Moving Towards Russia, Despite EC Visit?", Eurasia Energy Observer, 01/06/2011, http://www.*eurasia-energy-observer*.com/news/2011/turkmenistan-2

41 "Central Asia-China gas pipeline's capacity to nearly double", *China Daily,* 26/08/2011, http://www.chinadaily.com.cn/bizchina/2011-08/26/content_13198467.htm

recent rapprochement with RWE (July 2011) that has limited the number of Nabucco enthusiasts in Ashgabat. May be it is not accidental that the rapprochement between RWE-Gazprom in Europe nearly coincided with the decision of Turkmenistan to let Turkmengaz buy –for domestic consumption only- Petronas' first offshore gas production from Block 1.[42] Petronas was supposed to be Nabucco's first Turkmen-based customer.

Finally, despite public attestations to the contrary, Azerbaijan may be far less keen on promoting a TCGP option especially if this is not translated to any practical political gains for Baku in its continuing dispute with Turkmenistan over the Kyapaz/Serdar fields and the limits of their respective territorial waters in the Caspian Sea. Baku as well as Ashgabat understands that the EU need for a TCGP would help them resolve their bilateral disputes even though they naturally disagree on the method and context of the actual resolution. *They are both trying to get the EU on their respective side even though the EU is basically interested in pretending that the problem does not even exist.*

The EU wants to disassociate the TCGP from the Territorial Waters dispute in order to get it built as quickly as possible. The Azerbaijanis and the Turkmens want to do the exact opposite and the EU diplomats seemed to have lost track of this reality. *Moreover, even if the Kyapaz/Serdar dispute was resolved in Baku's absolute favour, a rather dubious prospect, Baku would have very little incentive to facilitate the transit of Turkmen gas through the SD II related infrastructure, since it would prefer to commit the system's transit capacity in order to serve its own gas exports beyond SD II.*

Azerbaijan understands that recently discovered offshore fields like Umid/Babek, Absheron, Shafag-Ashiman and Nakhchivan, could double by 2025 its net export capacity to 20 bcm/y, that is three to five years after SD II's exports reach their maximum level. That is exactly why the SD partners are demanding from the downstream pipeline consortia to be scalable in order to accommodate volumes exceeding the 10 bcm/y which could be expected to flow to Europe by 2017/2018.

In the long term Azerbaijan could be interested in getting some transit revenue from the facilitation of Turkmen/Central Asian supplies when its own gas exports will be diminishing and thus emerge as a significant transit country between resource rich Central Asian states and the lucrative European markets. It should also be noted though that SOCAR clarified its unwillingness to take any responsibility for the construction of TCGP while remaining available to continue negotiations with the Turkmen side under the EU framework.

42 "Turkmenistan Wary as European Partners Court Russia", *Nefte Compass*, 04/08/2011

SOCAR says that Turkmenistan has to agree on a tariff for the transport of its gas through Azerbaijan. SOCAR has offered several times at several levels average transport tariffs, flexible, transparent, and fixed for thirty years or longer, in order for the producers of Turkmenistan to make their calculations. Turkmenistan has to decide if it wants a European export option but it has to do it in ways that are in synch with SD plans. If the SD partners first expand the South Caucasus Pipeline and build TANAP and Turkmenistan comes after both projects are completed asking for the transit of its gas, then adaptations will be much more expensive.

In reality no adaptations may be needed after all. From the Azerbaijani perspective the TCGP project is a long-term *option, not a medium-term necessity* which is linked to the political resolution of the outstanding Caspian disputes between Baku and Ashgabat. As the SD partners were reaching their final decision between the Nabucco West and SEEP projects, an incident over the disputed Kyapaz/Serdar field that straddles the non-demarcated territorial waters of Azerbaijan and Turkmenistan, underlined the main reason why the original Nabucco project was unsustainable.

Despite several years of diplomatic efforts from the U.S. and the EU which were accelerated after November 2010 the construction of a TCGP remains as elusive as ever since the project was initially proposed by Shell in the late 1990s. An incident that apparently involves the shooting by Azerbaijani boat patrol guards of a Turkmen exploratory vessel that attempted to conduct seismic works over parts of the Kyapaz/Serdar field has sparked the latest round of recriminations and high level tensions between the two southern Caspian states.

On 18 June 2012 according to a statement by the Turkmen Foreign Ministry, Ashgabat noted that “Turkmenistan strongly protests the attempts of illegal actions on the part of the Azerbaijani border guards against the civilian vessel, conducting research and development in the sector of the Caspian Sea, which does not belong to Azerbaijan”. Azerbaijan has countered that the Turkmen boat was violating a 2008 bilateral agreement, brokered by the U.S., that called for the cessation of all exploration work over the disputed field until and unless the maritime boundaries between the two sates were fully delimitated.

The cornerstone of EU and US diplomacy on the TCGP project was that the pipeline could be constructed despite the absence of an agreement between Azerbaijan and Turkmenistan on their maritime boundaries and in extensio the sovereignty of the Kyapaz/Serdar field as well as parts of the ACG fields that Turkmenistan calls Osman and Omar. On 30 June Turkmenistan’s newly appointed Energy Minister Kakageldy Abdyllayev told TDH, the Turkmen State News Agency that the Azerbaijani position, which claimed that Azerbaijan was acting in ways that defended its sovereignty, “reflect the onesided view of the Azerbaijani side and do not reflect the real situation on this issue".[43]

Abdyllayev repeated the Turkmen position that (a) the 2008 agreement does not exist and that (b) Serdar field is entirely in the Turkmen sector of the Caspian Sea "since the median line is approximately near the meridian 51 degrees 10 minutes east longitude, according to the principles and norms of international maritime law". The hardening of Turkmenistan's position is also evidenced by the repetition of its claims that Azerbaijan and its AIOC partners are developing the ACG fields in ways that "do not comply with international law". *As a result, Abdyllayev declared that Ashgabat had decided to take its case into the International Court of Justice, a move that, if confirmed, will effectively spell the end of the TCGP negotiations.*[44]

Final Selection: A Comparative Analysis of the TAP and Nabucco West projects

When in 2003 the planners of the Nabucco pipeline named their 31 bcm/y project after the famous Verdi opera, they might not have been able to imagine that almost ten years later they would still be "signing" in the Southern Gas Corridor "operetta". In reality many of them would feel relieved that they are still able to perform one of the two leading roles even though the size of their role has been diminished by almost 2/3 compared to their original concept. It was nevertheless the exact downsizing of the original project that still allows Nabucco West to play in the "grand finale" against TAP over the selection route for the transport of 10 bcm/y of SD II gas to Europe. If Nabucco had been unable to transform from the 3.900 km project to a much smaller 1.312 km line that aspires to link European Turkey with Baumgarten, TAP would have almost certainly won.

The transformation of Nabucco to a far less ambitious project that is effectively tailor-made to meet the needs of the SD partners while disregarding the needs of potential suppliers from the Middle East (and most probably Turkmenistan) was not an automatic process. There have been significant tension and disagreements between the Nabucco partners as SOCAR and Botas championed the idea of the TANAP pipeline which basically replaced the Asiatic component of the original Nabucco but simultaneously annulled any realistic prospect for the medium-term export of Iraqi –or more precisely- Kurdish gas from the Khor Mor and Chemchemal fields that are currently developed by Nabucco leaders OMV and MOL.

43 "Azeri/Turkmens Dispute Derails TCGP Negotiations", M.E.E.S., 09/07/2012, pp.14-15.

44 "Turkmenistan Says Taking Oil Field Dispute With Azerbaijan To UN Court" http://www.gundogar.org/?024100000000000000011062012060000

Despite these tensions as SOCAR became more and more adamant in securing the leading role in the TANAP project, Nabucco was left with no real option but to adjust to SOCAR's requirements as another leading SD member, BP, was aggressively championing the rival SEEP. SEEP, whose regulatory and financial details were never fully detailed, initially appeared as a strong competitor to Nabucco given BP's backing and the fact that it aspired to utilize pre-existing pipeline infrastructure, such as the Interconnectors between Bulgaria, Romania, Serbia and Hungary, that would have been commissioned throughout SE Europe by 2015.

Some observers indicated that the vagueness of SEEP's technical details were deliberate since the entire project was in effect a SD *stratagem* to force Nabucco's compliance to the needs of SOCAR and its other SD partners that are developing in partnership with SOCAR other very promising acreage in Azerbaijan's offshore sector, like the Absheron (Total), Umid/Babek (SOCAR), ACG Deep (BP) and Shafag / Asiman (BP) fields. The potential exports of these fields should be given absolute priority over uncertain flows of natural gas that emanated from volatile areas like Kurdish Iraq and Turkmenistan were none of the abovementioned SD partners have any major upstream presence.

Even though SEEP's obscurity was deliberate and–in combination with TANAP's emergence- did make the downsizing of Nabucco practically inevitable, the principal reason behind SEEP's demise may be found in the fact that it never aspired to link SEEP with a major European hub. SEEP's principal target was to divide the 10 bcm/y of the SD gas almost equally between the five principal Balkan consumers (Greece, Bulgaria, Romania, Hungary and Serbia) and might have left the option of increasing its scalability to another 10 bcm/y in order to reach Baumgartner after SD II exports had been sold out. In effect SEEP appears to have violated one of SD's principal selection criteria, namely that the selected infrastructure should be nearly automatically scalable to export another 10 bcm/y of future Azerbaijani export capacity.

These additional 10 bcm/y, which may not be available before 2025, cannot be absorbed by the aforementioned five Balkan states and would have to be transported in toto to Baumgarten. Nabucco West offers both options and does not stop at the Romanian-Hungarian border, as SEEP's latest draft routing suggested. Nabucco proposes to sell 4-5 bcm/y to Bulgaria, Romania and Hungary while transporting the remaining 5-6 bcm/y to Baumgarten at a cost which is still unspecified. On 29 June Reinhard Mitscheck, the project's CEO noted in a press conference following the announcement of Nabucco West's selection the day before, that "Nabucco delivers freedom of choice to gas consumers and will contribute considerably to the security of supply in

Europe”[45] but of course did not disclose the actual cost of the scaled-down 1.312 km line. What he did stress though is that Nabucco has already in place a strong “legal framework with Romania, Bulgaria, Austria, it (Nabucco) also has European commission’s support” Moreover, Mitscheck emphasized “Nabucco West can transport gas not only one financial market, but to all Europe”.[46]

Mitscheck was indirectly referring to what may prove to be TAP’s Achilles ‘Heel: the lack of an Intergovernmental Agreement between Greece, Albania and Italy that would facilitate the granting of all the necessary environmental and Third Party Access permits. Even though Mitscheck appears to be undervaluing the significance of the Italian market as a major consumer of Azerbaijani gas as well as Italy’s ability to act as a transit state towards Switzerland and more importantly France, Total’s “home market”, he has a salient point when illustrating the support Nabucco has been getting from the European Commission.

EU Energy Commissioner Gunther Oettinger was quick to commend SD on its decision by noting that Nabucco West’s selection “represented a success for Europe and for our security of supply”.[47] The Commission’s dedicated endorsement of Nabucco is the principal reason why the continued absence of an IGA agreement between TAP’s “Host Governments” may prove to be detrimental to the project’s chances, despite the fact that it is considerably more attractive than Nabucco West from a financial and commercial point of view. TAP has access to a major scalable market in Italy that is also very well connected with all Central and Western European markets in Germany, Switzerland and France.[48]

It should be noted though that Nabucco West’ selections seems to have altered the mind of MOL, which has effectively announced its decision to withdraw from Nabucco in May 2012 and still (c.c. late June 2012) has not paid its share (€3 million) of the consortium’s 2012 budget of €18 million. On 2 July 2012, MOL’s spokesman, Domokos Szollar, told *DowJones* that “This (SD’s selection) could bring an end to the long period of uncertainty resulted from the infeasibility of the original Nabucco plan” adding that the decision in favour of Nabucco West confirmed MOL’s calculation that the original concept “wasn’t sustainable”.[49] It is still unclear whether Nabucco’s finances would make sense in the long-term as TAP’s shareholders’ composition changes to

45 “SD consortium selects second gas export route to Europe”, http://www.azernews.az/oil_and_gas/42636.html

46 en.apa.az/news.php?id=174756

47 “Commissioner Oettinger welcomes decision on “Nabucco West” pipeline”, http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/720&format=HTML&aged=0&language=EN&guiLanguage=en

48 *German Gas Supply via the 4th Corridor,* E.ON, paper presented at the European Infrastructure Management conference, 11/5/2012

49 “Hungarian MOL: SD consortium’s decision can bring end to uncertain period for Nabucco”, http://en.trend.az/capital/energy/2042536.html

include major global, European and regional players that would only increase the pipeline's commerciality. TAP's financial and commercial merits seem to have secured it a key ally that may eventually tip the scale in its favour vis-à-vis Nabucco West.

Source: TAP

On 27 June Al Cook, BP's Vice-President for SD Development, told Dow Jones the SD operator, which owns along with Statoil 25.5% of the consortium, had "in principle" completed negotiations to join TAP and "to help provide funding in the short term." He added that BP's participation "will be substantial… We will demonstrate that we are very serious about the success [of TAP]".[50] It is not yet clear how the shareholders composition of TAP would emerge as both the Italian and Greek governments are reviewing their strategies in order to exchange the signing of an IGA with Albania with the participation of Greek and Italian companies in TAP.

BP's share may even be higher than the present participation (15%) of E.ON in the TAP consortium and may even exceed 20%. However, a share of 20% may be the most likely compromise since the TAP partners are also looking to bring in an Italian and a Greek company. TAP executives have been negotiating with Italy's Enel and Greece's M&M (Mytilineos & Motor Oil) over a combined share of 20-30%. Enel is thought likely to ask for 15-20%, whereas the Greek gas trader is expected to seek 5-10%.

BP's announcement will likely precipitate the talks between TAP, Enel, ENI and M&M. The Italian government is increasingly keen on TAP following a rejection in June 2012 of the revised ITGI proposal by the SD partners. Mr Cook said BP's announcement will likely precipitate the talks between TAP, Enel, ENI and M&M. The Italian government is increasingly keen on TAP following a rejection in June 2012 of the revised ITGI proposal by the SD partners. Mr Cook said BP's decision to invest in TAP "was partially motivated by the changing regulatory and economic outlook in Italy." Italy's increased regulatory flexibility is an indication that Rome has fully abandoned ITGI.

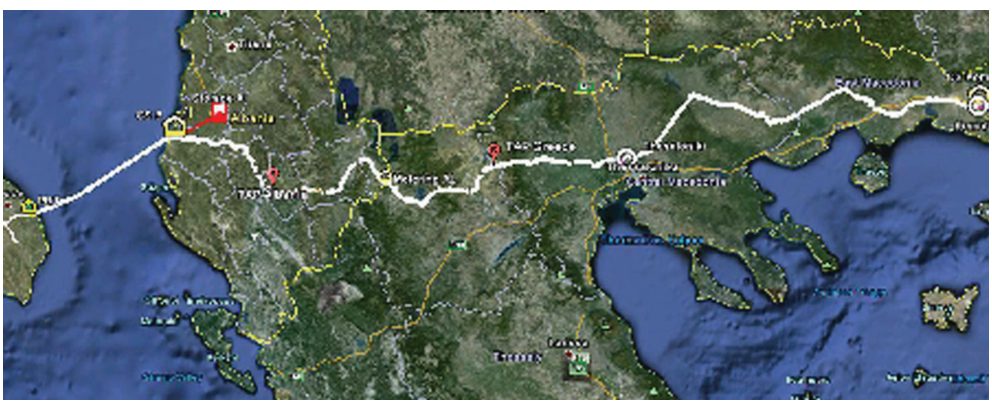
It is still unclear what the policy of the new Greek government will be, with former DEPA President Makis Papageorgiou being sworn in (June 2012) as Deputy Minister of Energy.

50 BP Plans Major Pipeline Investment for Caspian Gas" http://online.wsj.com/article/SB10001424052702303649504577492231449786036.html

Mr. Papageorgiou is perceived as a staunch supporter of the IGI/Poseidon component of ITGI, which was established during his tenure at state gas utility DEPA in 2008. The 17 June 2012 elections have resulted in a divided structure of power within the Greek Ministry of Energy where the top job landed in the hands of a non-elected University Professor of Cartography, Dr. Evangelos Livieratos who is a personal choice of PASOK's President and former Finance Minister Evangelos Venizelos.

In general terms it is believed though that Greece would not object to a strategic shift in its policy of supporting ITGI as a conduit of SD gas as long as this decision was synchronized with Italy and as long as a major Greek company participated in TAP in order to secure 1,5-2 bcm/y of SD gas for the long-term needs of its domestic market. As already mentioned on 29 June the SD consortium announced that it has selected the Nabucco West project to transport Azerbaijani gas to the South East European markets.

Since Nabucco East was replaced by SCP and TANAP the Nabucco consortium had no choice but to suggest a downsized and abridged version of the project – Na-



Source: TAP

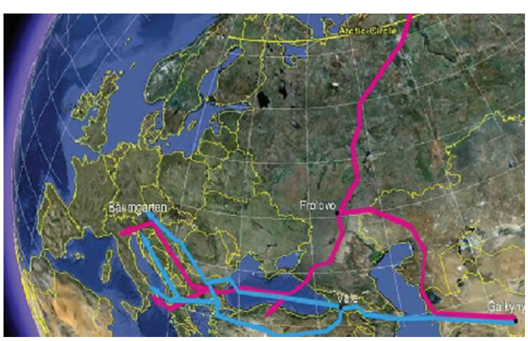
bucco West, which would be the way cheaper than Nabucco XL, which starts at the Caspian Coast and Classic, which starts at the Georgian-Turkish border. Apart from the strategic and geopolitical concerns of the SD consortium being dependent on the Nabucco consortium along the entire value chain another no less important reason of Nabucco Classic falling out of favor is the commercial viability of the project.

Big and expensive pipelines with spare capacity are considered as a commercially not attractive as it makes the transportation cost much higher. For instance, *according to a basic calculation based on a sales price assumption of US$400/mcm in Austrian destination markets in 2020, the netbacks to SD associated with SEEP or Nabucco West are around US$260/mcm, while the netback of Nabucco XL or Classic is much lower at US$125/mcm.* Needless to say, that the lower infrastructure tariffs mean more producer margin especially in times of financial crisis. Nabucco Classic had problems on the market end as well. Because there have been no sale and purchase agreements whatsoever the lenders could not finance the project and, thus, guarantee its materialization. Nabucco Classic did not even have a clear estimate of what the 3.900 km pipeline would cost while several companies of the consortium including RWE and MOL expressed serious doubts over the original project's feasibility and financiability.

Apart from the political support necessary to underpin both pipeline options as well as the ability of the partners to finance and construct the project without EU or other subsidies, a major parameter in the decision making process of the SD partners is the actual net back benefit in terms of value for sale of SD gas to Italy via TAP or to the Balkans/Baumgartner via Nabucco West. Both markets are different with different values. The South East European market is of strategic importance for Azerbaijan. At present the gas price in the region is 25 percent higher than the spot price in Austria.

This is only possible because other forces are interfering in the free flow of energy throughout the region. Most Balkan states buy nearly all of their gas from only one supplier, Gazprom, and have no access to alternative sources of gas and non-Russian controlled transport infrastructure. Nabucco Classic planned to supply little or no gas to Bulgaria and no gas to the nearby countries of Albania, Greece, Montenegro, FYROM, Croatia and Bosnia –Herzegovina. Balkan countries may be small markets but the combination of the small markets is the diversification of demand and is the guarantee of continuous demand and off-take of gas.

Nabucco West, if realized could be a game changer in terms of strategic imperative of reducing Russian Gazprom's market share through diversification of supply to Central European countries. In the Balkans, Gazprom has the ability to intervene and block access to pipelines for third parties. It is only possible because the Russian monopolist sets the gas price, and also owns a lot of downstream assets in the region through joint ventures. Caspian natural gas could change the situation in this market and as such is vital for the region.



On the other hand the average price for the Italian hub is marginally higher compared to existing Baumgarten prices. Moreover as the interconnectivity of Balkan gas markets (Greece, Bulgaria, Romania, Hungary, Croatia) expands by 2014/2015, the net back price will fall especially since the completion of the IGB (Interconnector Greece Bulgaria) pipeline may offer all the northern Balkan states access to Qatari LNG via the Greek Natural Gas Transportation System.

It is quite probable that Gazprom's stranglehold over Balkan gas markets will be broken either by Azerbaijani gas before SD II begins producing in 2018 or by Qatari LNG exports that are already available. *That is why the security of demand offered by SD access to a major market like Italy and via Italy to the core of the European market could constitute a major additional advantage for TAP and the Statoil-BP alliance.*

Conclusions

In approximately 6-12 months the SD consortium will make a strategic decision of historic significance concerning the selection of the main export pipeline whose construction will inaugurate Europe's Southern Gas Corridor strategy. The geostrategic, political and financial implications of this mega-pipeline project for Azerbaijan, the SD partners, the EU and the whole region have been analyzed in this report.

The selected evacuation route must be the most commercially viable and the selected market should be able to offer to the sellers long-term security of demand for a period of at least 20-25 years. The SD decision is not a merely commercial decision since it will benefit the people of Azerbaijan for decades to come. Future generations of Azerbaijanis are unlikely to congratulate decision makers for making less money to put in State Oil Fund of Azerbaijan (SOFAZ). There is no room for errors. Even the slightest mistake can have a negative impact on the future well being of the country.

The two final pipeline projects under consideration by the SD shareholders offer SOCAR and its partners several advantages and disadvantages. The major advantages of the Nabucco West option can be summarized as:

- Higher gas price in the Balkan component of the market as a result of the complete reliance on only one gas supplier.
- Nabucco West, if realized could be a game changer in terms of the strategic imperative of reducing Gazprom's market share through diversification of supply to Southeastern and Central European countries.
- If the planned and EU supported interconnectors are completed between the countries along the Nabucco West route (Bulgaria, Romania, Hungary, Austria) and the Western Balkans (Serbia, Croatia, B/H) they would have an additional asset and strength. Balkan countries may be small markets if viewed separately. Yet in combination they could guarantee a solid market for the first 10 bcm/y of SD gas.

- The specific importance for the SD consortium would be the guarantee of access to the German market.

However:

- The TEN (Trans-European Network) financed interconnectivity projects throughout SE Europe are not necessarily dependent on Nabucco. They can develop separately and will be completed several years ahead (circa 2015) from the Nabucco project or for that matter TAP.
- The markets along the route are small and gas import volume is limited. It is very difficult to foresee the entire Balkan markets to be able to absorb more than 10 bcm/y of new gas supplies beyond 2020. Moreover as more interconnectors are built and new sources of supply arrive in the Balkans from Arab or East Med sources the final net back price for the sellers will eventually diminish.
- Furthermore, the new discoveries on the Romanian coast of Black Sea would put some risks on the ability of the market to absorb imported gas. For the SD consortium it is preferable to leave substantial volume of gas in those countries rather than in the Austrian hub as it would give SOCAR an opportunity to get a direct access to the gas buyer companies and end users.
- This is particularly important in three Balkan countries (Albania, Montenegro and Kosovo) where no gas has been used. These are new markets and apart from gas supplies SOCAR would have a chance to invest in infrastructure and their downstream markets as it has been successfully doing with oil products in Georgia, Romania, Ukraine and Switzerland. In this sense TAP's projected expansion to the markets of the western Balkans is far more appealing to SOCAR and its partners.
- If Nabucco West would have to apply for Third Party Exemption again due to the reconfigured technical features of the project, it would take at least another year to obtain it.

The advantages of the TAP project can be summarized as follows:

- The gas price on the Italian hub is 20% higher than in Western Europe and around 5% higher (depending on seasonal fluctuations) than Baumgartner.
- Solid financial capability. It is still unclear whether Nabucco's finances would make sense in the long-term as TAP's shareholders' composition changes to include major global, European and regional players that would only increase the pipeline's commerciality. TAP's financial and commercial merits seem to have

secured it a key ally that may eventually tip the scale in its favour vis-à-vis Nabucco West.

- TAP would be well connected to the Italian gas grid to provide firm freely allocable capacity not only to a market that is able to absorb several tens of billion cubic meters in the long-run but also would be capable of reaching through TAG (Trans Alpine Gas Pipeline) Germany, other Central European markets, as well as other major consumers in Switzerland and France.
- Currently no firm capacity from Italy to Germany is available, but typical flows from Germany and France to Italy will allow for a virtual backhaul of approximately 10 bcm/y. Snam Rete Gas and Open Grid Europe offer capacity in adjacent grids in Italy and Germany.
- TAP recently signed two Memoranda of Understanding and Cooperation with the Croatian and Bosnian system operators, Plinacro and BH-Gas, who both promote the Ionian Adriatic Pipeline (IAP).[51] Starting at a tie-in point to TAP in Albania, the IAP aims to deliver gas to Albania, Montenegro, Bosnia and Herzegovina, and Croatia. In effect -if materialized -TAP would be able to guarantee the access of Azerbaijani gas to the Western Balkans as well. TAP has also signed respective MoU with Montenegro and Slovenia.

However:

- Higher gas prices in the Italian market could be a temporary manifestation of oligopolistic market positions. In the future the Italian market may be better supplied in terms of sources diversification as it fully implements the EU Third Energy Package.
- It is not excluded that the Italian market can be oversupplied. This is possible because of the financial crisis and a projected fall of demand. Furthermore, in the south of the country, there could be an additional volume of 20bcm/y in case all LNG and pipeline import projects (i.e. GALSI project) are completed.
- The other complexity that might occur is that TAP is terminating on the Italian border; as was mentioned above Snam Rete Gas - the Italian TSO would ship the gas further to the Northern Italy. All gas buyers and/or gas shippers will have to deal with Snam. The free pipeline capacity inside the SnamRete controlled system is under stress as constraints may appear in the system's ability to transport gas to the northern part of Italy.
- Most importantly TAP still lacks the political support of the Greek and Italian governments. The Italian and Greek governments may be ready to support the

51 http://www.trans-adriatic-pipeline.com/why-tap/benefits-for-south-eastern-europe/

Source: E.ON

project if: a) the TAP consortium includes one Italian and one Greek gas company and b) if the SD consortium would guarantee that the final decision will be primarily taken on the commercial merits of the projects rather than the geopolitical and political complications of its routing.

• The project does not have an IGA/HGA between Greece, Albania and Italy.

Complications abound, dozens of commentators generate tons of analyses on a daily basis on the Southern Corridor. Yet, neither words nor position papers produce gas, nor do they build pipelines. The SD II consortium needs to make a $25 billion decision over the next few months that will determine the future of Azerbaijani generations for decades to come. It needs to get everything in place over the coming months and would not necessarily wait until the self-set deadline of June 2013. If it waits Iraqi, Qatari, North African or East Mediterranean gas will "intervene" and capture the markets which SD might target.

The decision of the SD members will be based on a combination of political and economic criteria that will influence the position of several states and non-state actors. This will not be an easy decision to make given the complexity of the issue at hand and the fact that commercial and financial merits of a pipeline project do not guarantee its automatic selection. This could have been the case in a "perfect" commercial environment where (geo)politics do not intervene.

This is a theoretical environment that does not exist anywhere in the world and certainly not in so war-prone or crisis-prone areas such as the Southern Caucasus and the greater Black Sea region. Every seasoned observer of the Caspian Game understands that the flow of gas through the SD-chosen system will impact the regional geopolitics of the areas it crosses.

This paper tried to present the interplay between the economic and the political components of every decision-making process when it comes to the investments of so significant and capital intensive projects like the development and export of gas from SD Phase 2. Regardless of the project that will be finally selected the winner of this second –after the completion of the BTC oil pipeline- “round” in the Caspian Great Game is clear: Azerbaijani gas and diplomatic influence will flow in greater quantities towards the EU bringing back to Baku tens of billions of dollars in revenues and political capitalization.

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Circulation: 500
Order: 086

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ISSN: 2218-8436

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