EXTERNAL AND INTERNAL ASPECTS OF AZERBAIJAN'S ENERGY POLICY: EUROPEANIZATION PROCESS AND ITS LIMITATIONS

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ABSTRACT

EXTERNAL AND INTERNAL ASPECTS OF AZERBAIJAN'S ENERGY POLICY: EUROPEANIZATION PROCESS AND ITS LIMITATIONS

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September 2013, 116 pages

The thesis examines the bilateral relations between Azerbaijan and the European Union in the context of energy cooperation. The main research question of the thesis is to what extent Azerbaijan's domestic and external energy policies are compatible with the European Union's rules and regulations. The main argument of the thesis is that although Azerbaijan is compatible with the European Union externally, the country has largely opted for pursuing domestic energy policies which clearly differ from the European Union's own internal norms and regulations on energy market.

The thesis is composed of seven chapters. The first chapter is the introduction part; in addition, the second chapter will discuss Azerbaijan's energy profile. On the other hand, in the third chapter, Azerbaijan's partnership with the EU will be presented. The fourth and fifth chapters are about the energy politics of Azeri leaders and the pipeline politics of the third countries over the region. On the other side, while the sixth chapter is about the domestic energy reform in Azerbaijan, the seventh chapter will present the conclusion part.

Keywords: Oil, Natural Gas, The Southern Gas Corridor, Azerbaijan, The European Union

ÖZ

AZERBAYCAN ENERJİ POLİTİKASININ DIŞ VE İÇ YÖNLERİ:
AVRUPALILAŞMA SÜRECİ VE KISITLAMALARI

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Eylül 2013, 116 sayfa

Bu tez Azerbaycan ve Avrupa Birliği arasındaki ilişkileri enerji işbirliği kapsamında incelemektedir. Bu tezin temel sorusu; Azerbaycan'ın dış ve iç enerji politikaları yönünden Avrupa Birliği'nin kural ve düzenlemeleri ile ne derecede uyumlu olduğudur. Bu tezin temelargümanı ise şöyledir; Azerbaycan dış yönlerden Avrupa Birliği ile uyumlu olmasına rağmen, ülke Avrupa Birliği'nin enerji sektöründeki kendi iç kural ve düzenlemelerinden farklılıklar gösteren iç enerji politikaları takip etmeyi daha çok tercih etmektedir.

Bu tez yedi bölümden oluşmaktadır. Birinci bölüm giriş kısmını oluşturmakta; ilaveten ikinci bölüm Azerbaycan'ın enerji profilini ele alacaktır. Diğer taraftan, üçüncü bölümde Azerbaycan'ın Avrupa Birliği ile ortaklığı ele alınacaktır. Dördüncü ve beşinci bölümler Azeri liderlerin enerji politikaları ile üçüncü ülkelerin bölge üzerindeki boru hattı politikaları hakkındadır. Öte yandan, altıncı bölüm Azerbaycan'ın iç enerji reformunu ele almakta iken, yedinci bölümde ise sonuç kısmı sunulmaktadır.

Anahtar Kelimeler: Petrol, Doğal Gaz, Güney Gaz Koridoru, Azerbaycan, Avrupa Birliği

To my husband M. Tarık Öztürk and My Family...

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LIST OF ABBREVIATIONS

LNG	Liquidified Natural Gas
BCM	Billion Cubic Meters
BCMA	Billion Cubic Meters Annually
DESFA	Greek Energy Company
ECT	Energy Charter Treaty
TPAO	Turkish Petroleum Corporation
BOTAŞ	Turkish Petroleum Pipeline Corporation
SOCAR	State Oil Company of Azerbaijan
AIOC	Azerbaijan International Oil Company
ACG	Azeri-Chirag-Guneshli
BTC	Baku-Tbilisi-Ceyhan Pipeline
BTE	Baku-Tbilisi-Erzurum Pipeline
TANAP	Trans-Anatolia Pipeline
TAP	Trans-Adriatic Pipeline
ITGI	Turkey-Greece-Italy Interconnector
ENPI	European Neighborhood Policy Instrument
TACIS	Technical Aid to Commonwealth of Independent States
TAIEX	Technical Assistance Information Exchange Instrument
INOGATE	Interstate Oil and Gas Transport to Europe
PCA	Partnership and Cooperation Agreement
MoU	Memorandum of Understanding
SOFAZ	State Oil Fund of Azerbaijan
EITI	Extractive Industries Transparency Index

CHAPTER 1

INTRODUCTION

During the Soviet era, there is not much contact between the nationalities of the Caspian region and the European Union (EU). This is because of the political tension between the Soviet Union and the EU especially throughout the Cold War period and the obligation of these nationalities to pursue similar policies to the Soviets'. On the contrary, after the Soviet Union collapsed and the nations of the Caspian region gained independence, the bilateral relations between these newly states and the EU have developed significantly. Particularly, this is also true for Azerbaijan. In this context, parallel to the active foreign policy of Azerbaijan and the globalization trend all over the world, Azerbaijan and the EU have intensified their bilateral ties in the course of time.

1.1 Scope and Objective

The thesis seeks to examine on the bilateral relations of Azerbaijan and the EU in the context of energy. In this respect, the thesis focuses the current and prospective energy profile and politics of Azerbaijan, energy cooperation and europeanization of the energy markets in Azerbaijan parallel to the EU's internal regulations of energy markets, international pipeline projects which Azerbaijan has taken place and the domestic energy reform in Azerbaijan in the context of FDIs, management of energy revenues and transparency of Azeri energy sector.

Although, the thesis analyzes Azerbaijan's bilateral relations with the EU in accordance with the developments in its energy politics and foreign relations over the whole period after the independence; specifically, the progresses over the last decade is focused. However, the thesis does not focus the situation of Azerbaijan during the Soviet era so much.

1.2 Literature Review

There are plentiful academic studies regarding the recent important issue, energy security as well there are also various studies on the alternative pipelines going to the EU in the context of energy security. On the other hand, there are important studies regarding the role of Azerbaijan on these pipeline projects and increasing the energy security of the EU. All these studies are focused mostly on the economic aspects with also a significant emphasis on the political considerations. The main arguments of these studies are the need of the EU to diversify both its energy resources and routes in order to be able to meet the existing and the future energy demand as well Azerbaijan is defined as a country in the need to export its oil and gas to these alternative pipelines.

In this context, as mentioned by Gawdat Bahgat in his book *'Energy Security'*[1], energy security is multidimensional; in other words, it includes both economic and political aspects as well as both producing and consuming countries, so it requires both producing and consuming countries to cooperate. On the other hand, the author specifically focuses on the EU and the Caspian littoral states with their energy production and consumption profiles and attracts attention for the need of the two sides to cooperate in order to increase energy security and their gains.

Also, another important author in this issue, S. Frederick Starr in his article 'Prospects for Energy Security'[2] analyzes the partnerships of the EU with the Caspian littoral states in the context of energy cooperation. The author mentions that the EU is not truthful on these partnerships because the EU only aims to maximize its gains rather than win-win situation with its partners. As can be seen the scholars analyzing energy security sees cooperation between the countries on this issue as very important as long as the attitudes of the parties are truthful to each other.

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[1]Bahgat, Gawdat. *Energy Security: An Interdisciplinary Approach.*Chichester, West Sussex: Wiley, 2011.

[2]Starr, S. Frederick."Prospects for European Energy Security."*Energy Security in Europe: Proceedings from the conference "Energy Security in Europe"*. Lund: The Centre for European Studies (CFE) at Lund University, 2008. 227-230.

In addition, there are other scholars who analyzes not only energy security but also energy politics, namely, a combination of energy and international relations. In this context, Brenda Shaffer in her book *'Energy Politics'*[3] analyzes both the Caspian Sea politics and energy profile of the EU. In this regard, the author stresses the importance of the exploitation and exploration of the reserves in the Caspian although, there is no agreement between the littoral states on the legal status of the Caspian; however, in the book there is no reference to the importance of the Caspian resources for the energy security of the EU.

Mert Bilgin in his articles 'New Prospects in the Political Economy of Inner-Caspian Hydrocarbons and Western Energy Corridor Through Turkey'[4], 'Geopolitics of European Natural Gas Demand: Supplies from Russia, Caspian and the Middle East'[5] and 'Scenarios on European Energy Security: Outcomes of Natural Gas Strategy in 2020[6]' mentions the importance of the energy corridor to the EU with the resources of the important littoral states of the Caspian, namely, Azerbaijan, Kazakhstan and Turkmenistan while emphasizing the dynamics which forms the current and future energy profile of the EU toward 2020s.

Besides, other than these general evaluations made by these three scholars, there are also important scholars who analyze specifically the importance of Azerbaijan on energy, the alternative pipeline projects to the EU and the cooperation between Azerbaijan and the EU in this context. Some examples of these scholars are Gulmira Rzayeva, Nasib Nassibli, Vladimir Socor and Svante Cornell.

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[3]Shaffer, Brenda. *Energy Politics*. 24. Philadelphia: University of Pennsylvania Press, 2009.

[4]Bilgin, Mert. "New prospects in the political economy of inner-Caspian hydrocarbons and western energy corridor through Turkey." Energy Policy. 35.12 (2007): 6383-6394.

[5]Bilgin, Mert. "Geopolitics of European natural gas demand: supplies from Russia, Caspian and the Middle East."Energy Policy. 37.11 (2009): 4482-4492.

[6]Bilgin, Mert. "Scenarios on European energy security: Outcomes of natural gas strategy in 2020." Elsevier. 43. (2011): 1082-1090.

Gulmira Rzayeva, as a researcher of the Strategic Research Center of Azerbaijan attracts attention to the success of Azerbaijan on having a balanced approach to the EU and raises the role of Azerbaijan on the alternative pipelines including Nabucco, TAP and ITGI in the Southern Energy Corridor in her article 'Azerbaijan: Eurasia's Energy Nexus[7]'. In addition, in her another article, 'Azerbaycan ve Avrupa Enerji Güvenliği Ulusal Öncelikler ve Uluslararası Sorumluluklar[8]', Rzayeva compares Nabucco-West and TAP in the competition of being as the continuation line of TANAP.

Furthermore, as now a member of the Azeri parliament, Nasib Nassibli in his article 'Azerbaijan: Oil and Politics in the Country's Future[9]' mentions the success of Azerbaijan in its energy politics since its independence; however draws attention to the risks of having energy dominant economy by giving examples of geographical difficulties of the country and the redistribution of oil revenues. The scholar in his another article, 'Azerbaijan: policy priorities towards Caspian Sea[10]' states the energy policies of the country regarding the utilization of Caspian oil and gas resources as well the striving of the country against its neighbors Russia, Iran and Armenia.

On the other hand, Vladimir Socor in his articles, 'Azerbaijan Drives the Planning on Trans-Anatolia Gas Pipeline Project[11]' and 'Direct Road to Europe: Azerbaijan's

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[7]Rzayeva, Gulmira. "Azerbaijan: Eurasia's Energy Nexus." Turkish Policy Quarterly. 9.2 (2010): 55-68.

[8]Rzayeva, Gulmira. "Azerbaycan ve Avrupa Enerji Güvenliği Ulusal Öncelikler ve Uluslararası Sorumluluklar."*Hazar Raporu Bahar 2013*. (2013): 29-45.

[9]Nassibli, Nasib. "Azerbaijan Oil and Politics in the Country's Future." *Oil and geopolitics in the Caspian Sea Region*. Ed. Michael P. Croissant and Bülent Aras. Westport: Praeger, 1999. 101-131.

[10]Nassibli, Nasib. "Azerbaijan: policy priorities towards the Caspian Sea." *The Caspian Politics, Energy and Security.* Ed.Shirin Akiner. 1st ed. New York: RoutledgeCurzon, 2004. 157-180.

[11]Socor, Vladimir. "Azerbaijan Drives the Planning on Trans-Anatolia Gas Pipeline Project." Eurasia Daily Monitor.9.164 (2012).

Trans-Anatolia Gas Pipeline[12]' expresses the strategic importance and the details of TANAP as a recent important pipeline project which Azerbaijan participates, whereas, he compares the alternative pipelines going to Europe; namely, Nabucco-West and TAP in detail in his articles 'Nabucco Countries' Governments Appeal to EU for Support of the Project[13]' and 'TAP Project Surging Ahead of Rival Nabucco West (Part Two)[14]'

Moreover, one of the most comprehensive studies regarding Azerbaijan after the collapse of the Soviet Union is written by Svante Cornell. In this framework, the author in his book *'Azerbaijan Since Independence'*[15] analyzes the partnership of Azerbaijan with the Western powers including the EU deeply. In this analysis, Cornell draws attention to the point that under the cooperation and partnership between Azerbaijan and the EU, the most prominent issues are energy, trade and cooperation on security rather than democracy and governance. Thus, the author mentions the importance of Azerbaijan's getting stronger on the EU's lessening its demands on democracy.

Other than the books and articles of the scholars, the roots and legal framework of the bilateral relations between Azerbaijan and the EU can be found in the documents prepared by the relevant institutions of the EU. These documents include PCA (1999), MoU on Strategic Partnership between Azerbaijan and the EU (2006), the documents about European Neighborhood Policy Instrument and other financial aids provided to Azerbaijan by the EU including INOGATE, Energy Reform Support

[12]Socor, Vladimir. "Direct Road to Europe: Azerbaijan's Trans-Anatolia Gas Pipeline." Eurasia Daily Monitor. 9.2 (2012): 1-3.

[13]Socor, Vladimir. "Nabucco Countries' Governments Appeal to EU for Support of the Project." Eurasia Daily Monitor.10.79 (2013).

[14]Socor, Vladimir. "TAP Project Surging Ahead of Rival Nabucco-West (Part Two)." Eurasia Daily Monitor.10.57 (2013).

[15]Cornell, Svante E. *Azerbaijan Since Independence*. 24. New York: M.E. Sharpe, 2011.

Program, Twinning, TAIEX (Technical Assistance Information Exchange Instrument)[16].

All these studies are extremely valuable to the literature on the bilateral economic relations between the EU and Azerbaijan. However, they are not enough to integrate the Azerbaijan's significance for the energy security of the EU and the alignment of Azerbaijan to the EU's energy market in the context of various legal roots. Indeed, these studies handle these two issues separately. On the other side, generally, the analysis and the evaluation of Azerbaijan's alignment to the EU's energy market fundamentals are made by the reports prepared by the EU, not by the academic studies of the scholars.

In addition, there is also a lack of English literature regarding Azerbaijan. It seems very difficult to find a comprehensive analysis of both political and economic aspects of the country in one academic study together in English. As well, Azeri scholars' studies are also not enough to describe the strategic status of Azerbaijan on energy.

Another problem regarding the literature on the bilateral relations between Azerbaijan and the EU is that in the literature, Azeri alignment to the EU's energy standards and regulations is not evaluated from multi-aspects. In other words, there are both external and internal aspects in this alignment. For the external side; namely, the pipeline politics and cooperation on exploitation and exploration on oil and gas, Azerbaijan and the EU almost have non-problematic relations; however, when internal issues are considered, Azerbaijan is found to be somehow reluctant to align its internal energy markets to the EU's.

Accordingly, to eliminate this problem and have a more comprehensive analysis, the thesis focuses both sides together and argues the importance of Azerbaijan in the alternative oil and natural gas pipeline projects going to the EU and the efforts of Azerbaijan in order to align its energy markets with the EU's both externally and

[16] "Summary on EU-Azerbaijan Relations."Informest. <http://www.informest.it/docs/post/Azerbaijan EU relations.doc&xgt;., (accessed on 24 July 2013)

internally. Further, the thesis argues that Azerbaijan is more or less successful to align its energy market externally especially in the context of international companies' operations inside the country and the transportation of oil and gas via the international pipeline projects. However, the thesis also explains the drawbacks of the energy sector internally in detail regarding the alignment to the EU's energy markets. Especially, the internal operations of Azeri gas sector are a little bit far away from the standards of the EU's.

After briefly discussing the literature on the bilateral relations between Azerbaijan and the EU on energy, the next section will focus on the argument of the thesis.

1.3 Argument

The thesis studies the bilateral energy relations between Azerbaijan and the EU after the collapse of the Soviet Union; i.e., the independence of Azerbaijan. On the other hand, the thesis discusses that the energy politics of Azerbaijan and energy cooperation between Azerbaijan and the EU plays a formative role in the bilateral relations.

As well, it is certain that Azerbaijan's energy policy is quite important for the EU side and most of the time shapes the bilateral relations between Azerbaijan and the EU. In accordance with that, Azerbaijan and the EU pursue policies and cooperate in order to align Azeri energy markets, i.e., oil and gas both externally and internally to the EU's. In this respect, the thesis argues that Azerbaijan's energy markets are compatible to the EU's standards and regulations externally (regarding the international energy issues including pipelines and exploitation and exploration of new fields); although there are important remaining points which Azerbaijan diverges in its internal markets.

For that reason, the thesis aims to analyze the relations between Azerbaijan and the EU in accordance with the 'complex interdependence theory' from the external issues and 'realism' from both the unexplained dimensions of the external issues by the 'complex interdependence theory' and the internal issues. Indeed, the external and internal aspects of the bilateral relations between the two parties differ so much that requires a two dimension analysis with two conflicting theories.

'Complex interdependence theory' was developed by Robert Keohane and Joseph S. Nye in their book *'Power and Interdependence*[17]*'*. The theory is focused on interdependence or transnational connections between states from an economic aspect, because of the increase in the economic relations and interdependence and transnational connections especially after the World War II[18]. This theory mentions that enhanced economic relations will further increase cooperation between the parties[19].

In principle, there are three main characteristics of this theory according to Keohane and Nye.

> 1. Multiple channels connect societies.
> 2. The agenda of interstate relationships consists of multiple issues that are not arranged in a clear and consistent hierarchy.
> 3. Military force is not used by governments towards other governments in the region when complex interdependence prevails.[20]

In this framework, when the bilateral relations between Azerbaijan and the EU are analyzed, there can be seen a lot of channels connecting the two parties. These relations are not solely focused on the traditional channels of communication between the two sides. On the other hand, nongovernmental elites of both sides frequently come together as a normal process of their business. In addition, the most significant contact between the two parties belongs to multinational firms and corporation. This is because of the vast oil and natural gas reserves of Azerbaijan.

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[17]Keohane, Robert O., and Joseph S. Nye.*Power and Interdependence*. 3rd. New York: Longman, 2001. 20-33.

[18] İşler, Burcu. "ComplexInterdependenceTheory.", http://burcuisler.blogspot.com/2010/03/complex-interdependence-theory.html, (accessed on 1 June 2013)

[19]*Ibid.*

[20]"Complex Interdependence and Neoliberal Institutionalism.", http://miqdadsibtain.files.wordpress.com/2009/12/complex-interdependence-and-neoliberal-institutionalism.ppt, (accessed on 24 July 2013)

These firms and corporations are playing an important role in the exploitation and exploration of these reserves in Azerbaijan. Therefore, most of the time, the connection established by these firms or corporations can become more important than the political ones and lead not only the domestic politics but also the foreign policy of both sides.

In addition, as in the case of Azerbaijan and the EU, most aspects of their bilateral relations are related with energy and economics and to some extent social issues. In other words, there are various issues relevant to their bilateral relations and so foreign policies. Thus, it is not always possible to subordinate all of these issues to the military security in this case.

Indeed, cooperation on energy, economics and social affairs prevail as the most dominant aspects of the bilateral relations between the two sides. In addition, both Azerbaijan and the EU take place in important international organizations in accordance with their various agenda items and to resolve their problems in the international arena.

On the other hand, while evaluating the internal dimension of bilateral relations, i.e., the internal situation of the Azeri energy markets and the unexplained dimensions of the external relations by the 'complex interdependence theory'; the related theory becomes 'realism'. The theory was developed several authors including Hobbes, Machiavelli and Thucydides. In addition, the theory has four main assumptions.

> The first assumption is that the state is sovereign and is the primary unit of analysis in international relations. Non-state actors such as international organizations are of use only for matters that do not concern immediate security interests. When such interests are at stake, states will either try to manipulate or simply ignore non-state actors. The second assumption of realists is that the state is a unitary actor. In other words, the state speaks with one voice—one policy on international matters. Third, realists assume that the state is a rational actor, i.e., the state will make choices which maximize the benefits to the state. Fourth, realists

> assume that national security tops the list of priorities within the hierarchy of international issues.[21]

All of these assumptions are the opposite ones of the previous theory, i.e., complex interdependency. The main rationale of the theory is the fact that states pursues to maximize their interests and act in accordance with that. In addition, according to the theory, the states are expected to increase the level of national security.

As in the case of Azerbaijan, the country sees its internal energy market and energy politics strategic because energy is a kind of source of power in the Caspian region. In this context, it is very normal for Azerbaijan to have obstacles on the way to fully align its internal energy market to the EU's. In other words, the Azeri government follows realist policies regarding its internal energy markets including attempting to change the regional balance of influence through the use of energy as a foreign policy instrument. Furthermore, the relations of Azerbaijan with the third countries are not solely dependent on friendly values; namely, cooperation and partnership. On the other side, there are various converging points of interests in these relations. In this regard, in internal politics, Azerbaijan usually tries to pursue its interests on energy markets.

Parallel to that, Azerbaijan has become successful regarding the isolation of Armenia from all of the energy projects of the South Caucasus and Caspian regions; moreover, the country used its resources to draw attention and getting support of the important global players including the EU and the USA regarding these regions.

As a result, there were several structural problems of internal energy markets of Azerbaijan on the way of aligning the EU's energy markets that the country does not have so much effort to eliminate. These include lack of the necessary democratic reforms, corruption in the management of the companies, lack of privatization of state owned energy companies and somehow non-transparency in the internal

[21]Harrison, Tyler. "Classic Realism: Originsand General Characteristics." *Realism, sovereignty and international relations: An examination of power politics in the age of globalization*. University of South Florida, 2006. p.21.

regulations that the EU sees very important for its partnership with Azerbaijan on energy.

The convergence of Azeri energy markets to the EU's standards and regulations is also very important for the private oil companies of the EU which consider operating in Azerbaijan. In this context, if the level of convergence increases, these companies will think that the business environment of the country is almost the same as the EU's and they will make positive decisions regarding their investments.

Therefore, the thesis argues that one-sided evaluation of the bilateral relations between the EU and Azerbaijan is not enough to fully understand the issue; in this context, complex interdependency and realism both should be considered for the external and internal aspects of these relations respectively. From the external side, thanks to the developments in the oil and natural gas reserves and production of the Azeri fields, both Azerbaijan and the EU satisfy their priorities under a win-win situation. However, Azerbaijan also strategically uses its energy resources and its internal energy markets in order to maximize its gains and increase its influence over the Caspian region.

1.4 Research Method

The relations between Azerbaijan and the EU include a variety of areas ranging from political and economic relations to cultural issues. These issues cannot be extended to other areas much because Azerbaijan gained its independence only 20 years ago and started to have independent relations with third parties as well as the EU. For that reason, parallel to the objectives of the thesis, major circumstances of cooperation between the two parties since the independence of Azerbaijan will be concentrated on.

Moreover, regarding the research and data collection, library resources including books, academic journals, newspaper archives, explanations of important politicians, statistics, reports prepared by the bodies of the EU and some important international institutions and databases are used. On the other hand, internet resources including online journals, web sites of Azeri state departments and ministries and institutions of the EU are the other major sources of the thesis.

1.5 Organization of the Thesis

The thesis is structured on seven chapters. The first chapter includes the introduction part which describes the scope and objective, literature review, argument and research argument of the thesis. The second chapter is about the energy profile of Azerbaijan that covers short description historical information about the country, detailed information about the institutional structure of the energy sector in Azerbaijan, important production fields, statistics about the economy and oil and gas production. Moreover, at the end of the chapter, there are additional parts analyzing the long term energy prospects of the country.

The third chapter is about the EU's expectations from Azerbaijan in the energy market; specifically, energy cooperation of Azerbaijan with the EU in the context of major legal instruments including Partnership and Cooperation Agreement, Memorandum of Understanding on a Strategic Partnership, INOGATE and European Neighborhood Policy are analyzed deeply. In this chapter, Azerbaijan's importance in the EU's future energy plans is investigated in accordance with the diversification of the routes transporting oil and gas to the EU. Furthermore, Azerbaijan's current status and actions in order to align the energy regulations of the EU is questioned deeply.

In addition, in the fourth chapter, Azeri leaders' political strategies on the country's energy resources take place. In this chapter, after the previous leaders' policies are mentioned, the Haydar Aliyev period is analyzed and then the current energy policy of the country under the management of Ilham Aliyev is investigated.

The fifth chapter is about the pipeline politics of Azerbaijan and its energy relations with the third countries. In this context, firstly, the Southern Energy Corridor and its alternative pipeline projects are mentioned. At that stage, because of their strategic importance, the importance of Turkey and Georgia are examined. Secondly, the positions of the other Caspian littoral states; namely, Russia, Kazakhstan and Turkmenistan together with the pipeline projects and the existing pipelines of Azerbaijan with these countries are analyzed.

In the sixth chapter, Azerbaijan's domestic energy reform is examined via a detailed analysis of State Oil Fund, foreign direct investments of the country's energy sector and the successful steps of the country especially in transparency management in the energy sector.

The seventh chapter is the conclusion part of the thesis. In accordance with the developments up to now, it is argued that Azerbaijan pursues policies to align its energy market to the EU as externally much as possible in the context of europeanization; however, in its internal market, Azerbaijan is not so much compatible and there exist some obstacles on competition including corruption and non-transparent policies and practices of the state.

CHAPTER 2

AZERBAIJAN’S ENERGY PROFILE

Azerbaijan is a country at the crossroads. Since the times when Silk Road was very popular for the world trade, Azerbaijan’s territories have become very significant. The geographical situation of the country is one important item which has shaped the history of the country. In this context, for the last century, Azerbaijan lived a short period of independence around 1918; on the contrary, the country was under the governance of the Soviet Union between the years 1921 and 1991. Finally, Azerbaijan has gained its independence again since then.

Azerbaijan has been considered very important for petroleum reserves and production since the beginning of 19th century. The first production of oil started in 1872 and by the end of that century, Azerbaijan produced almost half of the world oil supply[22]. With the development of new oil fields, the importance of Baku increased and the region became one of the major oil production stations in the world[23].

The significance of Azerbaijan in oil production continued in the Soviet era especially throughout the first half of the 20th century. However, after this period, there was a substantial reduction of Caspian oil production until the collapse of the Soviet Union because the Soviet leaders switched from these resources to the alternative ones like Volga-Urals and Western Siberia[24].

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[22]"Energy." Embassy of the Republic of Azerbaijan to the United States of America. http://www.azembassy.us/5/52.html, (accessed on 20 Nov 2012)

[23]Balat, Mustafa. "Case of Baku-Tbilisi-Ceyhan Oil Pipeline System: A Review." Energy Sources Part B: Economics, Planning and Policy. 1.2 (2006): p.118-119.

[24]Bahgat, Gawdat. Energy Security: An Interdisciplinary Approach. Chichester, West Sussex: Wiley, 2011. p.131.

On the contrary, since 1980s, the importance of the Caspian energy resources, especially the resources of Azerbaijan has begun to increase again. After the collapse of the Soviet Union, Azerbaijan has become the leading country in oil and natural gas production and foreign direct investment levels in the region.

In this chapter, firstly, institutional structure of the energy industry in the country will be analyzed. In addition, important production fields and current statistics of oil and natural gas will be presented. Finally, long term energy outlook of the country will be briefly summarized.

2.1 Institutional Structure of Energy Industry in Azerbaijan

Since the beginning of the independence, Azeri energy sectors i.e., oil and natural gas are regulated by various important ministries and institutions of the country. Today the most important of these are State Oil Company, Ministry of Industry and Energy, Tariff Council and Azerbaijan's International Oil Company.

2.1.1 State Oil Company of Azerbaijan

During the Elçibey period, in September 1992, an important institution, State Oil Company of Azerbaijan (SOCAR) was established with the merger of the two other Azeri oil companies namely Azerineft and Azneftkimiya. SOCAR acts as a sole operator of the all activities related to the offshore and onshore oil exploration and production of the country with important international companies and signed many agreements with these companies for these operations[25].All these resulted in an increase not only in oil production but also in oil exports of Azerbaijan.

On the other hand, SOCAR has other types of operations including production and exports of oil chemistry products i.e. derivatives of oil and preparation for refinery and transportation of oil and gas[26]. The main reason to have a variety of operations is to increase the efficiency of the company; in this context, SOCAR has been

[25]"Azerbaijan Energy Report." (2012): p.3. Enerdata, www.enerdata.net, (accessed on 7 June 2013)

[26]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.12

restructured numerous times as a result now it consists of 19 separate units dealing with upstream and downstream operations[27]. For the upstream operations, SOCAR mainly invest, execute and operate; on the other hand, the company manages and markets the state share of Azeri oil revenues while for the downstream part, SOCAR owns and operates two refineries of Azerbaijan with a capacity of 400.000 bpd[28].

Indeed, the combination of different activities in the energy industry makes SOCAR the major energy giant inside the country; as well the company has a monopoly in the Azeri energy market. However, the importance of the company is not limited to the combination of various operations inside the country. This again shows the significance of the company for the country. When it is thought that Azeri economy is mostly funded by the oil revenues, the strong position of SOCAR can be understood clearly from these numbers.

On the other side, specific to the gas sector, Azerigas (integrated into SOCAR since 2009) is responsible for transportation and distribution; in this context, the market is closed for direct purchases of consumers and third-party access and in the near future there is no plan regarding the liberalization of the market on these issues[29]. As a result, all institutions of gas market belong to the state itself.

Besides, according to Figure 1, production and gas treatment stages are handled by SOCAR itself; however, transportation and distribution stages are operated by Azerigas as the subsidiary of SOCAR. In this context, possessing the transportation and distribution channels is also another reason of the strong position of SOCAR inside the country.

[27]*Ibid*, p.61-62

[28]*Ibid*

[29]*Ibid*, p.12

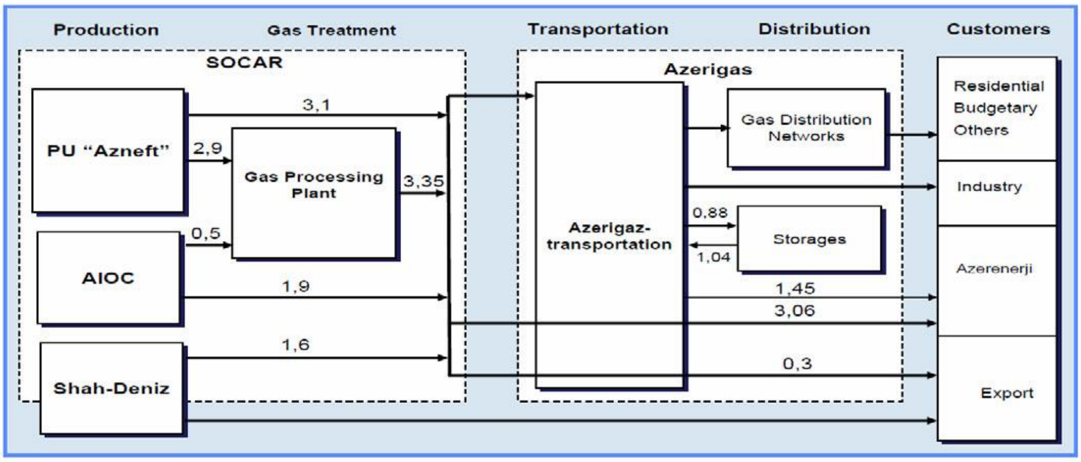

Figure 1 Gas production, transmission and distribution structure of Azerbaijan

Source:Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.68

2.1.2 Ministry of Industry and Energy

Until 2001, coordination of the energy sector is supervised by three different ministries (the Ministry of Raw Materials for the energy policy and the exploitation of energy resources, the Planning and Economic Committee and the Ministry of Economy), currently the Ministry of Industry and Energy (MIE) has become the main responsible ministry in this sector[30].

In this framework, MIE has the authority to implement state policy and regulation for the energy sector; furthermore, MIE is responsible for implementing the various regulations, orders and decrees issued by the government[31].

The MIE works closely with the important ministries. One of the main ministries is the Ministry of Economic Development which is responsible from economic development, investments, sustainable development and the promotion activities of various sectors including energy[32]. On the other side, as expected, MIE is in

[30]"Azerbaijan Energy Report." (2012): p.3. Enerdata, www.enerdata.net, (accessed on 7 June 2013)

[31]European Bank for Reconstruction and Development.Azerbaijan Country Profile. p.190 http://www.ebrd.com/downloads/legal/irc/countries/azerbaijan.pdf, (accessed on 10 Apr 2013)

[32]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.42-43

coordination with the important energy giants of the country in oil, gas and electricity. Among them, in coordination with MIE, SOCAR is a party to all of international consortiums of oil and gas projects in Azerbaijan[33].

2.1.3 Tariff Council

In addition, established in 2005, Tariff Council is another important authority of Azerbaijan in order to regulate energy prices especially in the gas market.

> The Tariff Council establishes the tariff methodology, approves the tariff level proposed by regulated companies (including but not limited to energy), proposes changes to the legal framework as it relates to pricing and settles disputes over price regulation and tariff application.[34]

In other words, Tariff Council handles all the details of the pricing. As well, Tariff Council is managed by a combination of several important ministries of the country.[35] Among them, Ministry of Economic Development acts as the chairman of the Council while the other responsible ministries including MIE, Ministry of Finance and Ministry of Taxes are the members of the Council.

The most important areas regulated by Tariff Council are about the products of monopolies either natural or state monopolies and the products whose tariffs are regulated by the state. These products include not only goods but also services. In this context, the main areas under the responsibility of Tariff Council are utilities, energy, industry, transport, education, telecommunications, public health etc.; on the other hand, the main monopolies regulated by the Council are several open joint stock companies Azersu, Azerenerji, SOCAR, Azerigaz[36].

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[33] *Ibid*

[34] *Ibid*, p.42

[35] *Ibid*

[36] Asadov, E. Republic of Azerbaijan.Secretariat of the AR's Tariff (Price) Council.State Regulation of Tariffs (Prices) in Azerbaijan. Secretariat of the AR's Tariff (Price) Council, p.3 http://www.narucpartnerships.org/Documents/1E_Tariff_Council_Regulations_and_Authorities_Asadov_Eng.pdf, (accessed on 27 July 2013)

In this regard, the prices of oil and natural gas products are regulated in similar way by Tariff Council[37]. However, regarding the transportation of these products, oil products are not regulated by the Tariff Council[38].

Furthermore, the decisions of the Tariff Council are not unquestionable. The companies operating in the energy sector have the right to appeal against the decisions of the Council either directly or via the court action in order to amend or terminate the related decisions of the Council[39].

2.1.4 Azerbaijan International Oil Company

The companies of the AIOC consortium are BP (UK), Chevron (USA), Devon Energy (USA), Statoil (Norway), TPAO (Turkey), Amerada Hess (USA), SOCAR (Azerbaijan), ExxonMobil (USA), INPEX (Japan), ITOCHU (Japan)[40]. With the sale of BP's share in AIOC to SOCAR's affiliate AzACG, the new ownership structure of AIOC has become as follows; BP with 35.83%, SOCAR (AzACG) 11.64%, Chevron 11.27%, INPEX 10.96%, Statoil 8.56%, Exxon 8%, TPAO 6.75%, ITOCHU 4.3% and Amerada Hess 2.72%[41].

AIOC has an important role in the Azeri energy sector since the conclusion of the 'Contract of the Century' which will be mentioned below in detail. In this context, Azerbaijan showed the competency of the country via bringing the major

[37]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.49

[38]European Union.European Commission. Energy infrastructure priorities for 2020 and beyond - A Blueprint for an integrated European energy network. p.35 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2010:0677(01):FIN:EN:PDF, (accessed on 20 June 2013)

[39]European Bank for Reconstruction and Development.Azerbaijan Country Profile. p.2 <http://ebrdrenewables.com/sites/renew/countries/azerbaijan/profile.asp&xgt;, (accessed on 20 May 2013)

[40]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.61-62

[41]*Ibid*

international energy companies together in order to increase the exploitation of oil. Furthermore, AIOC operates in various areas including alternative pipelines transporting Azeri oil and gas to different routes and production of additional reserves in ACG and Shah Deniz-II in the short and medium term.

2.2 Important Production Fields

Since its independence, Azerbaijan discovered various oil and gas fields that have attracted increased attention of the global and regional players. The most important ones of these discoveries are Azeri-Chirag-Guneshli for oil and Shah-Deniz for natural gas.

2.2.1 Azeri-Chirag-Guneshli

Specifically, at the beginning of independence, Azerbaijan did not have adequate financial resources so according to Haydar Aliyev, the best solution was to open the country's oil fields to foreign companies[42].

In accordance with that, since the beginning of the year 1994, Aliyev implemented active policies in the foreign affairs of Azerbaijan and in this context, started the negotiations with the Western oil companies. As a result, Azeri-Chirag-Guneshli field has been the first and most important oil production location in Azerbaijan since the independence of the country. It is stated that the field has been very attractive commercially with its multi-billion known reserves[43]. The importance of the field has increased with the deal known as 'The Contract of the Century' which can be described as the major achievement of the Haydar Aliyev period. Thus, Azerbaijan got the change to produce and export its oil to various countries.

> The 30-year contract or "contract of the century" as it is commonly known, called for production of 700.000 b/d[44]. It provided for the

[42]Kleveman, Lutz. *The New Great Game Blood and Oil in Central Asia.* 1st ed. New York: Atlantic Monthly Press, 2003. p.22.

[43]Olsen, Willy. "The Role of Oil in the Development of Azerbaijan." *The Caspian Politics, Energy and Security.Ed. Shirin Akiner.* 1st ed. New York: RoutledgeCurzon, 2004. p.130.

[44]Barrel per day

> development of the Azeri, Chirag, and Guneshli offshore oil fields in the Caspian Sea. Other investors include the US companies Amoco (17%), Pennzoil (4.8%), Unocal (9.5%), and Exxon (5%), Russia's LUKOIL (10%), Norway's Statoil (8.5%), Japan's Itochu (7.45%), the UK's Ramco (2%), Turkey's TPAO (6.75%), Saudi Arabia's Delta (1.6%), and Azerbaijan's SOCAR (10%)[45].

Indeed, there is one point that attracts much attention that Azerbaijan succeeded to bring all these international oil giants together. This is very important for the country to develop its oil reserves and strength its economy. In this framework, Azerbaijan has become the leading country in its region in terms of foreign direct investment (FDI) statistics and the number of production sharing agreements (PSA) in which there are a lot of investor companies to have shares in oil and natural gas production of a specific field.

The field started to operate under several phases. First, in February 2005 Central Azeri region, in December 2005 West Azeri region, in October 2006 East Azeri region and finally in April 2008 Deepwater Guneshli started to operate with significant volumes of production[46].

> The fields are estimated to hold 6.5 billion barrels (890 million tons) of crude oil and currently produce around 800,000 barrels per day (bpd) (40 million tons per year).[47]

Regarding the developments in the production phase of the ACG field, as a future prospect, with the completion of the maintenance work at the field in 2012, it is expected that oil production will pick up and support budget and revenue of the country which are very dependent on profit of oil and natural gas[48]. Moreover, it is

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[45]Bahgat, Gawdat. *Energy Security: An Interdisciplinary Approach.*Chichester, West Sussex: Wiley, 2011. p.134.

[46] Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.51

[47]*Ibid*

[48]"Country Report Azerbaijan. "Economist Intelligence Unit. p.8. http://country.eiu.com/FileHandler.ashx?issue_id=1068550491&mode=pdf, (accessed on 15 Dec 2012)

foreseen that during the second half of 2012-2016 (with the increase in the production of hydrocarbons in Azerbaijan because of the Chirag oilfield's (COP) start of operation in the 2013), energy production levels of the country will improve[49].

2.2.2 Shah-Deniz

Although, natural gas production is not developed as much as the oil sector during the first years of independence, it is also important and promising for the future of the country. In this context, since 1999, most of the gas reserves are on the Caspian basin of the country and the Shah Deniz has the largest natural gas reserves with 1.2 trillion cubic meters on the mentioned basin[50].

On the other hand, an international consortium has been managing the exploration of the field; the members of the consortium are BP Amoco (operator-25.5%), Statoil (25.5%), SOCAR (10%), Lukoil (10%), the Iranian company NIKO (10%), Total (10%), and TPAO (9%)[51].

It is remarkable that in the Shah-Deniz project consortium, both Russia and Iran have shares 20% in total that give them to have a voice in the project. This is also important from the aspect that Azerbaijan succeeded to eliminate the Russian and Iranian pressure and oppositions against the exploration and exploitation of Azeri gas in the Shah-Deniz project.

Moreover, regarding the developments in the production phase of the Shah Deniz field, after the first phase of the field started to operate in 2006 with a 9 bcma

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[49] *Ibid*

[50] Rzayeva, Gulmira. "Azerbaijan: Eurasia's Energy Nexus." Turkish Policy Quarterly. 9.2 (2010): p.61

[51] *Ibid*

production, the second phase of the field is expected to contribute with an additional 16 bcma[52].

Besides, the field has several advantages when compared with the other fields in the Caspian. “Primarily, the main gas field in Azerbaijan-Shah Deniz is located closest to the European markets from all existing fields. Secondly, unlike Turkmenistan, Iran and Russia, where the productions of natural gas produced from existing fields, and these fields have begun seriously depleted, the deposit Shah Deniz is only started and could still be operated for many years[53]”.

In this framework, a project called ‘Southern Gas Corridor’ came to the fore in order to transport Azeri gas to the European market and meet the increasing energy demand of this market. This is planned not only with the Azeri gas but also with the option of transporting the prospective Central Asian gas; namely, the natural gas of Kazakhstan and Turkmenistan.

In this framework, in accordance with the Joint Declaration on Southern Gas Corridor, with the Shah-Deniz Phase II, Azerbaijan will be an important energy supplier with its 10 bcma gas supply to the EU regardless of the project chosen for transporting Caspian gas to the EU[54]. This is because both Azerbaijan and the EU aim to have several alternative routes in the Southern Corridor transporting Azeri, Central Asian and Middle Eastern natural gas to the European markets.

2.3 Current Information and Statistics of Oil and Natural Gas

Although, Azerbaijan can be considered as a newly independent state, its economy has a continuous growth rate as a natural consequence of the exploration and

[52]"Shah Deniz." BP, http://www.bp.com/productlanding.do?categoryId=9006668&contentId=7078987 , (accessed on 7 June 2013)

[53]Ibrahimov, Rovshan. "Russian President’s visit to Azerbaijan: Possible Scenarios in Energy Cooperation." Journal of Turkish Weekly. (2008): p.1

[54]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.65

exploitation activities in oil and natural gas. Moreover, Azerbaijan is a country whose energy resources are the main driver of the economy as can be seen from Table 1about the total natural resources rents (oil and natural gas) in GDP (%). Most of the growth in the economy belongs to the contribution of these energy resources mainly oil and natural gas[55].

Table 1: Azerbaijan's Total Natural Resources Rents Share of GDP (%), 2008-2011

Azerbaijan-Total Natural Resources Rents % of GDP	**2008**	**2009**	**2010**	**2011**
	63.5	42.4	45.8	45.1

Source: Worldbank, http://data.worldbank.org/, (accessed on 15 May 2013)

Certainly, growth is related also with the global market prices of oil and the turbulences in the financial markets of global players. For example, since 2008, the demand for oil has decreased as a result of the global financial crisis; however, in 2009 economic growth in Azerbaijan succeeded to remain above 9%[56]. However, in recent years some sectors other than energy including tourism, trade, construction, transportation, communication and agriculture started to have important growth rates. On the other side, the dominance of industrial production is significant among the main sectors in the GDP.

From the side of oil, according to the statistics of 2011, in Azerbaijan, there are 58 oil and gas fields in total, of which 41 belong to onshore and 17 belong to offshore[57]. As presented in Figure 2, when the energy producing fields in Azerbaijan are analyzed, it can be seen that Azeri-Chirag-Guneshli field comes first regarding the profits of oil and gas sales by fields in Azerbaijan. Total profit of the mentioned field

[55] Bahgat, Gawdat. Energy Security: An Interdisciplinary Approach. Chichester, West Sussex: Wiley, 2011. p.133.

[56] Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.20-22

[57] *Ibid*, p.44

is far more than the other fields with almost $ 19 billion. Shah-Deniz is the second and followed by other oil or natural gas production fields.

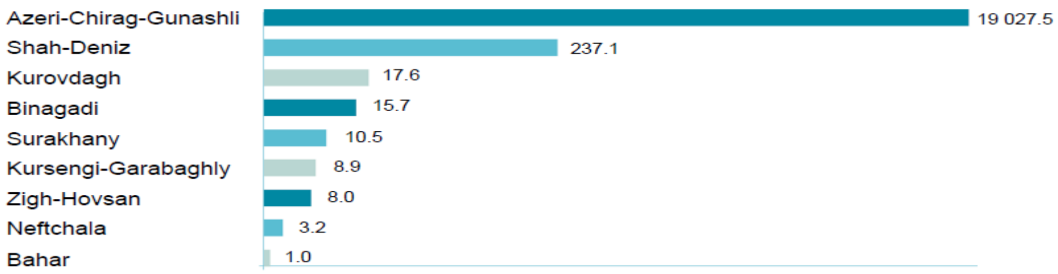

Figure 2 Proceeds from Profit Oil and Gas Sales by Fields, 2011 (Million US Dollar)

Source: Republic of Azerbaijan. State Oil Fund of the Republic of Azerbaijan. Annual Report 2011.State Oil Fund of the Republic of Azerbaijan, p.15 http://www.oilfund.az/uploads/annual_2011en.pdf, (accessed on 10 Apr 2013)

As well, according to the Central Bank of Azerbaijan, total exports decreased to $32.6 billion in 2012 from $34.4 billion in 2011[58]. Among the total exports, as presented in Table 2 oil exports are the dominant item that constitutes more than 90% of total exports.

> In 2012, oil exports amounted to $29.4 billion: $27.7 billion from exports of crude oil and $1.7 billion from petroleum products. The AIOC made oil exports worth of some $26.1 billion and other producers' exports amounted to $1.7 billion; this included SOCAR, who produced oil worth $1.6 billion and the Shah Deniz gas field, which produced condensate worth $134.9 million.[59]

However, the dominance of oil and gas both in the GDP and the exports makes the country vulnerable to the external and internal economic shocks. This called as 'resource curse effect' can be dangerous for the future of the economy if the necessary

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[58]Republic of Azerbaijan.Central Bank of the Republic of Azerbaijan. Balance of Payments of the Republic of Azerbaijan for January-December 2012. p.4 http://en.cbar.az/assets/2639/Macroeconomic_parameters_of_the_Balance_of_Payments_of_the_Republic_of__Azerbaijan_for_January-December_2012.pdf, (accessed on 5 June 2013)

[59]*Ibid*, p.3

measures are not taken. In this respect, Azerbaijan has been giving priority to diversify its economy and improve the position of the non-oil sector as mentioned above; furthermore, in order to increase the social welfare, the country established important institutions.

On the other hand, as presented in the Table 2, when reserves and internal consumption of oil and gas are analyzed, Azerbaijan consumes around 10% of its oil production according to the statistics of BP as of June 2013. This shows Azerbaijan has a big potential to export. Moreover, Azerbaijan is the third biggest country according to the reserves and production of oil in Eurasia after Russia and Kazakhstan. Likewise, although Azerbaijan consumes more than the half of the production of natural gas currently, it is highly expected that by 2017 the production will increase significantly with the completion of the Shah-Deniz Phase II. However, Azerbaijan is in the last rank according to the proved reserves and production of natural gas when compared with the other Caspian littoral states.

Table 2: Oil and Natural Gas Statistics of Azerbaijan as of June 2013

	Oil	
Proved Reserves	1 *(thousand million tonnes)*	7 *(thousand million barrels)*
Production	872*(thousand barrels daily)*	43.4*(million tonnes)*
Consumption	93*(thousand barrels daily)*	4.2*(million tonnes)*
	Natural Gas	
Proved Reserves	31.5*(trillion cubic feet)*	0.9*(trillion cubic meters)*
Production	15.6*(trillion cubic feet)*	14*(million tonnes of oil equivalent)*
Consumption	8.5*(trillion cubic feet)*	7.6 *(million tonnes of oil equivalent)*

Source:"BP Statistical Review of World Energy June 2013." BP. BP, p.6, 8-11, 20,22-25. http://www.bp.com/content/dam/bp/pdf/statistical-review/statistical_review_of_world_energy_2013.pdf, (accessed on 6 June 2013)

In this framework as presented in Figure 3,, in May 2006, Azerbaijan's oil production has started to increase until now meaning that Azerbaijan has started to exploit its oil reserves effectively. One point is also interesting that Azeri oil extraction did not decline during the years 2008 and 2009. On the contrary, there is a significant increase during these years when the global crisis was so severe.

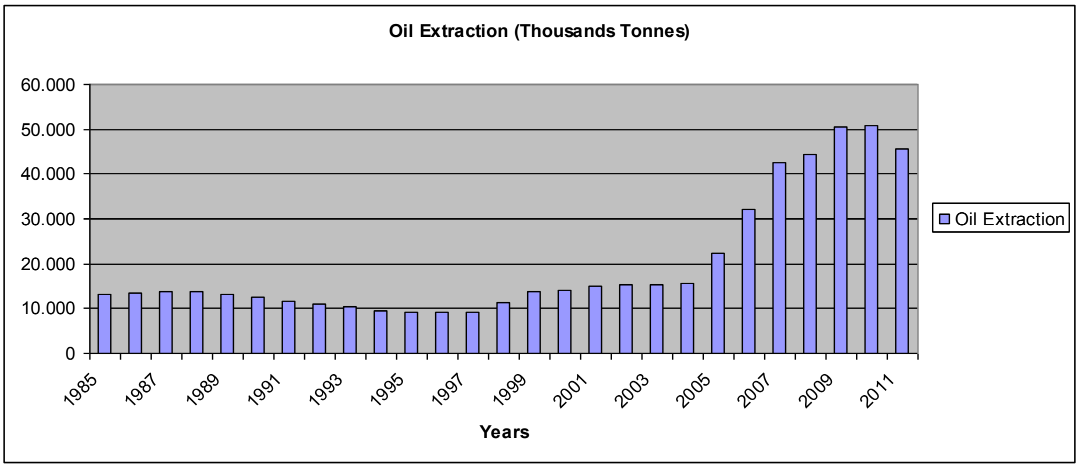

Figure 3 Oil Extraction of Azerbaijan (Thousand Tones)

Source:"Energetics." The State Statistical Committee of the Republic of Azerbaijan. The State Statistical Committee of the Republic of Azerbaijan, http://www.stat.gov.az/source/balance_fuel/indexen.php, (accessed on 10 June 2013)

On the other hand, as predented in Figure 4, with the completion of the Baku-Tbilisi-Erzurum (South-Caucasus Pipeline) in 2006, Azerbaijan's natural gas production has also started to increase significantly. The produced gas belongs to mainly the reserves of Shah-Deniz Phase II. The trend of oil between the years 2008 and 2009 is also true for the case of natural gas. Between these years, natural gas production of the country increased slightly even though the effects of global economic crisis were dominant all over the world. In addition, after the Shah-Deniz Phase II starts to operate the volumes of gas to be produced is expected to increase dramatically.

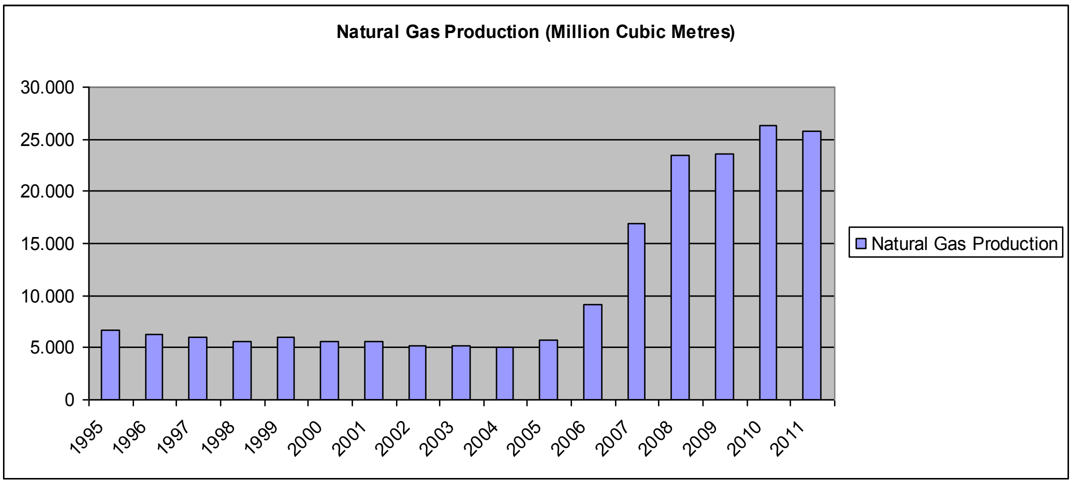

Figure 4 Natural Gas Production of Azerbaijan (Million cubic Meters)

Source:"Energetics." The State Statistical Committee of the Republic of Azerbaijan, http://www.stat.gov.az/source/balance_fuel/indexen.php, (accessed on 10 June 2013)

The increasing importance of the country in energy resources can be explained in the light of several reasons. First, via the pipelines, Azerbaijan is connected to the north (Russia), South (Iran) and the West (Turkey and Georgia). Second, the country is located closer to European customers than its regional counterparts; Kazakhstan and Turkmenistan[60].In addition, according to the Energy Charter Secretariat Follow-up In-depth Review, it is expected that there will be a substantial increase in oil production of Azerbaijan mainly from the Azeri-Chirag-Guneshli oil field and it will reach 1.4 million bpd in 2015; furthermore, via the BTC pipeline for the year 2015, more than five times larger than the domestic demand will be left for exports[61].

2.4 Azerbaijan Long Term Energy Outlook

According to the statements by SOCAR, it is expected that by 2015 the total gas production of Azerbaijan will be around 35-40 bcm and after 2017, Shah Deniz

[60]Dobronravin, Nikolay. "Oil, Gas, Transit, and Boundaries: Problems of Transport Curse." *Resource Curse and Post-Soviet Eurasia: Oil, Gas and Modernization.* Ed. Vladimir Gel'Man and Ed. Otar Marganiya. Lanham: Lexington Books, 2010. p.162-163.

[61]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.53

phase will add 16 bcm gas per year[62]. In this context, by 2018, the yearly gas production of the country will increase to 50 bcm; 15 bcm of which will belong to domestic consumption and the rest of which will belong to export[63].

On the contrary, according to the 2011 Country Report of Azerbaijan by Economist Intelligence Unit, the oil production growth will be slower and this is expected to affect the country's economy adversely[64]. Moreover, until 2016, the growth rates of the country will be lower because of the worsened predictions for oil sector and accompanied by the government declaration to cut down the oil production estimate from 51.5 million tons to 46 million[65].

Furthermore, it is also expected that with the increase in production levels, the rivalry between the EU and Russia to utilize the energy resources of Azerbaijan will intensify in the period of 2012-2016, and the country will secure economic advantage by the mentioned rivalry[66]. As a result of this rivalry, the country is coming under pressure from both the West to have new energy deals and Russia to reject the deals other than the Russian ones so, Azerbaijan has to pursue a cautious and balanced approach towards both of the parties[67].

Regarding the oil supply, it is expected that in 2013 construction of Chirag Oil Project will be concluded and most of the major Western energy companies investing in Azerbaijan will continue to dominate the energy sector during the next decade;

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[62]Rzayeva, Gulmira. "Azerbaijan: Eurasia's Energy Nexus." Turkish Policy Quarterly. 9.2 (2010): p.58

[63]*Ibid*

[64]"Country Report Azerbaijan." Economist Intelligence Unit. p.1. http://country.eiu.com/FileHandler.ashx?issue_id=1068550491&mode=pdf, (accessed on 15 Dec 2012)

[65]*Ibid*, p.4-5

[66]*Ibid*, p.1

[67]*Ibid*, p.3

however, oil growth is expected to be slower during this period as a result of existing large field to be on stream[68].

Moreover, according to Table 3 in the medium term Azeri oil production is expected to increase; on the contrary, in the long term it will partially decline.

Table 3: Oil Production of Azerbaijan, 2012-2020

	2012	**2013**	**2014**	**2015**	**2016**	**2020**
Crude Oil Production (Thousand, b/d)	1,020	1,030	1,042	1,056	1,138	1,138

Source:"Country Report Azerbaijan. "Economist Intelligence Unit. p.6. http://country.eiu.com/FileHandler.ashx?issue_id=1068550491&mode=pdf, (accessed on 15 Dec 2012)

Indeed, Azerbaijan is very promising regarding the natural gas reserves and production levels for the next decade and so gas exploration will continue over this period; in addition, gas deposits of the ACG field is planned to be explored during the next decade[69]. Moreover, the Shah-Deniz Phase II is planned to be completed around 2017 with the production level of up to 30 bcm[70]. According to Table 4, all these will boost the natural gas production of the country and until 2020; the amount of production will reach more than two fold.

[68]*Ibid*, p.5

[69]*Ibid*, p.6-7

[70]*Ibid*

Table 4: Natural Gas Production of Azerbaijan, 2012-2020

	2012	**2013**	**2014**	**2015**	**2016**	**2020**
Natural Gas Production (ktoe)	16,654	17,426	18,243	19,112	29,059	37,515

Source:"Country Report Azerbaijan. "Economist Intelligence Unit. p.6. http://country.eiu.com/FileHandler.ashx?issue_id=1068550491&mode=pdf, (accessed on 15 Dec 2012)

Indeed, Azerbaijan's importance in oil and gas production has been continuing since the previous centuries. Together with the aforementioned oil and gas fields, the country is promising regarding the discoveries, production and export of its energy reserves not only in the short term, but also in the long term.

To conclude, the chapter examines the energy profile of Azerbaijan in detail and the next chapter is going to examine the main dimensions of the partnership between Azerbaijan and the EU on energy.

CHAPTER 3

AZERBAIJAN-EU PARTNERSHIP ON ENERGY

In this chapter, firstly, the profile of EU's oil and natural gas markets together with the future plans of the Union in those sectors will be analyzed and secondly, the europeanization process of the energy sector in Azerbaijan will be presented in detail.

3.1 EU's Future Plans in the Energy Sector

EU members mostly can be defined as energy dependent countries. In this context, currently these countries cannot meet their energy needs on their own and most of the time import oil and gas from the countries outside the Union. In addition, in the future the situation for the member states seems to worsen.

> The EU imports over 60% of its gas and over 80% of its oil…Growing population and rising standards of living could push global energy demand up by 40% by 2030…In this complex reality, the EU needs to take a strong, effective and equitable position on the international stage to secure the energy it needs, while promoting free and transparent energy markets and contributing to greater security and sustainability in energy production and use.[71]

According to the estimates, by 2030 the EU will only be able to meet 25% of its total demand and need secure new resources of natural gas[72]. Moreover, if the policies of the EU on climate, transport and energy efficiency do not change, oil would further be dominant in primary energy with a 30% share in 2030[73]. According to the Energy

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[71]European Union.European Commission. On security of energy supply and international cooperation - "The EU Energy Policy: Engaging with Partners beyond Our Borders". p.2 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2011:1022:FIN:EN:PDF, (accessed on 20 June 2013)

[72]Erdoğdu, Erkan. "Bypassing Russia: Nabucco project and its implications for the European gas security."Renewable and Sustainable Energy Reviews. 14.9 (2010): 2936-2945.

[73]European Union.European Commission. Energy infrastructure priorities for 2020 and beyond - A Blueprint for an integrated European energy network. p.7 http://eur-

Roadmap of the EU for 2050 too, oil is expected to stay in the energy mix of the EU by the year 2050[74].

Undeniably, there is a big divergence between the prior and new member states of the EU regarding the urgency of meeting the energy needs. In this respect, it is at the core of the EU's policies to form a common energy policy for the EU as a whole. The main reason of this divergence is naturally, the different levels of oil and gas demands in different EU member states. While, most of the new member states in the Eastern Europe are almost completely dependent on Russian oil and gas, most of the major Western EU members are not.

On the other hand, in the last decade, there were important disputes between Russia and the transporting states of Russian oil and gas to the European markets which in turn resulted in disruptions in the European oil and gas flow. This affected the new members of the EU the most which were mostly reliant on the Russian energy resources. As a response to that risk, the EU leaders have tried to increase the European energy security by alternative policies.

In this framework, EU's new energy strategy is based on several main priorities; achieving energy efficiency, building an integrated energy market, achieving highest level of safety and security, extending Europe's leadership in technology and innovation and strengthening the external aspect of the energy market[75].

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lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2010:0677(01):FIN:EN:PDF, (accessed on 20 June 2013)

[74]European Union.European Commission. Energy Roadmap 2050. p.12 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0885:FIN:EN:PDF, (accessed on 15 June 2013)

[75]European Union.European Commission. Energy 2020 A strategy for competitive, sustainable and secure energy. p.5-6 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0639:FIN:EN:PDF, (accessed on 17 June 2013)

3.1.1 Diversification of Routes

EU published two different papers for the years 2020 and 2050 respectively regarding the energy needs and energy sector of the Union. In this context, in order to find alternative supplies for the EU's energy demand, three additional priority corridors have been identified in these papers; Southern Corridor from the Caspian Basin, Central Asia and the Middle East to the EU, North-South Corridor through Central Eastern and South-East Europe and North-South Corridor in Western Europe[76].

At that point, it should be mentioned that maintenance of cooperation on building international partnerships with the energy producer countries is very strategic for the EU. On the other hand, energy producer countries are also diversifying their supply routes and the EU should not fall behind of this process and use this chance to strengthen its cooperation with its partners in its neighborhood including Norway, Russia, Ukraine, Azerbaijan, Turkmenistan and Gulf countries according to its agenda set on September 2011[77].

In this framework, EU is one of the strongest supporters of the alternative Caspian routes to Europe for both oil and natural gas. Indeed, the EU mainly aims to diversify the energy resources and increase energy security among its members. At that point, Azerbaijan is one of the key players in the Caspian basin. While the country is strategically important for the energy security of the EU, it is also very important for the regional energy policies of Russia. In this context, the EU established a variety of legal linkages with Azerbaijan in order to cooperate with that country and secure the supplies of oil and gas coming from Azerbaijan as opposed to the efforts of Russia.

[76]European Union.European Commission. Energy infrastructure priorities for 2020 and beyond - A Blueprint for an integrated European energy network. p.11 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2010:0677(01):FIN:EN:PDF, (accessed on 20 June 2013)

[77]European Union.European Commission. Energy Roadmap 2050. p.18 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0885:FIN:EN:PDF, (accessed on 15 June 2013)

In this context, for the energy security of the EU, the Southern Corridor Project which will transport the Caspian resources to the European customers is the most significant one. By this project, Azerbaijan is expected to contribute to the EU's energy security when the Shah Deniz II Field is completed and the EU plans to diversify its energy resources and increase its energy security[78].

In addition, actualization of one of the alternative pipelines is very important and urgent for EU's future targets and current developments are in favor of these targets. For example, on October 2011, Turkey and Azerbaijan signed an agreement on the transportation of the gas of the second phase of Shah-Deniz and this will further support EU's energy policies on the Caspian[79]. However, alternative pipelines are expected to include not only the energy supplies of Azerbaijan but also the resources of alternative countries such as Turkmenistan, Kazakhstan and other Middle Eastern countries.

3.1.2 Diversification of Energy Resources

Other than the diversification of routes, as another option,the EU member states should exert efforts on reducing energy demand of especially on fossil fuels. It is highly probable that before 2020 especially oil supplies could decrease; in this context, consumers need to be made more aware on reducing their consumption of fossil fuels[80]. As mentioned previously, the EU has already taken steps in order to reduce the use of fossil fuels accordingly low carbon usage. In this framework, the

[78]Ismayilov, A, and E Taghiyeva. "SOCAR, EU and Turkmenistan to discuss Trans-Caspian gas pipeline." Trend News Agency, 3 Jun. 2012. p.1-2

[79]"Country Report Azerbaijan. "Economist Intelligence Unit. p.11. http://country.eiu.com/FileHandler.ashx?issue_id=1068550491&mode=pdf ,(accessed on 15 Dec 2012)

[80]European Union.European Commission. Energy 2020 A strategy for competitive, sustainable and secure energy. p.13 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0639:FIN:EN:PDF, (accessed on 17 June 2013)

EU set target of reducing its primary energy consumption by 20% until the year 2020[81].

On the other hand, the EU published several documents describing the road map of the EU for the medium and long term regarding this issue. These documents are Energy Efficiency Plan 2011, Directive on Energy Efficiency and the Roadmap for Moving to a Competitive Low Carbon Economy by 2050. With the final target of reducing the carbon usage by 80% until 2050, the EU aims to succeed this target via by 40% until 2030 and by 60% until 2040[82].

Undeniably, the aim to reducing the use of fossil fuels and promoting the use of renewables is also important from not only the environmental but also the economic aspects from the side of the EU. With the decrease in the usage of fossil fuels, the EU is highly expected to be protected against high fossil fuel prices and the fluctuations in these prices that is an important dynamic of the economic crisis.

3.1.3 The Need for a Common Energy Policy within the EU

Currently, the major supplier of energy resources (oil and gas) to the EU is Russia. However, this dependency varies from the west and east of the Europe and this creates difficulty for the EU's policy makers to settle on a common energy policy for the Union. For example, though with heavy volume of gas consumption, Western EU members are less dependent on gas imports from Russia; on the contrary, Eastern EU members are more dependent on Russian gas[83]. Furthermore, the impact of each member of the EU to the energy policy of the Union is not the same.

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[81]European Union.EuropeanCommission.Energy Efficiency Plan 2011. Brussels: European Commission, p.2 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0109:REV1:EN:PDF, (accessed on 20 Jun 2013)

[82]European Union.European Commission.Roadmap for Moving to a Competitive Low Carbon Economy in 2050. Brussels: European Commission, p.4 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0112:FIN:EN:PDF, (accessed on 20 June 2013)

[83]Bilgin, Mert. "Scenarios on European energy security: Outcomes of natural gas strategy in 2020." Elsevier. 43. (2011): p.1086.

In this context, it is very important for the EU to have a common stance in energy policy. In accordance with this fact, the leaders of the EU had the initiative to integrate its internal energy market in the year 2011. However, different EU members have different energy demands regarding fossil fuels. Thus, their urgency to diversify the routes or energy mixes differs. For example, Eastern and Central European countries are almost dependent on imports of energy; on the contrary, Western European countries are not so much dependent on imports and have a diversified energy structure.

Thus, obtaining sustainable and competitive energy supplies is very crucial to the EU from the aspects of economy, industry and welfare of their citizens[84]. In this context, for the EU, the most important thing is to make the member states act in coherence with the others and have a coherent and common internal policy. In order to succeed this, the EU should also consider the external policy of the Union prior to 2014 which is the deadline of the EU to complete the internal energy market[85].

3.2 Cooperation with the EU and Europeanization of the Energy Sector in Azerbaijan

In general, foreign direct investments in Azerbaijan are very important for economic performance and these investments are mainly focused on the energy sector. However, since the independence, there exist structural problems in the country including bureaucratic structuring, weak legal infrastructure and existence of the monopolies that prevent the development of the foreign direct investments in non-oil sectors. In this framework, Haydar Aliyev brought some measures in order to improve the business environment by bringing foreign investors together. It can be

[84]European Union.European Commission. On security of energy supply and international cooperation - "The EU Energy Policy: Engaging with Partners beyond Our Borders". p.2 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2011:1022:FIN:EN:PDF, (accessed on 20 June 2013)

[85]*Ibid*

monitored that these efforts of Haydar Aliyev resulted in the improvement of the investment environment of the country.

Nevertheless, the legislation of Azerbaijan regarding some sectors; including oil does not permit for foreign investors to operate on their own in the country; furthermore, these investors have no chance other than searching for an Azeri partner[86]. In addition, privatization of the state institutions is not at the expected level especially for the big enterprises in the country according to most of the international organizations. However, privatization programs of Azerbaijan have been successful on small and medium state entities[87].

Additionally, investment environment especially in the non-oil sector is mostly described as less improved and governed by unclear laws and regulations with uneven or arbitrary enforcement[88]. As previously mentioned, the main drawback for the Azeri economy is very concentrated structure of the economy both on a regional and sector aspects and the share of Azerbaijan in the world trade is almost at insignificant levels showing the lack of integration of the country to the world trade[89].

When the bilateral trade relations between Azerbaijan and the EU are analyzed, it can be seen that Azerbaijan is the major trading partner of the EU in the Caucasus. In addition, EU-27 is Azerbaijan's leading trading partner; in 2012, Azeri exports to the EU are $11.2 billion of which $11.1 billion (99%) belongs to the mineral fuels

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[86]Dikkaya, Mehmet, and Adem Çaylak. "Haydar Aliyev Döneminde Azerbaycan'ın Ekonomik ve Politik Dönüşümü: Fırsatlar ve Sorunlar." Uluslararası Stratejik Araştırmalar Kurumu. 3.5 (2008): p.140.

[87]*Ibid*

[88]European Union. European Neighborhood and Partnership Instrument Azerbaijan Country Strategy Paper 2007-2013.p.12-13 http://ec.europa.eu/world/enp/pdf/country/enpi_csp_azerbaijan_en.pdf, (accessed on 5 June 2013)

[89]European Union.European Commission. European Neighborhood Policy Country Report Azerbaijan. p.21 http://ec.europa.eu/world/enp/pdf/country/azerbaijan_country_report_2005_en.pdf., (accessed on 20 June 2013)

including oil and natural gas[90]. In this context, it would be useful to mention about the dominance of the EU in the foreign trade of the Azerbaijan. In 2012, out of 32.6 billion total exports of Azerbaijan, the EU's share in total exports is 34%. On the other hand, Azeri imports from the EU are $2.6 billion[91].

Energy products almost dominate EU's imports from Azerbaijan; on the other hand, EU exports to Azerbaijan are more diversified with the majority of machinery, precious stones, vehicles other than railway[92]. In this context, one sided structure of the foreign trade makes vulnerable the economy of Azerbaijan against the external economic and financial shocks. Thus, it is clear that Azerbaijan should diversify the product range subject to its exports to the EU in order to decrease the risk of being dependent on just a single item in exports.

As well, Azerbaijan has agreed to align with the EU in terms of most of its energy sector in order to solve the problems and reach a standardized and compatible legislation along with management. This is also important for attracting more foreign direct investment to the country and the improvement of the business environment for both the existing and the planned foreign investors. In accordance with that, Azerbaijan has been pursuing several alignment programs with the EU.

On the other side, the EU aims to increase its energy security and search for alternative suppliers for the future. In this context, in the European Security Strategy of 12 December 2003, the challenges for the Union on this issue and the vital position of Azerbaijan as an alternative supplier are identified.

> As an oil and gas producer and transit country, Azerbaijan has a pivotal role to play in this, including by opening up of alternative transportation routes for energy resources from the Caspian and Central Asia to Europe.

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[90] Trademap, http://www.trademap.org/index.aspx?ReturnUrl=%2fCountry_SelProductCountry_TS.aspx, (accessed on 1 June 2013)

[91] *Ibid*

[92] *Ibid*

> The EU has both direct trade and political interests in fostering regional cooperation in various sectors including energy and transport.[93]

In other words, Azerbaijan started to become one of the most important partners for the EU in order to diversify the Union's energy; therefore energy-related matters will be one of the main aspects of the EU's bilateral relations with Azerbaijan and the technical assistance given to Azerbaijan[94]. Below, the legal framework which surrounds the basic economic ties between Azerbaijan and the EU will be analyzed in detail.

3.2.1 Partnership and Cooperation Agreement

Since the collapse of the Soviet Union, the EU pursued active policies regarding the ex-Soviet region around the neighborhood of the Union. The main aim of the EU in this strategy is to increase the political influence of the EU and search the possible ways in order to eliminate and resolve the conflicts over these regions[95].

After the end of 1990s, in order to achieve these targets, the EU signed ten Partnership and Cooperation Agreements (PCA) with the countries in its neighborhood. These countries are Russia, ex-Soviet countries in the Eastern Europe, several countries in the South Caucasus and Central Asia; namely, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Ukraine, Uzbekistan and Tajikistan. Through these PCAs, the EU aims several issues including providing a proper frame for political dialogue, supporting the efforts made by the countries to reinforce their democracies and improve their economies, accompanying their move to a market economy and boosting trade and investment[96].

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[93]European Union. European Neighborhood and Partnership Instrument Azerbaijan Country Strategy Paper 2007-2013. p.5 http://ec.europa.eu/world/enp/pdf/country/enpi_csp_azerbaijan_en.pdf, (accessed on 5 June 2013)

[94]*Ibid*, p.41-42

[95]European Union.European Commission. European Neighborhood Policy Country Report Azerbaijan. p.2-3 http://ec.europa.eu/world/enp/pdf/country/azerbaijan_country_report_2005_en.pdf, (accessed on 20 June 2013)

[96]"Partnership and Cooperation Agreements (PCAs): Russia, Eastern Europe, the Southern Caucasus and Central Asia." Europa Summaries of EU Legislation. European Union, p.1

In this context, the PCA between the EU and Azerbaijan entered into force in 1999 and has become the major legal framework for the bilateral relations then[97]. According to the PCA, the relations between the two parties are incorporated into the principles of democracy, international law, human rights and market economy[98].

As mentioned previously, the scope of the PCA between Azerbaijan and the EU covers a variety of issues ranging from political to economic areas. In this regard, PCA provides intense cooperation between the parties on political dialogue, bilateral trade and investment, legislation and culture with the commitment for peace, security and dispute settlement[99]. In addition, when the comprehensive coverage of the agreement is taken into account, it can be seen that PCA can be used as a framework for the prospective deals between the parties in other detailed areas.

3.2.2 European Neighborhood Policy and European Neighborhood and Partnership Instrument

The enlargement of the EU with the new ten member states in the year 2004 is an important milestone for the neighborhood policies of the Union that brought new chances to enhance the existing bilateral political and economic relations with the new neighborhood. On the other hand, the EU strongly favors the political stability and economic welfare in the South Caucasus region. In this regard, in the year 2003, the EU posted a Special Representative to the South Caucasus region in order to assist the EU in developing a comprehensive policy towards that region and prevent

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http://europa.eu/legislation_summaries/external_relations/relations_with_third_countries/eastern_europe_and_central_asia/r17002_en.htm, (accessed on 1 June 2013)

[97]European Union.European Commission. European Neighborhood Policy Country Report Azerbaijan. p.2-3 http://ec.europa.eu/world/enp/pdf/country/azerbaijan_country_report_2005_en.pdf, (accessed on 20 June 2013)

[98]*Ibid*

[99]*Ibid*

and resolve the conflicts there[100]. As in the case of Azerbaijan and Armenia, the major dispute is over Nagorno-Karabakh.

As a result of the increase in the attributed importance to the new neighborhood, in 14 June 2004 the EU invited the Southern Caucasus countries including Azerbaijan to join the newly established legal framework called as European Neighborhood Policy (ENP). In this context, the ENP targets ambitious objectives for its partners to make strong commitments on having shared values and political, economic and institutional reforms as envisaged by the EU; in addition, specifically, the EU invited its partners to have closer relations in political, economic and cultural areas with the EU in order to have common responsibility in conflict prevention and resolution and further economic integration[101].

In this context, the EU plans to draw the required roadmaps for its partners and follow the progress status of these countries. After that, in March 2005, a Country Report which analyzes the progress of Azerbaijan regarding its political and economic reform via highlighting the main areas that feasible and valuable bilateral cooperation can be achieved was published[102].The strategic importance of the report is that it serves a main guideline for assessing the progress in the EU's bilateral relations with Azerbaijan in the future[103].

Moreover, in the framework of ENP, on November 2006, Azerbaijan and the EU developed an Action Plan for a five-year period including goals and actions for the

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[100]European Union. European Neighborhood and Partnership Instrument Azerbaijan National Indicative Programme 2007-2010. p.5 http://ec.europa.eu/world/enp/pdf/country/enpi_nip_azerbaijan_en.pdf, (accessed on 5 June 2013)

[101]European Union.European Commission. European Neighborhood Policy Country Report Azerbaijan. p.2 http://ec.europa.eu/world/enp/pdf/country/azerbaijan_country_report_2005_en.pdf, (accessed on 20 June 2013)

[102]"Summary on EU-Azerbaijan Relations."Informest. <http://www.informest.it/docs/post/Azerbaijan EU relations.doc&xgt;, (accessed on 24 July 2013)

[103]European Union.European Commission. European Neighborhood Policy Country Report Azerbaijan. 2005. p.2

short and medium run. These are specifically focused on the issues including democratization, human rights, socio-economic reform, poverty alleviation, energy, conflicts and industry-specific issues[104]. In accordance with the Action Plan, Azerbaijan and the EU also signed a Memorandum of Understanding (will be discussed below in detail) in order to establish a partnership on energy that resulted in strengthening the EU's energy relations with Azerbaijan via promoting the modernization, efficiency and reform in the domestic energy sector of Azerbaijan[105].

In addition to these, the Country Strategy Paper (CSP) for Azerbaijan between the years 2007-2013 as the primary strategy document for the EU's engagement with the country was published. Furthermore, in the CSP, Azerbaijan's progress is found to be rather slow and the other areas are identified as requiring progress in the next future; on the contrary, the progress on pursuing a reform strategy in order to establish democracy and a market economy all over the country and make Azerbaijan closer to the EU is welcomed[106].

Under CSP, the assistance given by the EU in the context of the ENP is described in detail[107]. In this context, as in the cases of other partners, the assistance to Azerbaijan between these years is also planned to be provided under the European Neighborhood and Partnership Instrument (ENPI) which is developed in order to establish good neighborliness between the EU and its partners in the framework of ENP[108]. Obviously, the fundamental of the EU's assistance mentioned in CSP is based on the existing legal framework; the PCA and the ENP.

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[104]"Summary on EU-Azerbaijan Relations."Informest. <http://www.informest.it/docs/post/Azerbaijan EU relations.doc&xgt;., (accessed on 24 July 2013)

[105]*Ibid*

[106]European Union. European Neighborhood and Partnership Instrument Azerbaijan Country Strategy Paper 2007-2013. p.3 http://ec.europa.eu/world/enp/pdf/country/enpi_csp_azerbaijan_en.pdf, (accessed on 5 June 2013)

[107]*Ibid*

[108]*Ibid*

Besides, the priority areas of the assistance provided by the EU between the years 2007-2013 can be found in the ENPI National Indicative Program for the years 2007-2010. These areas are democratic development and good governance, socio-economic reform, fight against poverty and administrative capacity building, support for legislative and economic reforms in the transport, energy and environment sectors[109]. The aforementioned priority areas under the national ENPI for Azerbaijan have been selected on the basis of the joint EU-Azerbaijan policy objectives and the EU's comparative advantage as a donor and lessons learnt from previous assistance and complementarity with other donors[110].

The assistance of the EU for these three headings which will be mentioned in detail below is planned to be €30, €32 and €30 million respectively, so €92 million in total[111].

3.2.2.1 General Evaluation in the Context of ENPI

The EU's assistance in the context of ENPI aims to focus on both economic and social reform in coordination with important international institutions if necessary. In this context, it targets to support Azerbaijan's ambitious reform agenda to establish democracy and the market economy and to ensure that Azerbaijan is successful enough in managing its oil and gas revenues efficiently and transparently for the welfare of its society; moreover, the assistance also stipulates to further enhance EU-Azerbaijan cooperation in some sectors including energy and transport with the significant contribution of the EU[112].

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[109] *Ibid*

[110] *Ibid*, p.25

[111] European Union. European Neighborhood and Partnership Instrument Azerbaijan National Indicative Programme 2007-2010. p.5 http://ec.europa.eu/world/enp/pdf/country/enpi_nip_azerbaijan_en.pdf, (accessed on 5 June 2013)

[112] European Union. European Neighborhood and Partnership Instrument Azerbaijan Country Strategy Paper 2007-2013. p.19 http://ec.europa.eu/world/enp/pdf/country/enpi_csp_azerbaijan_en.pdf, (accessed on 5 June 2013)

Regarding the cooperation in the energy sector, Azerbaijan and the EU plan to achieve necessary reforms in the Azeri energy market in the context of the existing legal framework including also the MoU on Energy signed in 2006 (will be described in detail below). The main aim of the EU's assistance is to increase the alignment of the Azeri energy sector to the EU's markets

In total, Azerbaijan has been provided about €400 million assistance by the EU between the years 1991 and 2006[113]. The assistance is provided under some mechanisms such as the TACIS (Technical Aid to Commonwealth of Independent States) Program (€116.5 million in technical assistance), TACIS Exceptional Assistance Program (EXAP), Food Security Program (FSP) (€57 million), post-war rehabilitation activities and other support under thematic budget lines (€176.2 million in total)[114].

Furthermore, some of the ENP instruments containing Twinning, TAIEX[115] and Sigma[116] are extended to Azerbaijan by the EU in order to establish one to one partnership between the institutions of the EU member states and Azerbaijan for a period of 24 months in average[117].These instruments are very important especially for the reforms in Azerbaijan accompanied by the EU's assistance because they constitute the field practices of the agreed legal framework between Azerbaijan and the EU. In this context, Twinning is planned to help Azerbaijan to develop modern and capable administrations for the application of the EU legislation in coordination with Twinning Program Administration Office, while TAIEX and SIGMA are

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[113] *Ibid*, p.15-16

[114] *Ibid*

[115] Technical Assistance and Information Exchange

[116] Support for Improvement in Governance and Management

[117] "Homepage."Twinning. European Union, http://www.twinning.az/index.php, (accessed on 1 June 2013)

planned to disseminate EU's members' effective practices through short term tools including seminars, workshops or study visits[118].

Moreover, the Twinning instrument provides a more flexible and operational mechanism for the strengthening of organizational capacity and institutional building, particularly by allowing the direct cooperation between neighboring countries and EU member states' administrations. In this framework, the Government of Azerbaijan has stated a strong interest in twinning, specifically with new member states with whom Azerbaijan might share some joint features (Baltic countries, Romania, Bulgaria, etc.)[119].

In this regard, one important example in accordance with this cooperation was executed by the Ministry of Industry & Energy of Azerbaijan with the Federal Ministry of Economics and Technology of Germany to implement a project regarding legal approximation and structural reform in the energy sector of Azerbaijan between the years 2008 and 2010 lasted 18 months with a budget of €1.1 million[120].

3.2.3 Inogate

Specific to energy sector, another important tie existing between Azerbaijan and the EU is INOGATE program. INOGATE is mainly technical cooperation program on energy between the EU and its partners in the Eastern Europe, the Caucasus and Central Asia[121]. The first initiatives regarding INOGATE started in 1996 and

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[118] *Ibid*

[119] European Union. European Commission. Commission Decision of on the ENPI Annual Action Programme 2007 in favor of Azerbaijan. 2006. p.11

[120] "Twinning, TAIEX and SIGMA in Azerbaijan-Completed Projects."Twinning. European Union, http://www.twinning.az/content.php?lang=en&page=174, (accessed on 1 June 2013)

[121] European Union. European Commission and Inogate Technical Secretariat. Inogate Programme Status Report 2011. p.8-9 http://www.inogate.org/media/documents/INOGATE Status Report EN.pdf, (accessed on 10 Dec 2012)

enhanced in 2004 with Baku Initiative[122]. In this context, INOGATE aims four objectives including convergence of Azeri energy markets according to the EU's principles, enhancement of energy security, support for sustainable development and attraction of investments on common energy projects[123].

Furthermore, INOGATE also supports the implementation of other areas including Eastern Partnership, Energy Security Platform, Energy Community Treaty and Memorandum of Understanding signed between the EU and Azerbaijan, Kazakhstan, Turkmenistan, Ukraine and Uzbekistan[124]. In this respect, the EU aimed to enhance the existing cooperation ties between itself and the mentioned countries of Eurasia via the convergence of the energy markets of these countries and of the EU in order to secure clean, sustainable, adequate and reliable energy resources at affordable prices; moreover, the convergence was planned to include the integration of the energy policies of the parties on the subjects of trade, transit and technical and environmental standards[125].

In this framework, technical cooperation via INOGATE is channeled to the partners in a variety of ways including transfer of know-how, web-site, publications, presentations, seminars and events which identifies the priority matters and networks the relevant stakeholders of the partners[126].

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[122]The "Baku Initiative" was launched on the occasion of the Energy Ministerial Conference held in Baku on 13 November 2004 between the European Commission and the Black Sea and the Caspian Littoral States and their neighbors, including Azerbaijan in order to integrate the energy markets of the region into the EU market with the transportation of the Caspian energy resources to Europe via alternative channels. ("Energy&Transport International Relations-Baku Initiative."Directorate General Energy and Transport. Directorate General Energy and Transport, http://ec.europa.eu/dgs/energy_transport/international/regional/caspian/energy_en.htm, (accessed on 5 May 2013))

[123]*Ibid*

[124]*Ibid*

[125]*Ibid*

[126]European Union.European Union and Inogate Technical Secretariat. INOGATE Programme and the Republic of Azerbaijan. p.2 http://www.inogate.org/attachments/article/46/az_en.pdf, (accessed on 23 June 2013)

In addition, in the year 2006 the second conference under which energy was the major issue was held in Astana (Kazakhstan). As a result of this conference, the EU and its partners agreed on an Energy Road Map with the detailed plans of action regarding the enhancement of the existing energy cooperation between the parties. As a result of the conference, it was also agreed that European Commission became the monitor of the implementation of the Road Map with the technical support of INOGATE[127]. In this framework, in the year 2011, INOGATE Technical Secretariat has prepared a review in order to assess the state of play in achieving the objectives of the Energy Road Map and evaluating the progress of the partner countries of the EU[128].

In this context, in the review of INOGATE Technical Secretariat in 2011, four main headings of cooperation are identified; namely, energy market convergence, energy security, sustainable development and investment attraction[129]. Each partner of the EU is evaluated according to the progress made under these main headings. In the Review, countries has been ranked in terms of its stage of development as 'basic', 'developing', 'advanced' and 'mature'[130].

Under the first heading; energy market convergence, countries are evaluated according to their progress on the sub-headings of third-party access, unbundling[131], independent energy regulators[132], technical rules and integrated regional markets[133].

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[127]European Union.European Commission and Inogate Technical Secretariat. InogateProgramme Status Report 2011. p.8-9 http://www.inogate.org/media/documents/INOGATE Status Report EN.pdf, (accessed on 10 Dec 2012)

[128]*Ibid*

[129]*Ibid*, p.11

[130]*Ibid*

[131]Structural separation between transmission activities and production/supply activities of vertically integrated companies (European Union.European Commission and Inogate Technical Secretariat. Inogate Programme Status Report 2011. p.12 http://www.inogate.org/media/documents/INOGATE Status Report EN.pdf, (accessed on 10 Dec 2012))

[132]The regulator is an individual entity, acting under the supervision and/or control of a ministry (usually either the ministry in charge of economy, the ministry in charge of energy, or referring

According to the Review, Azerbaijan is at the 'basic' level in all of these sub-headings. On the other hand, some other countries including Armenia, Georgia, Kazakhstan and Moldova have more advanced status than Azerbaijan has[134].

Moreover, under the second heading; energy security, countries are assessed according to their progress on the sub-headings of maintenance, rehabilitation/upgrading, new energy infrastructures, metering and billing[135]. According to the Review, Azerbaijan has a status of 'developing' under all sub-headings. On the contrary, Armenia, Belarus and Moldova have 'advanced' level in the maintenance part[136].

Besides, under the third heading; sustainable development, countries' progress are evaluated according to the sub-headings of policy commitment, energy efficiency and renewable energy sources (EE/RES) framework development, EE/RES action plans and measures, creation of energy agencies, environmental assessments and environmental standards, Kyoto Protocol mechanisms and gas flaring reduction. According to the Review, Azerbaijan's status for creation of energy agencies, Kyoto Protocol mechanisms and gas flaring reduction is 'developing'; however, for the rest of the sub-headings, the country's status is determined as 'basic'[137]. On the contrary,

directly to the President of the Country). Azerbaijan has a regulator in this category;" (European Union. European Commission and Inogate Technical Secretariat. InogateProgramme Status Report 2011. p.13 http://www.inogate.org/media/documents/INOGATE Status Report EN.pdf, (accessed on 10 Dec 2012))

[133]European Union.European Commission and Inogate Technical Secretariat. InogateProgramme Status Report 2011. p.11 http://www.inogate.org/media/documents/INOGATE Status Report EN.pdf, (accessed on 10 Dec 2012)

[134]*Ibid*, p.18

[135]*Ibid*, p.11

[136]*Ibid*, p.22

[137]*Ibid*, p.27

countries like Armenia, Georgia, Ukraine and Uzbekistan are at ‘advanced’ level for the subheading of ‘Kyoto Protocol mechanisms’[138].

Finally, under the fourth heading; investment attraction, countries are assessed according to their progress on the sub-headings of investment framework, investment climate and investment planning. According to the Review, Azerbaijan’s status for the sub-headings ‘investment climate’ and ‘investment planning’ is ‘developing’; however, the status of the country for the sub-heading of ‘investment framework’ is ‘basic’. On the other side, the picture is almost the same for the other partner countries[139].

When the overall conclusions of the review of the INOGATE Technical Secretariat in 2011 are analyzed, Azerbaijan is generally found to be at basic or developing stages[140]. However, these results are not so reflective because some countries in the review have oil and gas reserves; on the contrary, some countries do not. Thus, evaluating all these countries in one basket may not be so productive. In accordance with that there must be additional parameters or grouping while analyzing these countries more effectively.

In accordance with that, there are additional points worth to be mentioned in the review. In 2011 Azerbaijan ranks as 66th in the ‘Ease of Doing Business Ranking 2011’ published by the World Bank and the International Finance Cooperation[141]. Moreover, Azerbaijan is one of the countries who endorsed the Istanbul Action Plan (IAP)[142], an Anti-Corruption Action Plan in the context of the Anti-Corruption Network for Eastern Europe and Central Asia of the OECD and accordingly,

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[138] *Ibid*

[139] *Ibid*, p.31

[140] *Ibid*

[141] *Ibid*, p.28

[142] The Istanbul Action Plan (IAP) is a sub-regional peer review programme launched in 2003 in the framework of the Anti-Corruption Network for Eastern Europe and Central Asia by OECD. (Anti-Corruption Network for Eastern Europe and Central Asia-Istanbul Action Plan)

Azerbaijan has committed to take measures against corruption[143]. Besides, Azerbaijan also modernized its taxation system and criminalized active and passive bribery[144]. As a result of all these actions, Azerbaijan is promising regarding 'investment attraction' in the future. However, most of the countries including Azerbaijan are criticized to apply restrictions to private investment in energy infrastructure as an area of strategic importance and in these countries the privatizations in the energy sector are not at the level they should be[145].

In this regard, there are several projects of Azerbaijan which have been held in coordination with INOGATE (also listed in Table 5). The subjects of the projects include oil, gas, electricity, energy security, investment attraction, renewable energy, sustainable energy development, energy efficiency and convergence of energy markets. Indeed, INOGATE has very fruitful results and important contributions to the energy markets of the partner countries.

[143] *Ibid*

[144] *Ibid*, p.29

[145] *Ibid*, p.34

Table 5: INOGATE Projects of Azerbaijan

Title	Project period	Energy theme	Country/Countries
Energy Saving Initiative in the Building Sector in the Eastern European and Central Asian Countries (ESIB)	01/01/2010 - 31/12/2013	Renewable Energy, Sustainable Energy Development, Investment Attraction	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine, Uzbekistan
Supporting Participation of Eastern European and Central Asian Cities in the 'Covenant of Mayors'	20/09/2011 - 20/09/2013	Energy Efficiency, Renewable Energy	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan
INOGATE Technical Secretariat and integrated programme in support of the Baku Initiative and the Eastern Partnership energy objectives	01/02/2012 - 31/01/2015	Oil, Gas, Electricity, Energy Efficiency, Renewable Energy, Climate Change, Convergence of Energy Markets, Energy Security, Sustainable Energy Development, Investment Attraction	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine, Uzbekistan

Source: INOGATE Projects,

http://www.inogate.org/index.php?option=com_inogate&view=projects&Itemid=75&lang=en,

(accessed on 1 July 2013)

3.2.4 MoU on a Strategic Partnership between Azerbaijan and the EU

On 7 November 2006, the EU and Azerbaijan signed a Memorandum of Understanding on Energy (MoU) that shows a clear strategic commitment to modernize the energy sector through energy cooperation, on the basis of mutual interest[146].

[146]European Union.European Commission. Commission Decision of on the ENPI Annual Action Programme 2007 in favor of Azerbaijan. 2006. P.3-4

According to the MoU between the EU and Azerbaijan, the two parties agreed to cooperate in four areas including gradual harmonization of Azeri legislation to the EU's in the field of energy especially electricity and gas sectors, enhancement of safety and security of supplies and transit routes from Azerbaijan to the EU, development of a comprehensive energy demand management policy like measures on energy saving, climate change, renewables and technical cooperation accompanied by exchange of expertise[147].

As a result of the cooperation on enhancing the safety and security of energy supplies and transit systems from Azerbaijan and Caspian basin to the EU, it is planned to have a further important move towards the closer integration of Azerbaijan with the EU in the energy market[148].

On the other hand, both the EU and Azerbaijan also agreed a possible joint program to cooperate on a variety of detailed areas including evaluation of the existing hydrocarbon transit and supply system, with a view to developing an infrastructure reconstruction plan, if necessary, examine ways to improve safety and security of Azerbaijan transit and export pipeline system, identify and promote additional sources and supply routes for gas and oil to Azerbaijan and onwards to the EU, promote the harmonization of technical norms and standards in Azerbaijan's hydrocarbon sector with EU industrial practices, making parallel the quality and environmental standards for oil products with those of the EU and assist Azerbaijan where suitable in its implementation of the 'Oil and Gas Chapter' objectives in the State Program for the Fuel and Energy Sector in Azerbaijan[149].

Regarding the area of technical cooperation with exchange of expertise, both parties agreed on the possible cooperation fields including twinning of future Azerbaijan

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[147]European Union. Memorandum of Understanding on A Strategic Partnership Between the European Union and the Republic of Azerbaijan in the Field of Energy.p.5 http://ec.europa.eu/energy/international/doc/mou_azerbaijan_en.pdf, (accessed on 10 June 2013)

[148]*Ibid*, p.8

[149]*Ibid*, p.9-10

regulatory bodies with the EU regulatory bodies in the field of energy, introduction of modern European technology into Azerbaijan energy sector (R&D) and exchange of expertise regarding security and safety in the field of energy[150].

As can be seen, Azerbaijan and the EU have already established various legal channels to increase their cooperation and strengthen their partnership on a range of issues. However, currently the most important of these issues is cooperation on energy in order both to increase energy security of the EU members and diversify the export options of Azerbaijan via the alignment process of the Azeri energy markets to the EU's.

To conclude, the chapter examines the main dimensions of the partnership between Azerbaijan and the EU on energy in detail and the next chapter is going to examine the political strategies of Azeri leaders on energy since independence.

[150] *Ibid*, p.11-12

CHAPTER 4

EVOLUTION OF AZERI LEADERS' STRATEGIES

In this chapter, regarding their strategies on politics and economy, specifically on energy; firstly, the leaders prior to Haydar Aliyev, namely, Mütellibov and Elçibey, secondly Haydar Aliyev and finally Ilham Aliyev will be presented in detail.

4.1 The Era of the Leaders Prior to Haydar Aliyev

Foreign relations in Azerbaijan's politics can be described as non-stable prior to the Ilham Aliyev's period. First of all, the first leader of the country between the years 1991 and 1992, i.e. Ayaz Mütellibov generally had a pro-Russian attitude and acted according to the political decisions of Moscow. On the other hand, Mütellibov had a very cautious position towards West because of the leader beware from Russia. This situation threatened the sovereignty of the country as well as the power of the President. Moreover, such dependency on Russia included the risk of impeding the required measurements of the newly state.

On the other hand, during the period of Mütellibov, there were important problems related to the Nagorno-Karabakh; specifically the Khojaly region. In this context, Armenia with the help of Russian forces carried out a massacre more than genocide over the territories of Khojaly on February 25-26 of 1992 that in turn created anger and sadness among Azerbaijan[151]. The details of the Khojaly massacre are very tragic and the losses of Azeris are also accepted later on by the Armenian side[152].

> During the height of clashes in the Karabakh region, Khodjaly's civilians could not flee and were brutally attacked by Armenian armed forces over the night of February 25-26, 1992. As a result, 613 people were killed,

[151] İpek, Pınar. "Azerbaijan's Foreign Policy and Challenges for Energy Security." Middle East Journal. 63.2 (2009): p. 230.

[152] Bölükbaşı, Süha. Azerbaijan: A Political History. 1st. 24. London, Newyork: I.B Tauris, 2011. p.182.

> including 106 women, 63 children, and 70 elderly people; 1,275 people were taken hostage, and the fate of 150 people remains unknown.[153]

However, at first, Azeri government made conflicting explanations regarding the event and rejected the loss of the territories of Khojaly region. On the other hand, the government initially rejected the level of the tragedy by explaining that only two Azeris were dead during the event[154]. The main reason of this failure for the Azeris was the lack of a united army over the territories of the country and later on Mütellibov explained the reason of the lack of an army that the intention of Russia to establish a common army for the Commonwealth of Independent States (CIS) members convinced them to delay the creation of an army[155].

The details of Khojaly massacre are very important in order to be able to understand the Azeri politics immediately after independence[156]. In this regard, the political elites of the country blamed the President for this failure and finally Mütellibov was forced to leave Presidency.

After Mütellibov, between the years 1992 and 1993 the new President of Azerbaijan became Ebülfez Elçibey[157]. The new President had a more nationalistic view; thus, followed policies against Russia. In this context, the biggest success of the Elçibey period was the elimination of the Russian army from the territories of Azerbaijan. Moreover, the main aim of Elçibey's foreign policy was to get western support for the problems in Nagorno-Karabakh. However, this was not enough to solve these problems and provide political stability over the territories of Azerbaijan.

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[153] İpek, Pınar. "Azerbaijan's Foreign Policy and Challenges for Energy Security." Middle East Journal. 63.2 (2009): p. 230.

[154] Bölükbaşı, Süha. Azerbaijan: A Political History. 1st. 24. London, Newyork: I.B Tauris, 2011. p.183.

[155] *Ibid*

[156] *Ibid*

[157] *Ibid*

In addition, considered as pro-Russian, there was a military uprising of Surat Huseynov as one of the colonels of Azerbaijan demanding the resignation of Elçibey together with the other cabinet members. It is very interesting that this uprising coincided with several important events for Azerbaijan and hindered them. First, Azerbaijan was about to sign a magnificent oil deal with a Western consortium with seven multinational companies on June 1993; however, these companies did not include Russia's oil companies that was perceived by Russia as an antagonistic move[158]. Second, a ceasefire was expected regarding the problems between Armenia and Azerbaijan on Nagorno-Karabakh and finally Azerbaijan was preparing to leave Ruble and use its own currency, Manat[159].

As a result, Elçibey was also forced to leave the Presidency on June 21, 1993 because of the uprising as well as domestic turbulences inside the country resulting from the Nagorno-Karabakh problem[160].

In this context, the Azeri foreign policy which was against Russian demands resulted in the increase of the Russian support to Armenia in the Nagorno-Karabakh conflict, not only in politics but also in military[161]. Obviously, one of the major reasons of the instability throughout the Elçibey period are the rich oil reserves of Azerbaijan and the strong wish of the country to use this advantage in order to get political support from the Western powers.

At that point, it should be mentioned that two different approaches until the year 1993, namely, pro-Russian and anti-Russian, were not enough to solve the political and economic problems of Azerbaijan, so the country could not have stability through the first years of the independence.

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[158]*Ibid*, p.203

[159]*Ibid*

[160]İpek, Pınar. "Azerbaijan's Foreign Policy and Challenges for Energy Security." Middle East Journal. 63.2 (2009): p. 229.

[161] *Ibid*

4.2 Haydar Aliyev Era

After Elçibey, with the election of Haydar Aliyev as the new President of the country in 1993, the situation changed. When compared with the previous two presidencies, Haydar Aliyev followed a more balanced policy against neighbors of Azerbaijan. The general strategy of the President can be based on living in peace with all countries, solving its problems without using power, preventing interventions of other countries to Azeri internal affairs, establishing diplomatic relations with the other countries and representing the country at the international institutions.

Haydar Aliyev took strategic and wise steps regarding the oil and gas sectors and using energy foreign policy to shape the external political relations. In this framework, one of the first items in the agenda of Haydar Aliyev was to cancel the oil Agreement on 1993 and signing a new deal; i.e., Contract of the Century by renegotiating the terms of the deal[162]. The most attractive thing in this agreement is the given 10 percent share to Lukoil in order to prevent Russian objection for Azerbaijan to exploit the offshore oil and gas unilaterally[163].

> He showed that he had considerable acumen by courting Russia by dropping the anti-Russian rhetoric of his predecessor and involving the latter's Lukoil in the Azerbaijan International Oil Consortium's projects, while refusing the deployment of Russian peacekeepers in and around the NKAO (Nagorno Karabakh Autonomous Oblast). He also improved relations with Iran by moving away from Elchibey's anti-Iranian stance, dropping the latter's irredentism *vis a vis* Iranian Azerbaijan.[164]

Indeed, during the first six months of the Aliyev's Presidency, Azerbaijan followed a pro-Russian policy[165]. When the negative events prior to the Aliyev's period is considered, it was vital for Aliyev to establish closer ties with Russia in order to protect national interests of Azerbaijan. As a matter of fact, Haydar Aliyev had

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[162]Bölükbaşı, Süha. Azerbaijan: A Political History. 1st. 24. London, Newyork: I.B Tauris, 2011. p.206.

[163]*Ibid*

[164]*Ibid*, p.219

[165] *Ibid*

already lots of experience in Soviet Politburo about Russia's impact on Azerbaijan. In this context, on 22th of June 1993 Aliyev suspended the meetings regarding the energy deals with the Western oil companies and also cancelled the project which aimed to transport Azeri oil to the Mediterranean port of Turkey. As a result, during this period Azerbaijan started to establish warm relations with Russia.

Besides, to further improve the bilateral relations with Russia, on 24th June 1993, Azerbaijan joined the CIS. The main motive of Azerbaijan to have close relations with Russia was to get support for the problems related to Nagorno-Karabakh. However, this did not happen. On the contrary, Russian military forces continued to help the Armenian army at that situation.

However, during the Putin's period, bilateral relations between Azerbaijan and Russia has started to gain momentum[166]. As a matter of course, Aliyev had important contributions on the improvement of bilateral relations with Russia. Likewise, in order to minimize the international support of Armenia in the international arena, Azerbaijan succeeded to attract Western capital to its oil sector.

Moreover, with the era of Haydar Aliyev, Azerbaijan became an active member of important international organizations including Asian Development Bank, European Development Bank, Islamic Development Bank and United Nations[167]. In this framework, Azerbaijan has succeeded to reach the necessary monetary resources to restructure the economy and in parallel to these, the country has achieved to establish external trade relations with many countries.

Azerbaijan also engaged in other international arenas[168]. In this context, Azerbaijan signed the Energy Charter Treaty (ECT) and PEEREA (Protocol on Energy Efficiency and Related Environmental Aspects) on December 1997 and the ECT

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[166] *Ibid*

[167] Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.6

[168] *Ibid*

entered into force on April 1998[169]. The main aim of the Energy Charter Treaty is to establish a legal base for energy security in accordance with the principles of open, competitive markets and sustainable development[170].

During the Aliyev era, Azerbaijan's another strategy has become to bring in many large companies from different countries as possible as a tool for achieving its foreign policy objectives; in this context, companies including BP, Exxon, Statoil, Itochu etc. started to invest in Azeri energy sector[171].

Indeed, Haydar Aliyev took many steps on the way of establishing market economy in the country and attracting FDIs from the energy giants of the West[172]. The main aim of the leader is to eliminate the Russian dominance around the sovereignty of the country and promote the alternative projects regarding the exploration and exploitation of its reserves including BTC. However, throughout the first decade of independence, the main development plans of the country were based on economy. Other political issues including the consolidation of democracy and improvement of the conditions of the political ruling were planned to be considered at the next stages.

However, the Aliyev era is criticized for nepotism and the close relatives' of Haydar Aliyev taking place in the important positions of the country.

> Heidar Aliev's brothers, Jalal and Agil Aliev, his nephew Jamil Aliev and his son-in-law, Vasif Talibov have held high-profile YAP (Yeni Azerbaycan Partiyası) posts. Jalal Aliev is also a parliamentarian and holds a controlling share of Azercell, the country's major mobile phone operator. Other relatives and in-laws, including Ilham Aliev's sister, Sevil Alieva, are also involved in business activities and/or are heavily

[169] *Ibid*

[170] "About the Charter."Energy Charter. Energy Charter Secretariat, http://www.encharter.org/index.php?id=7, (accessed on 24 July 2013)

[171] İpek, Pınar. "Azerbaijan's Foreign Policy and Challenges for Energy Security." Middle East Journal. 63.2 (2009): p. 233.

[172] *See*, Bölükbaşı, Süha. Azerbaijan: A Political History. 1st. 24. London, Newyork: I.B Tauris, 2011.

> represented in prominent YAP positions and government and high-level state bureaucracy.[173]

This resulted in a decrease in the confidence which the international organizations and the third countries had for the country that become an important criticism point even today.

4.3 Ilham Aliyev Era

As the son of Haydar Aliyev, Ilham Aliyev was elected as the new President of the country on August 2003 prior to the decease of Haydar Aliyev on December 2003. According to Ilham Aliyev, Azeri energy policy is and will be further based on some fundamental principles together with the current trends in Azeri foreign policy. In this context, via establishing friendly relations as the philosophy of the country, Azerbaijan wants to further increase the number of foreign companies operating in the energy sector of the country as well the country targets to achieve this without any mistake[174]. In addition, the country increases its exports via diversifying its export routes as also mentioned by Ilham Aliyev.

> "We have four gas pipelines, and today Azerbaijani gas is exported to all neighboring countries. In the future, Azerbaijani gas exports will grow. Right now we are working on large trans-national projects, which will ensure long-term economic development. They will transform Azerbaijan into an even stronger country - Azerbaijan's word will hold more clout, and our position in the world will strengthen. We are creating a strong country, a strong economy, a strong policy," Aliyev said.[175]

The explanations of Ilham Aliyev are very important regarding the confidence of the current leader of Azerbaijan over the energy policies of the country; in addition, they show that Ilham Aliyev also follow friendly relations with its partners in the energy sector as his father did previously. On the other hand, the explanations show that the

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[173]Bölükbaşı, Süha. Azerbaijan: A Political History. 1st. 24. London, Newyork: I.B Tauris, 2011. p.218.

[174]"Azerbaijan has flawless energy policy - Aliyev." Central Asia Business News. (2012)

[175]*Ibid*

country follows a comprehensive strategy regarding its energy sector and the strategy includes various aspects.

> Economic and social development strategy by the national leader Heydar Aliyev who stated that "Oil is Azerbaijan's grand wealth, and belongs to nation: not only to present generation, but also to the forthcoming ones", continues effectively under auspices of President Ilham Aliyev.[176]

In this context, in 2005, Azerbaijan under the leadership of Ilham Aliyev adopted the State Program for the Development of Fuel and Energy Sector for the years 2005-2015[177]. Mainly, the Program aims to completely meet the demand for electricity power from own resources of the country and satisfy the demand for the energy services of the population as well as the economy through the development of the energy sector[178]. Specifically, one of the aims of the Program is to increase the number and volume of the foreign direct investments (FDI) to the energy sector of the country.

As well, the program is focused on several directions including to increase the production of energy resources, ensure Azerbaijan's access to the global energy markets through the attraction of international energy giants and huge investments in the projects of oil and gas, establish export pipelines to ensure the delivery of Azeri oil products to the global markets, accumulate and increase the oil revenues for the next generations, meet the social needs of the present generations and provide economic prosperity to the country[179].

In this context, Ilham Aliyev as the new leader of the country has followed the steps of his father in the foreign policy and also energy sector and continued strategic

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[176]Republic of Azerbaijan.Extractive Industries Transparency Agency. EITI Azerbaijan annual Report 2011. 2011. p.7

[177] Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.26-27

[178]*Ibid*

[179]*Ibid*

partnership with the global players[180]. In this context, through the Ilham Aliyev period, Azerbaijan takes place in most of the regional and international organizations; in this framework, with the membership of Economic Cooperation Organization (ECO), Black Sea Economic Cooperation (BSEC) and Commonwealth of Independent States (CIS), Azerbaijan has become a strategic player in its region.

Moreover, in 2011, Azerbaijan signed a joint declaration with the EU on committing to supply substantial volumes of gas over the long run to the EU[181]. In fact, EU's structural need on energy resources is a major contribution to the Azerbaijan's success in the international arena. In this framework, the EU is decisive to cooperate with Caspian littoral states including Azerbaijan, Kazakhstan, and Turkmenistan on alternative pipeline projects transporting Caspian oil and gas reserves to the EU because of the strong decision to eliminate Russian dominance in the EU energy market.

As another major development, during the Ilham Aliyev era, SOCAR has become an international energy giant which has significant influence not only in Azerbaijan but also in the neighborhood. In this context, SOCAR has expanded the types of sectors in which it operates. For instance, SOCAR entered into the petrochemicals and media sectors in Turkey. On the other hand, in June 2013, SOCAR declared its acquisition of 66% shares of natural gas system operator in Greece; namely, DESFA. All these are very important for Azerbaijan to complete its transportation infrastructure to European continent and to establish strong business ties as well as the legal framework[182].

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[180] *See*, İpek, Pınar. "Azerbaijan's Foreign Policy and Challenges for Energy Security." Middle East Journal. 63.2 (2009).

[181] Ratner, Michael, Paul Belkin, Jim Nichol, and Steven Woehrel. "Europe's Energy Security: Options and Challenges to Natural Gas Supply Diversification. "European Gas Hub. Congressional Research Service, p.14 http://www.europeangashub.com/custom/domain_1/extra_files/attach_148.pdf, (accessed on 1 Apr 2013)

[182] "Azerbaijan's SOCAR Acquires Greek Gas Transmission System Operator." Natural Gas Europe. Natural Gas Europe. http://www.naturalgaseurope.com/socar-acquires-defsa-greece-tso, (accessed on 24 July 2013)

On the other hand, for the recent period of the Ilham Aliev era, according to the Energy Charter Secretariat's Follow-up Review in 2011, Azerbaijan is found to be successful in fulfilling most of its commitments under the Energy Charter Treaty and especially in the oil and gas sectors; furthermore, Azerbaijan's FDI policy is considered as fairly open and described in the Review document in detail as shown below[183].

Then again, the Review has some remarks regarding the maintenance of the development in Azerbaijan. In this framework, the Charter invited Azerbaijan to review and update the existing 'State Program on development of fuel-energy complex of the Republic of Azerbaijan in 2005-2015 for a medium and long-term solution for the energy sector of the country and in order to familiarize with the practices and disciplines of the World Trade Organization (WTO)[184].

In this context, although there are still some problematic areas to be solved, Azerbaijan seems to be mostly completed its commitments under the Energy Charter Treaty that shows the improvement in the position of the country's energy markets all over the world[185]. This is very significant for the Ilham Aliyev era because the leader seems to be successful regarding the completion of its obligations under various international platforms including Energy Charter Treaty and also the legal framework between Azerbaijan and the EU.

To conclude, the chapter examines the evolution of Azeri leaders' strategies on energy in detail and the next chapter is going to examine the pipeline politics of Azerbaijan and its partners.

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[183]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.7

[184]*Ibid*

[185] *Ibid*

CHAPTER 5

PIPELINE POLITICS

Since its independence, Azerbaijan has progressed significantly regarding establishing pipelines to export the country's energy resources i.e., oil and natural gas to the other countries in the region. On the other hand, since the last decade, Azerbaijan also engaged in more challenging pipeline projects that attracted attention of both regional and global players.

In this chapter, firstly, Azerbaijan and Southern Gas Corridor and later the energy relations of the country with its neighbors will be analyzed in detail.

5.1 Azerbaijan and Southern Gas Corridor

Southern Energy Corridor is planned to transport natural gas supplies to the EU from the territories of Caspian and Middle East with a capacity ranging between 60 to 120 bcm per year[186]. In other words, Southern Corridor is seen as a modern Silk Road connecting regions and creating a framework to boost foreign trade, exchange of knowhow and technology via new energy transportation routes[187].

According to the Prague Summit which establishes the framework of the Southern Corridor, it is decided to give needed political, technical and financial support for the actualization of the Southern Corridor, including Trans-Caspian transference projects with the aim of diversifying energy resources, markets and transportation routes, that will both increase the energy security of the joining countries and create

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[186] Stefanova, Boyka. "European Strategies for Energy Security in the Natural Gas Market." Journal of Strategic Security. 5.3 (2012): p.58.

[187] European Union.European Council European Commission.Prague Summit Southern Corridor. p.1 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/misc/107598.pdf, (accessed on 1 June 2013)

nondiscriminatory and profitable occasions for energy producers, users and transit countries in a competitive, maintainable and timely manner[188].

Moreover, it is also agreed to achieve the energy security of all parties including user and transit states, such as Turkey, Georgia and Azerbaijan without prejudice to the Parties' commitments in the international arena[189]. As another result of the Prague Summit, the parties agreed on establishing effective energy cooperation as well as establishing direct routes among the Caspian Sea and from the region to the EU in order to transport oil and natural gas.

However, there are some issues which hinder the Southern Corridor project. For example, as a negative consequence of the delays of the expansion and development of the Southern Corridor, the Central Asian countries in the Caspian region which currently use Russian routes for the transportation of supplies to Europe, started to divert their look the projects of the east rather than the alternative projects of the Southern Corridor[190].

On the contrary, at that point Azerbaijan has a competitive advantage when compared with its energy producing neighbors among the ex-Soviet countries in the Caspian. In this context, Azerbaijan has alternative routes connecting its resources to the European countries as can be seen from Figure 5. Moreover, Azerbaijan also has lots of advantages on the transportation of its oil and gas to Europe without the dominance of the Russia driven routes. In this context, as can be seen from Figure 5 currently there are two active pipelines of Azerbaijan operating on the Southern Corridor; namely, Baku-Tbilisi-Ceyhan (BTC) and Baku-Tbilisi-Erzurum (BTE) which will be mentioned in detail below.

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[188]*Ibid*, p.3-4

[189]*Ibid*

[190]Ratner, Michael, Paul Belkin, Jim Nichol, and Steven Woehrel. "Europe's Energy Security: Options and Challenges to Natural Gas Supply Diversification. "European Gas Hub. Congressional Research Service, p.2 http://www.europeangashub.com/custom/domain_1/extra_files/attach_148.pdf, (accessed on 1 Apr 2013)

Figure 5 Export Routes for Oil and Gas Starting from Azeri Territories

Source: Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.54

In this regard, Azerbaijan gives a lot importance to the alternative pipeline projects which diversify its export directions. In accordance with that since the independence, the country has already succeeded to engage in a variety of pipeline projects as well as the existing pipeline infrastructure going to Georgia, Turkey, Iran and Russia. As can be seen from the map, Azerbaijan is somehow successful on its diversification targets of the export directions[191]. The country's energy export hub includes major players in its region including Georgia, Turkey, Russia and Iran. In addition to that in the Southern Corridor, there are various alternative projects and in the majority of them, Azerbaijan is the main source of natural gas which will be transported to the EU. Only in the South Stream Pipeline Project driven by Russia, Russia is the main source of the natural gas. In accordance with the alternative projects of the Southern Corridor, the main transit countries of the Azeri energy resources are Turkey and Georgia and these countries are also the main existing partners of Azerbaijan with their position as a transit country in BTC and BTE.

5.1.1 Turkey

Turkey's strong ties with Azerbaijan have evolved for a long time both in politics and economics. Because of not only the common nationalities and religion, but also

[191] Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.54

the cooperation in politics and economics, two states are really good associates although there have been some political problems over time.

At the crossroads of three continents, Turkey is around the major oil and gas suppliers of the country. However, because of the newly geological formation of its territories, the country's oil and gas reserves are not enough to meet its whole demand. In this context, Turkey imports oil mainly from Russia with its share of almost 30%, Iran, Saudi Arabia, Iraq, Libya, Syria and Egypt; on the other hand, with its dependency on imports with 97%, Turkey imports most of its natural gas from Russia with 60% followed by Iran, Azerbaijan and Algeria with their share of almost 10%[192].

Actually, Turkey has a strategically important position which connects Asia to Europe. Thus, the country wants to use this advantage. In this context, Turkey wants to transport the Caspian energy resources and especially the resources of Azerbaijan- a country- generally following pro-Turkish policies after independence. Indeed, the current developments in energy cooperation between Azerbaijan and Turkey are very significant and the cooperation between the two countries has intensified.

5.1.1.1 Baku-Tbilisi-Ceyhan Pipeline

On May 2006, a new pipeline called as BTC started to operate. "The BTC pipeline that stretches for 1768 km and carries crude oil from the Azeri-Chirag-Guneshli (ACG) oil field connects the Caspian offshore fields with the Turkish Mediterranean port of Ceyhan. The pipeline's throughput capacity is 1.2 million barrels a day[193]". From the total length, 443 km belongs to Azerbaijan, 249 km to Georgia and 1, 076 km to Turkey[194].

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[192]Göral, Emirhan. "Avrupa Enerji Güvenliği ve Türkiye." Avrupa Araştırmaları Dergisi. 19.2 (2011): p.126.

[193]"Energy." Embassy of the Republic of Azerbaijan to the United States of America. p.1 http://www.azembassy.us/5/52.html, (accessed on 20 Nov 2012)

[194]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.54-55

Actually, the pipeline is the main export route of the oil production in Azeri-Chirag-Guneshli field. It starts from the Sangachal Terminal in Azerbaijan after, passes from Georgia and reaches the final point- Ceyhan in the southern Turkey[195]. The main aim of using the Georgian route for this pipeline was eliminating the routes of Armenia with which Azerbaijan has had problematic political relations since the beginning of 1990s especially on Nagorno-Karabakh issue[196]. Moreover, eventually crude oil of both Kazakhstan and Azerbaijan started to be brought via the pipeline[197].

Azerbaijan, Georgia and Turkey as the relevant governments with the host government agreements govern the construction and operation of BTC[198]. On the other hand, the oil to be exported via BTC has been managed by a consortium (known as the BTC Co.). The members of the consortium are British Petroleum (BP)-United Kingdom (30.1%), SOCAR-Azerbaijan (25%), Unocal-United States (8.9%), Statoil-Norway (8.71%), TPAO-Turkey (6.53%), ENI/Agip-Italy (5.0%), Total Final Elf-France (5%), Itochu-Japan (3.4%), Index-Japan (2.5%), Conoco Phillips-United States (2.5%), Amerada Hess-United States (2.36%)[199].

5.1.1.2 Baku-Tbilisi-Erzurum Pipeline (South Caucasus Pipeline)

Azerbaijan increased its importance not only with oil transportation via BTC but also with another pipeline carrying natural gas of the country to the west as parallel to BTC. The pipeline is called as Baku-Tbilisi-Erzurum (BTE). On September 2006, BTE as a 692 km long pipeline with a capacity over 7 bcm was built and it began to

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[195]Balat, Mustafa. "Case of Baku-Tbilisi-Ceyhan Oil Pipeline System: A Review." Energy Sources Part B: Economics, Planning and Policy. 1.2 (2006): p. 121.

[196]The Oil Satrap." Economist. 375.8430 (2005): p.1.

[197]Mankoff, Jeffrey. Eurasian Energy Security. New York: Council on Foreign Relations Press, 2009. P.19.

[198]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.54-55

[199]Balat, Mustafa. "Case of Baku-Tbilisi-Ceyhan Oil Pipeline System: A Review." Energy Sources Part B: Economics, Planning and Policy. 1.2 (2006): p. 123.

carry the natural gas production from Shah-Deniz field in Azerbaijan to Turkey with a possible extension to the South-Eastern Europe[200].

The pipeline is very significant because via BTE, first Azeri gas exported to the Southern Corridor. This means a lot when the Russian dominance in the region is analyzed. In this context, Azerbaijan succeeded to establish an independent gas direction going to Turkey. Moreover, other than the production of Shah-Deniz fields, Kazakh natural gas is also planned to contribute to the supplies of the pipeline and in total BTE brings 8.8 bcm of natural gas per year to Turkey[201].

The pipeline is also important because of the possibility of the connection with other projects in the Southern Corridor that transport natural gas to the European countries[202]. Furthermore, according to the SOCAR, Azerbaijan is practically ready to supply 2 bcm per year to Europe and 10 bcm in 2017[203].

5.1.1.3 Turkey-Greece-Italy Interconnector

Another important pipeline planned to use Turkish territories in order to transport Azeri gas is sponsored by Italy's Edison- Turkey-Greece-Italy Interconnector (ITGI) project and it started with the Intergovernmental Agreement signed in Rome in 2007[204].

[200]"Energy." Embassy of the Republic of Azerbaijan to the United States of America. p.1 http://www.azembassy.us/5/52.html, (accessed on 20 Nov 2012)

[201]Mankoff, Jeffrey. Eurasian Energy Security. New York: Council on Foreign Relations Press, 2009. P.19.

[202]Bilgin, Mert. "New prospects in the political economy of inner-Caspian hydrocarbons and western energy corridor through Turkey." Energy Policy. 35.12 (2007): p. 6390

[203]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.12

[204]Rzayeva, Gulmira. "Azerbaijan: Eurasia's Energy Nexus." Turkish Policy Quarterly. 9.2 (2010): p. 63.

Moreover, for the project, firstly it is planned that the initial flow of gas to the pipe will be in 2015[205]. Moreover, the total capacity will be 10 bcm in a year[206]. The route of the pipeline is planned to start from Turkey, continue with Greece and end with Italy. The part between Turkey and Greece has been operating since 2007; on the contrary, for the rest of the directions are still pending the clarification of the future projects of the Southern Corridor.

In this context, firstly ITGI was one of the alternative pipelines for Azerbaijan in the Shah-Deniz II project[207]. In accordance with that Azerbaijan considered this project very important because Azerbaijan has already agreed to supply natural gas to Turkey as the start point of the mentioned pipeline.

However, after TAP is chosen (details will be explained below) as the first route to transport the Azeri gas to Europe, the future of ITGI become unclear[208]. Still, the chance of ITGI project does not seem to be eliminated completely for the prospective projects of the Southern Corridor in the coming years.

5.1.1.4 Trans-Anatolia Pipeline

In June 2012, Azerbaijan and Turkey signed an agreement to build TANAP and the partners of TANAP consortium are decided to be SOCAR from Azerbaijan and BOTAŞ and TPAO from Turkey[209] with 80%, 15% and 5% respectively[210].

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[205] *Ibid*

[206] "Edison - ITGI: Today's Agreement in Azerbaijan is a Big Step Forward for Opening the Southern Gas Corridor." Edison Corporate. Edison Corporation, http://www.edison.it/en/media/press-releases/2011-01-13-edison-itgi-todays-agreement-in-azerbaijan-is-a-big-step-forward-for-opening-the-southern-gas-corridor.shtml, (accessed on 13 June 2013)

[207] *Ibid*

[208] *See,* "Nabucco Seçilmedi Çünkü...." BorsaGündem., http://www.borsagundem.com/haber/nabucco-secilmedi_-cunku/398631, (accessed on 29 June 2013)

[209] Ratner, Michael, Paul Belkin, Jim Nichol, and Steven Woehrel. "Europe's Energy Security: Options and Challenges to Natural Gas Supply Diversification. "European Gas Hub. Congressional Research Service, http://www.europeangashub.com/custom/domain_1/extra_files/attach_148.pdf, (accessed on 1 Apr 2013)

According to the assumptions, it is envisaged that the construction of TANAP will start at the end of 2013 or at the beginning of 2014; furthermore, its capacity is planned to be 16 bcm per year by 2020, 23 bcm by 2023 and 31 bcm by 2026 with an estimated cost of $7 billion[211]. This means Azerbaijan plans to increase the final capacity of the projected pipeline. On the other hand, Azerbaijan has other targets regarding the improvement of the infrastructure related to TANAP; in this context, the country also plans to increase the capacity of BTE up to 60 bcm in order to make TANAP a reality[212].

As a result of the deal on TANAP project, Azerbaijan showed its strong position and its capacity to invest abroad and major projects[213]. On the other hand, by this way, the country enhanced its influence and effect on the decision making in the international energy markets. Another important issue is that TANAP succeeded to resolve the financing issue of Turkey part of the Southern Corridor that was not achieved by the alternative project; namely, Nabucco. Moreover, the project consolidates the important position of Turkey as an energy hub and the position of Azerbaijan as the energy exporter of the Caspian region.

On the other hand, Azerbaijan has already agreed with Turkey on the import levels of Turkey from TANAP. In this context, Turkey has promised to import 6.6 bcm annually from Azerbaijan until 2017 and 6 bcm after that year[214]. Moreover, the actualization of TANAP is also very important for Turkey because of the need to meet high levels of gas demand in the Western region of the country.

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[210]Socor, Vladimir. "Azerbaijan Drives the Planning on Trans-Anatolia Gas Pipeline Project." Eurasia Daily Monitor. 9.164 (2012): p.1-3.

[211]*Ibid*

[212]*Ibid*

[213] *Ibid*

[214]"Trans-Anatolia Gas Pipeline: Wider Implications of Azerbaijan's Project (Part One)." Eurasia Daily Monitor.9.3 p.1-2 (2012).

Besides, the project is open to the other international energy giants; in this context, Azerbaijan seems to be expecting the important oil companies including BP, Total and Statoil to have shares of the project in the future[215]. As can be understood, Azerbaijan wants to operate TANAP with the same partners in the Shah-Deniz Consortium. In accordance to that, the country gives some concessions to these companies in order to satisfy their interests and convince them. There can be several reasons behind this decision but the most important one is the trust which Azeri policy makers and business environment attributes to these companies as a result of the different projects operated in the country.

In addition, at first, the development of the TANAP planned to be continued with two promising channels; Nabucco West or TAP that has significantly improved the chances of Caspian natural gas to be transported Europe in large quantities[216]. However, on 28 June 2013 Shah-Deniz Consortium declared its decision on choosing TAP as the continuation point of TANAP throughout the Southern Europe and eliminated the rival Nabucco-West.

As a result, starting and continuing with TANAP, Turkey and Azerbaijan have friendly political and economic relations that strengthen their political harmony on the issues of their region[217]. In accordance with that, their partnership is not limited only to TANAP. In overall, Azerbaijan and Turkey aims to have integration in refinery, energy and logistics; in this context, SOCAR invested in the projects of PETKİM an important company in the petro chemistry industry of Turkey which

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[215]Socor, Vladimir. "Azerbaijan Drives the Planning on Trans-Anatolia Gas Pipeline Project." Eurasia Daily Monitor. 9.164 (2012): p.1-3.

[216]Ratner, Michael, Paul Belkin, Jim Nichol, and Steven Woehrel. "Europe's Energy Security: Options and Challenges to Natural Gas Supply Diversification. "European Gas Hub. Congressional Research Service, http://www.europeangashub.com/custom/domain_1/extra_files/attach_148.pdf, (accessed on 1 Apr 2013)

[217]"Trans-Anatolia Gas Pipeline: Wider Implications of Azerbaijan's Project (Part One)." Eurasia Daily Monitor.9.3 p.5 (2012).

also shows the effective use of oil revenues in Azerbaijan for re-investment in other projects[218].

5.1.1.5 Nabucco Pipeline

With the construction of BTC and BTE pipelines, to some extent, Azerbaijan abolished the economic and strategic monopoly of Russia on itself[219]. Until June 2013, another ambitious project called as Nabucco was one of the strong candidates which would contribute to this trend in Azerbaijan's energy politics. This project is planned to transport Caspian gas as far as Austria via the territories of Turkey, Bulgaria, Romania and Hungary. Furthermore, it is planned to have 31 bcm of gas and around 8 billion Euros will be spent for the construction, moreover, at first, the construction was expected to start in 2013 and end in 2017 with the initial flow of gas to the pipe[220].

The main aim of the project was to diversify the natural gas resources for the most vulnerable regions of the EU in the east; in other words, the regions over the exact route of the pipeline[221]. By this way, at first the EU planned to increase its energy security; at the same time, to decrease the Russian dominance all over the region. However, since the first day Nabucco has come to fore, there have been considerations that the reserves of Azerbaijan will not be enough to fill the project so alternative suppliers are still being searched. In this context, Kazakhstan and Turkmenistan are defined as the other candidates to provide gas to the project, but this issue has not been resolved yet[222].

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[218]*Ibid*

[219]Mankoff, Jeffrey. Eurasian Energy Security. New York: Council on Foreign Relations Press, 2009. P.23.

[220]Abbasov, Namiq. "The Nabucco Pipeline: How Does It Serve Azerbaijan's Energy Interests?."Journal of Turkish Weekly. p.1 http://www.turkishweekly.net/op-ed/2861/, (accessed on 7 May 2013)

[221] *Ibid*

[222]"Country Report Azerbaijan. "Economist Intelligence Unit. p.12 http://country.eiu.com/FileHandler.ashx?issue_id=1068550491&mode=pdf, (accessed on 15 Dec 2012)

The main source of the problems related to the Kazakh and Turkmen reserves is Russia's deterrence regarding the cancellation of the oil and natural gas agreements with these countries[223]. On the other side, Iran and Iraq are once considered to be as the other suppliers but they seem to be not appropriate at least in the short term because of the political problems of Iraq and international embargo against Iranian resources. As a result of these problems, Nabucco has been never guaranteed regarding the assurance of the secure supply.

There is also another obstacle which always stands in the way of Nabucco, namely, the financing problems. As a result of the increase in the expected overall costs of the project (around €8 billion), there were regular delays of the start of the construction from 2011 to 2013 and the delays of the start of the deliveries from 2017 to 2018 in turn decreased the probability of the actualization of Nabucco[224].

As a result of these, a reduced version of Nabucco; namely, Nabucco-West was planned to be constructed over a distance of 1,300 km throughout the Eastern Europe as a linkage to TANAP that resulted in the simplification of the construction[225]. Moreover, the partners in the Nabucco West pipeline become BEH Bulgarian (Bulgaria), BOTAŞ (Turkey), FGSZ (Hungary), OMV (Austria) and Transgaz (Romania)[226]. With the reduced version, Nabucco-West again joined the race of the alternative pipelines over the Southern Corridor. However, this time Nabucco-West has a rival; i.e. TAP.

[223]Erdoğdu, Erkan. "Bypassing Russia: Nabucco project and its implications for the European gas security."Renewable and Sustainable Energy Reviews. 14.9 (2010): p.2940.

[224]Stefanova, Boyka. "European Strategies for Energy Security in the Natural Gas Market." Journal of Strategic Security. 5.3 (2012): p.59.

[225]*Ibid*

[226]Ratner, Michael, Paul Belkin, Jim Nichol, and Steven Woehrel. "Europe's Energy Security: Options and Challenges to Natural Gas Supply Diversification. "European Gas Hub. Congressional Research Service, http://www.europeangashub.com/custom/domain_1/extra_files/attach_148.pdf, (accessed on 1 Apr 2013)

5.1.1.6 Trans-Adriatic Pipeline

Trans Adriatic Pipeline (TAP) starts from Thessaloniki in Greece, then continues on the territories of Albania and by passing the Adriatic Sea, finally reaches the Apulia area in Italy[227]. Firstly, the capacity of the pipeline was declared to be around 10 bcm and supplied by the natural gas of Shah-Deniz II; however, later the capacity has been revised to be 20 bcm as a result of the development of further energy resources[228]. In addition, TAP is planned to develop additional natural gas storage facilities in Albania in order to ensure the security of supply to the EU if an operational problem occurs.

Besides, ownership composition of TAP is dominated mostly by the companies of the non-EU countries. In this context, Norway (Statoil) and Switzerland (AXPO) have 42.5% shares respectively in the project, on the contrary, Germany (E.ON Ruhrgas) as the single EU member country in the project has 15% share[229]. Another issue that attracts attention is about the final route of the pipeline, i.e. Italy. The pipeline is planned to transport Caspian gas to Western and Northern parts of the European continent, where the energy mix as well as gas supplies are already well diversified and also LNG linkages are available[230].This situation creates a big problem for the Southeastern and Central members of the EU by diverting the alternative gas supplies away from them although these countries are still heavily dependent on the Russian resources which is against the EU's common energy policies[231]. In accordance with that the partner countries of Nabucco claims that TAP

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[227]"Shah Deniz II Natural Gas Field: What Will Azerbaijan."International Strategic Research Organisation.Internetional Strategic Research Organisation, p.2 www.usak.org.tr, (accessed on 1 March 2013)

[228]*Ibid*

[229]Socor, Vladimir. "Nabucco Countries' Governments Appeal to EU for Support of the Project." Eurasia Daily Monitor. 10.79 (2013): p.2-3.

[230]*Ibid*

[231]*Ibid*

is not appropriate regarding the strategic targets of the European Commission to create Southern Gas Corridor[232].

TAP is planned to interconnect with TANAP directly at the border of Turkey and Greece; in accordance with that the two projects signed a MoU in November 2012 in order to form the framework of technical and commercial cooperation between the two sides[233]. As well, TAP signed two MoUs with the consortium of Ionian Adriatic Pipeline (IAP) in order to tie TAP to IAP in Albania and transport the gas from TAP to the northern regions of Albania, Montenegro, Bosnia and Herzegovina and Croatia; as well most of these countries have not been connected to the European gas grid yet[234].

On the other side, the actualization of the project has many advantages for Azerbaijan. The most important of them is the promotion of the diversification of routes and the increase in the options of access to European energy markets[235]. As a result, the rivalry between Nabucco-West and TAP for the resources of the Shah-Deniz II phase resulted in the election of TAP by the Shah-Deniz Consortium.

5.1.1.7 Comparison of Nabucco and TAP/ Why TAP is Chosen by Shah-Deniz Consortium

The election of TAP as the first major pipeline of the Southern Gas Corridor got both positive and negative reactions from the partners of these projects and the third parties[236]. In this context, naturally, there are advantages and disadvantages of both

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[232]*Ibid*

[233]"The Missing Link." TAP, http://www.trans-adriatic-pipeline.com/why-tap/the-missing-link/, (accessed on 20 May 2013)

[234]"TAP's Contribution to South Eastern Europe and Balkan Region." TAP, http://www.trans-adriatic-pipeline.com/why-tap/benefits-for-south-eastern-europe/, (accessed on 17 July 2013)

[235]"Shah Deniz II Natural Gas Field: What Will Azerbaijan."International Strategic Research Organisation.International Strategic Research Organisation, p.2 www.usak.org.tr, (accessed on 1 March 2013)

[236] "Nabucco Seçilmedi Çünkü...." BorsaGündem., http://www.borsagundem.com/haber/nabucco-secilmedi_-cunku/398631, (accessed on 29 June 2013)

projects; however, at least for the moment, it is clear that the advantages of the TAP exceed the advantages of Nabucco-West.

The decision of TAP has been criticized because of the original rationale of the EU to increase the supply security and the diversification for the some new member states especially in the Eastern Europe and Balkans[237]. Originally, with the completion of Nabucco, it was aimed that these new member states would benefit most from the supply diversification; however, at present, under the option of TAP, the Caspian gas will be diverted to the Western European countries which do not have so much urgency regarding diversification[238].

On the contrary, Nabucco-West is criticized and TAP is favored as a result of several reasons. Since its first day, Nabucco is faced with major obstacles including security of supply and the uncertainty of the suppliers. These are the major reasons of the delays in the start date of the project and becoming prominent of TAP in a relatively short period of time. Regarding TAP, there will be no need to construct Trans-Caspian pipeline that was the main problem for Nabucco[239].

In addition, throughout the discussion, there were disagreements with Turkey and the project management of Nabucco about the transit fees that also made Azerbaijan doubtful about the future of the pipeline[240].

On the other side, there were important problems related to the management of the project. In this context, there were bureaucratic problems and the lack of agreement, so coherence between the partners of Nabucco-West. In particular, the last example

[237]Socor, Vladimir. "TAP Project Surging Ahead of Rival Nabucco-West (Part Two)." Eurasia Daily Monitor. 10.57 (2013): p.2

[238]*Ibid*

[239]"Shah Deniz II Natural Gas Field: What Will Azerbaijan."International Strategic Research Organisation. Internetional Strategic Research Organisation, p.2 www.usak.org.tr, (accessed on 1 March 2013)

[240]*Ibid*

of these problems is the withdrawal of the Austrian partner from the project; namely, OMV from the Nabucco-West.

Obviously, when there is an economic deal between two parties, the first and most important issue is the cost. In this framework, while the total cost of TAP is around €1.5 billion, the number is €8 billion for Nabucco-West, more than fivefold of TAP[241]. This makes Nabucco-West not commercially viable[242]. The main reason of the cost difference is the difference between the lengths of the projects. While the total length is around 1,300 km for Nabucco-West, it is 800 km for TAP.

Moreover, there is another economic consideration on the decision of TAP. In the market throughout the route of TAP; in other words, Italy and the other countries in the Balkans, the energy prices are much more competitive that makes TAP more attractive for the Shah-Deniz Consortium. Besides, TAP is very important because of the effective financial management of the project. While, Nabucco-West is expecting funds from the partner countries and the institutions of the EU, TAP does not burden the cost of the project to these public funds of the partner countries at the same time, the project is declared as aiming at to develop the economy and create additional job opportunities[243].

Another advantage of TAP when compared with Nabucco-West is the situation of Statoil both in its capacity as a producer of the Shah-Deniz II and in its capacity as a TAP partner that gives a competitive advantage to TAP against Nabucco-West[244]. In this context, on 22 January 2013 TAP and the members of Shah-Deniz consortium

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[241]"Nabucco Seçilmedi Çünkü...." BorsaGündem., http://www.borsagundem.com/haber/nabucco-secilmedi_-cunku/398631, (accessed on 29 June 2013)

[242]Ratner, Michael, Paul Belkin, Jim Nichol, and Steven Woehrel. "Europe's Energy Security: Options and Challenges to Natural Gas Supply Diversification. "European Gas Hub. Congressional Research Service, p.3 http://www.europeangashub.com/custom/domain_1/extra_files/attach_148.pdf, (accessed on 1 Aprl 2013)

[243]"TAP's Contribution to South Eastern Europe and Balkan Region." TAP, p.2 http://www.trans-adriatic-pipeline.com/why-tap/benefits-for-south-eastern-europe/, (accessed on 17 July 2013)

[244]Socor, Vladimir. "TAP Project Surging Ahead of Rival Nabucco-West (Part Two)." Eurasia Daily Monitor.10.57 (2013).

initialed an agreement on a possible TAP Joint Venture that would give BP, SOCAR and Total up to 50% of the shares of TAP and leave the residual shares to the existing members of the TAP; namely, Statoil, AXPO and E.ON Ruhrgas[245].

On the other hand, the route of TAP throughout the territories of Greece and Albania is very significant. Via the actualization of TAP, the countries in the Balkans which are solely dependent on coal and oil will be connected to the gas grid of the European continent. The design of TAP also offers additional advantages. In this context, it is planned to have 8 bcm reverse flow in the TAP project which is expected to be activated in the case of emergency and seen as appropriate according to the EU requirements set out in the Regulation No. 994/2010 regarding the measures to safeguard security of natural gas supply[246].

Actually, TAP is the most appropriate project in the first phase of the Southern Corridor, because, it offers the best for the interests of the major players in the region; mainly, Azerbaijan, Russia and Turkey. By TAP, at least initially, there is a win-win situation for all sides.

In this context, obviously the efforts of SOCAR and Gazprom; in other words, Azerbaijan and Russia over the Greece energy market are very important. Gazprom joined the privatization tender bid of the Greece natural gas supply corporation company, DEPA. Immediately after that, SOCAR joined the privatization tender bid of the other Greece company, DESFA, the main responsible company of the internal gas transmission in Greece[247].

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[245] *Ibid*

[246] "TAP's Contribution to South Eastern Europe and Balkan Region." TAP, p.1 http://www.trans-adriatic-pipeline.com/why-tap/benefits-for-south-eastern-europe/, (accessed on 17 July 2013)

[247] "Şah Deniz Neden Trans-Adriyatik Boru Hattını Seçti." 21. Yüzyıl Türkiye Enstitüsü. Enerji ve Enerji Güvenliği Araştırmaları Merkezi, http://www.21yyte.org/arastirma/enerji-ve-enerji-guvenligi-arastirmalari-merkezi/2013/07/01/7090/sah-deniz-neden-trans-adriyatik-boru-hattini-secti, (accessed on 1 July 2013)

The occurrence of these two initiatives almost at the same time demonstrates the showdown between Azerbaijan and Russia in the Greece market and implicitly, the showdown between Azeri initiative pipeline projects throughout the EU and Russian driven South Stream[248]. In addition, Greece authorities manipulated this rivalry in order to eliminate the recent economic turbulence of their country. In accordance with that, Greece authorities' efforts were based on to convince Azerbaijan to choose TAP, if the country wanted the privatization of DESFA to be actualized and to be the winner.

Another important matter shaping the election of TAP is the fact that Russia has always been thinking that together with TANAP, Nabucco-West is the most important rival of South Stream because their routes completely overlap throughout the European continent[249]. In order to prevent this risk, Russia preferred the election of TAP by the Shah-Deniz Consortium and with this aim; Gazprom withdrew its offer on the tender bid of DEPA as a favor. This is very important because it paved the way for SOCAR to win the tender bid of DESFA and so Azerbaijan to choose TAP as the major continuing pipeline a connection to TANAP over the Southern Gas Corridor.

By these initiatives, at least initially, the obstacles on the way of South Stream have been eliminated; at the same time, Russia showed a somehow good will via opening the way for the Azeri gas over the EU. In other words, TAP opened the way for both South Stream and TANAP. Thus, even Turkey as the partner of Nabucco did not oppose the election of TAP because the country urgently needs the Azeri gas transported with TANAP[250].

However, after all these developments, it cannot be said that Nabucco project is over from now on, because, the Shah-Deniz is expected to be actualized within several

[248] *Ibid.*

[249] *Ibid.*

[250]*Ibid*

stages. Although, for the first stage, TAP is chosen, for the other stages, there is also a possibility for Nabucco to be another pipeline alternative. Nevertheless, this time Azerbaijan may choose to be one of the suppliers other than being the only one as in the case of TAP.

5.1.2 Georgia

Since the collapse of the Soviet Union, Azerbaijan and Georgia have had good and friendly relations and there are several motives of this. First of all, both Azerbaijan and Georgia have an important interest on increasing the cooperation on energy. In this context, Azeri oil and gas are very important for the energy need of Georgia. With the start of operation of both BTC and BTE, Georgia has enabled to secure its energy supplies.

On the other side, Azerbaijan also needs to use the Georgian routes in the Southern Caucasus in order to transport its oil and gas to Turkey and Europe[251]. This is vital for Azeri economy because of the disputes with Armenia on Nagorno-Karabakh and the Russian dominance all over the Northern Caucasus. Moreover, because of the European political embargo for Iran, Azerbaijan also cannot use the alternative Iranian routes for transporting its energy resources. In this context, other than BTC and BTE, there exists another pipeline and one additional project proposed which aim to transport Azeri energy resources to Georgia and alternative European suppliers.

As a result of the problems of the Russian routes, on April 1999, the second pipeline with a capacity of 150,000 b/d was built between Baku and Supsa- an important port of Georgia on the Black Sea[252]. By the new pipeline (also called as Western route), Azerbaijan decreased its dependence on Russia over regional pipelines.

[251] *See*, Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011.

[252]Ismailzade, Fariz. "Energy cooperation takes priority: LUKoil's expansion in Azerbaijan and the change of the Russian government's attitude." Russian Foreign Energy Policy:An Analytical Compendium (Volume 1). 2007. p.18.

Although, the major advantage of the pipeline is its shortness, Supsa has the problem of being able to store up only one-quarter of the oil that Novorossiysk can process[253]. Moreover, there are also security problems that some parts of this pipeline are only ten miles away from Nagorno-Karabakh, a region currently occupied by Armenia[254]. Thus, it is probable that in the future, there can be disputes between Azerbaijan and Armenia regarding the ownership rights of the territory through which the pipeline passes.

On the other hand, in 2010 together with Romania, Azerbaijan and Georgia agreed to jointly develop an LNG project called as Azerbaijan-Georgia-Romania Interconnector (AGRI) under the partnership of the oil and gas companies of these three countries. AGRI aims to transport Azeri gas to Georgia's cost on the Black Sea via pipeline and after the liquefaction of the gas at that place, it is planned to be transported to Romania via tankers and re-gasified there in order to be transported again via the pipeline to the territories of the EU[255].

This project is important because it eliminates the necessity for the traditional pipelines and provides flexibility over the Black Sea and an additional route to the territories of the EU[256]. If the increasing trend in oil and gas prices continues, AGRI is expected to become more feasible in the short to medium term.

5.2 Energy Relations with Other Energy Producing Neighbors

Caspian is one of the most debated areas in the region. Although, it seemed that there were no real problems between the Soviet Union and Iran until 1991 about it, with the independence of the other littoral states, namely Azerbaijan, Kazakhstan and Turkmenistan, the picture has dramatically changed. Previously, the legal status of

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[253]Sicherman, Harvey, and Gerald Robbins. "Chapter 4: The Economy, Politics, and Religion." Azerbaijan. (2005):p.1

[254]*Ibid*, p.2

[255]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.69-70

[256] *Ibid.*

the Caspian is determined by the two agreements signed between Soviet Union and Iran in 1921 and 1940 respectively. These agreements were based on sharing Caspian resources between the two countries[257].

In the new structure, the littoral states have different views regarding the legal status of the Caspian. First view is that Caspian is a sea therefore subject to the United Nations Convention (this approach is also called as 'condominium'), moreover in accordance with this view, the littoral states would be able to share the resources[258].

The second approach is that Caspian is a lake. In this approach, Caspian is planned to be divided into national sectors or zones that would meet at an equidistant median line[259]. In other words, each littoral state will have a share according to a median line which divides the Caspian into sections with the same distances from the shores of different littoral states.

At the beginning of 1990s, Russia and Iran supported the view that the Caspian was a sea. "Part of the reason for this position was that a division of the Caspian into national sectors would put Russia and Iran at a disadvantage in terms of access to major, known oil fields. One argument that Russia and Iran utilized to support their stance was that, as an ecosystem, the Caspian should be managed jointly[260]".

Later on, Iran has continued to be inflexible and insisted on its view. "Iran prefers that the littoral states would adopt a 'condominium' approach wherein the states use the sea jointly and by consensus[261]". This means that Iran prefers joint usage of the resources of the Caspian Sea as well if a littoral state wants to explore and exploit a

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[257]O'Lear, Shannon. "Resources and Conflict in the Caspian Sea." *The Geopolitics of Resource Wars.* Ed. Philippe Le Billion. New York: Taylor&Francis Group, 2005. p. 175.

[258]*Ibid*, p.170

[259]*Ibid*

[260]*Ibid*

[261]*Ibid*, p.175

resource in the Caspian Sea, that state firstly should ask the other littoral states for permission.

On the other hand, Azerbaijan's position on this issue has changed since its independence up to now. First position of the newly independent state was against the view of the Russia and Iran which stated that the Soviet-Iranian Agreements were the main determinant of the legal status of the Caspian. However, after signing the Contract of the Century, the country began to claim more rights in the Caspian for exploring energy resources because the mentioned Contract included some areas that extended far beyond the median line of the Caspian for the Azerbaijan[262]. In this context, the President Aliyev's comment is important: "In drafting the division principle, we should recognize the degree to which every littoral country has developed the shelf and the value of the sea for each country[263]".

As a final position, Azerbaijan now advocates the establishment of maritime boundaries into national sectors based among median lines. On the other hand, Azerbaijan has pursued a balanced approach regarding Russia in order to be able to utilize its resources without Russian opposition. In this framework, Azerbaijan gave concessions to the oil companies of Russia and Iran in order to decrease the pressure coming from these countries regarding the demarcation issue of the Caspian Sea[264].

In this context, Azerbaijan also signed agreements with Kazakhstan and Russia, as a result, the northern part of the Caspian was divided between the three countries[265]. Furthermore, Kazakhstan also stated the importance of the cooperation on the environment, fishing, and navigation[266]. As can be understood, it is clear that there is

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[262]Granmayeh, Ali. "Legal History of the Caspian Sea." *The Caspian Politics, Energy and Security.* Ed. Shirin Akiner. 1st ed. New York: RoutledgeCurzon, 2004. p.20

[263]*Ibid*

[264]İpek, Pınar. "Azerbaijan's Foreign Policy and Challenges for Energy Security." Middle East Journal. 63.2 (2009): p.235

[265]Bahgat, Gawdat. Energy Security: An Interdisciplinary Approach. Chichester, West Sussex: Wiley, 2011. p.147-148.

[266]*Ibid*

a consensus on the legal status of the Caspian between Russia, Azerbaijan and Kazakhstan and the northern part of the Caspian can be considered less problematic than the southern part. On the contrary, Turkmenistan calls for a division of the Caspian based on the Soviet-Iranian Agreements until the five littoral states have a consensus upon a new legal system[267]. Although it is considered that there is a consensus between the northern littoral states, in the southern part of the Caspian there has not been a solution yet.

In this context, Azerbaijan followed a watchful and balanced foreign policy regarding not only its region and neighborhood, but also the global players[268]. This situation has brought a lot of advantages to the energy sector of Azerbaijan. In this context, the country has a relatively stable politics and economy that has lead the increasing amount of FDIs in the country, especially in the energy sector. Below, energy relations with important players will be analyzed deeply. In this context, Table 6 shows a summary of the existing pipelines of Azerbaijan. As can be seen from the table, other than Armenia, Azerbaijan has already developed various pipeline routes in its neighborhood, including Russia, Georgia and Iran. As well, the country has also engaged in other prospective pipeline projects with the other Caspian littoral states; namely, Kazakhstan and Turkmenistan.

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[267] *Ibid*

[268] İpek, Pınar. "Azerbaijan's Foreign Policy and Challenges for Energy Security." Middle East Journal. 63.2 (2009): p.235

Table 6: Oil and Natural Gas Transportation Routes of Azerbaijan

Project	**Route**	**Capacity (million barrels per day for oil/cubic feet per year for gas)**	**Length (km)**	**Investment ($)**	**Actual Status**
AIOC Baku-Supsa	Azerbaijan-Georgia	0.11-0.21	880	590 million	Operational since 1999
AIOC Baku-Novorossiysk	Azerbaijan-Russia	0.30	1397	600 million	Operational since 1997
AIOC Mahachkala-Novorossiysk (through Chechnia)	Azerbaijan-Russia	0.12-0.16	328	140 million	Operational since 2000 includes railway transportati on
Baku-Tebriz(Baku-Astara)	Azerbaijan-Iran	0.20-0.40	NA	500 million	Swap line
BTC	Azerbaijan-Georgia-Turkey	1	1760	3.40 billion	Operational since 2006
BTE: gas	Azerbaijan-Georgia-Turkey	175-565 billion	280	782 million	Operational
Trans-Caspian: Gas	Turkmenistan-Azerbaijan-Turkey	1.10 trillion	1696	2-3 billion	Feasibility made, the process continues

Source: Bilgin, Mert. "New prospects in the political economy of inner-Caspian hydrocarbons and western energy corridor through Turkey." Energy Policy. 35.12 (2007):6388-6389.

As can be seen, Azerbaijan has been pursuing a balanced approach in its bilateral relations with the regional partners. As a result, the country seems to be successful regarding lessening the opposition claims of the countries like Russia and Iran and gaining support on its energy policies from its regional partners including Turkey and Georgia and the global players like the EU.

To conclude, the chapter examines the pipeline politics of Azerbaijan and its partners in the region including Turkey, Georgia, Russia, Iran, Kazakhstan and Turkmenistan. In addition, the next chapter is going to focus on the domestic energy reform in Azerbaijan.

CHAPTER 6

DOMESTIC ENERGY REFORM IN AZERBAIJAN

In this chapter, domestic energy reform of the country will be presented together with the detailed analysis of State Oil Fund, FDIs and PSAs and EITI. In this context, the usage of excess oil and natural gas revenues is most of the time a problematic issue for the energy-rich and producing countries. If these countries do not wisely divert these revenues to the non-oil areas of the economy, the growth in the economy will not be maintained as can be seen from the past experiences of other countries.

This concept known as Dutch Disease is also a danger for Azerbaijan[269]. Unless the country effectively canalizes these resources to the other areas of the economy, one sided structure of the economy makes the country vulnerable to the shocks in the oil and gas markets. In this context, Azerbaijan has taken some measures and established a state fund in order to divert these resources for the social development and welfare of the country. As well, the country also joined in Extractive Industries Transparency Index in order to increase its reputation and ease of doing business inside the country for the giant international energy companies.

6.1 State Oil Fund of Azerbaijan

During the era of Haydar Aliyev, to manage the increasing revenue levels effectively for the future of the generations, Azerbaijan established the State Oil Fund (SOFAZ) in 1999[270]. According to the Presidential Decree No. 73 of 27 November 2008, the State Oil Fund's Supervisory Board consists of Artur Rasizade (Prime Minister), Valeh Alesgerov (State Economic Policy Advisor), Samir Sharifov (Minister of Finance), Shahin Mustafayev (Minister of Economic Development), Elman

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[269] "Energy." Embassy of the Republic of Azerbaijan to the United States of America. http://www.azembassy.us/5/52.html, (accessed on 20 Nov 2012)

[270] *Ibid.*

Rustamov (Chairman of the Management Board of the Central Bank), and Mahmud Kerimov (President of National Academy of Sciences)[271]. On the other hand, Sh. Movsumov is the Executive Director of SOFAZ.

The main aim of the Fund is to invest in the non-oil sector, save for the future economic growth and prevent unequal income distribution[272]. In this context, while income tax taken from oil companies goes to the state budget, the profits of the government from the new oil and natural gas reserves are transferred to SOFAZ[273].

Additionally, around 60% of the total revenues of state budget come from SOFAZ in the year 2011[274]. Besides, this trend is expected to continue in the short to medium term. In this framework, with SOFAZ, the country also aimed to provide an equal distribution of oil wealth among the population. In this regard, transparency is a very important issue for SOFAZ. In this framework, SOFAZ held regular auditing of the Fund's financial statements by a global auditor to be able to provide transparency; this was Ernst&Young for the fiscal year 2011[275].

Furthermore, SOFAZ uses a variety of instruments in order to disclose information to the public in accordance with the existing legal framework; namely, the Law of 'On the right to obtain information'; these are press releases, quarterly or annual

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[271]Republic of Azerbaijan.State Oil Fund of the Republic of Azerbaijan. Annual Report 2011.State Oil Fund of the Republic of Azerbaijan, p.52 http://www.oilfund.az/uploads/annual_2011en.pdf, (accessed on 10 Apr 2013)

[272]European Union.European Commission. European Neighborhood Policy Country Report Azerbaijan. p.13 http://ec.europa.eu/world/enp/pdf/country/azerbaijan_country_report_2005_en.pdf, (accessed on 20 June 2013)

[273]Ibid, p.15

[274]"Country Report Azerbaijan. "Economist Intelligence Unit.p.6 http://country.eiu.com/FileHandler.ashx?issue_id=1068550491&mode=pdf, (accessed on 15 Dec 2012)

[275]Republic of Azerbaijan.State Oil Fund of the Republic of Azerbaijan. Annual Report 2011.State Oil Fund of the Republic of Azerbaijan, p.62 http://www.oilfund.az/uploads/annual_2011en.pdf, (accessed on 10 Apr 2013)

reports, press conferences, disclosures and publications in the mass media[276]. One of the major reasons of the improvement of non-oil sectors in Azerbaijan is the successful practices of SOFAZ. According to the reports of SOFAZ, by the end of 2011, $10.5 billion of the total currency reserves of Azerbaijan ($40.3 billion) was separated out for SOFAZ[277]. This means almost one fourth of the total reserves belong to SOFAZ.

As mentioned above, SOFAZ is a very strategic institution regarding the improvement of the non-oil sectors and prevention of resource-curse effect. In this framework, there has been a dramatic increase in oil revenues. At the same time, the reserve level of SOFAZ from the increasing oil revenues is between 0% and 60.2% during the last decade and for the last several years, it is around 30%- 40%[278]. In addition, as can be seen from Figure 6, SOFAZ uses 55% of its total reserves meaning $ 36.5 million is used. Moreover, the assets of SOFAZ have increased almost 60 fold since 2001[279].

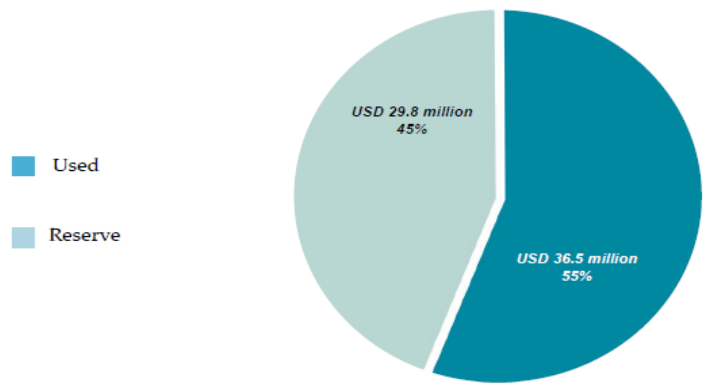

Figure 6 The Oil Fund's Reserve Level, 2001-2011

Source: Republic of Azerbaijan. State Oil Fund of the Republic of Azerbaijan. Annual Report 2011. State Oil Fund of the Republic of Azerbaijan, p.10-11 http://www.oilfund.az/uploads/annual_2011en.pdf, (accessed on 10 Apr 2013)

[276] *Ibid*

[277] *Ibid*

[278] *Ibid*, p.10-11

[279] *Ibid*

Besides, main sources of SOFAZ's revenues are proceeds from oil and gas sales (97.6%), revenues from management of the Fund's assets (1.1%), price adjustment revenues under Shah-Deniz Phase I (0.65%), dividends from BTC Oil Pipeline Project (0.42%), bonus payments, transit fee payments, acreage fees and other revenues[280].

With its revenues, SOFAZ has a much diversified investment portfolio mostly based on less risky instruments. Moreover, SOFAZ's investments are located mainly in Europe with a level of almost 70% of total investments[281]. In this context, between the years 2006 and 2011 the return on the SOFAZ investment portfolio is between 0.8% and 4.5% with a significant decrease since 2008[282].

6.2 Foreign Direct Investments and Production Sharing Agreements

'Contract of the Century' has motivated the other deals and eight more contracts immediately followed, for different oilfields off Azerbaijan's Caspian coast[283]. Moreover, as stated by the Azerbaijani authorities, to date there are 31 PSAs between Azerbaijan and the international oil companies[284].

In addition, PSAs until now have been included into the legislative system as the laws of Azerbaijan and they are permitted to come first over the general legislation in case of any difference[285].This is very important because PSAs give an additional guarantee to their partners regarding doing business in Azerbaijan. Moreover, when the details of the PSAs are analyzed, it should be mentioned that AIOC under the

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[280]*Ibid*, p.14

[281]*Ibid*, p.41

[282]*Ibid*, p.43

[283]Sicherman, Harvey, and Gerald Robbins. "Chapter 4: The Economy, Politics, and Religion." Azerbaijan. (2005): p.1

[284]"Energy." Embassy of the Republic of Azerbaijan to the United States of America. http://www.azembassy.us/5/52.html, (accessed on 20 Nov 2012)

[285]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.11

operation of major international energy giants, has the major share (80%) in total oil and gas production over the territories of the country; on the other side, SOCAR's share is around 20%[286].

Especially during the 2000s, the rise of the prices in global oil markets increased the level of FDIs in Azerbaijan[287] and it is expected that the inflows of FDIs in the country will further increase for the period of 2012-2016[288]. Besides according to the forecasts of SOCAR, the total FDIs by the PSAs will increase to 60 billion dollars in the short run[289]. When the investor countries in Azerbaijan are analyzed, it can be seen that USA, United Kingdom and Norway are the leading countries since 2002[290].

On the other hand, the investment environment and regime in Azerbaijan is remarkably open for the foreign investors. According to the Energy Charter Secretariat Follow-up In-depth Review of Azerbaijan, no special permits or specific registration requirements exists in the country meaning that foreign investors benefit a non-discriminating regime[291].

In this context, the types of investors are determined in the related legislation and they are mentioned as foreign legal entities, foreign citizens, stateless citizens and citizens of the Azerbaijan Republic permanently living abroad, if they have been

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[286]Energy Information Administration. Country Analysis Briefs Azerbaijan. 2012.

[287]Dobronravin, Nikolay. "Oil, Gas, Transit, and Boundaries: Problems of Transport Curse." *Resource Curse and Post-Soviet Eurasia: Oil, Gas and Modernization.* Ed. Vladimir Gel'Man and Ed. Otar Marganiya. Lanham: Lexington Books, 2010. p. 165.

[288]"Country Report Azerbaijan. "Economist Intelligence Unit. p.9. http://country.eiu.com/FileHandler.ashx?issue_id=1068550491&mode=pdf, (accessed on 15 Dec 2012)

[289]Rzayeva, Gulmira. "Azerbaijan: Eurasia's Energy Nexus." Turkish Policy Quarterly. 9.2 (2010): p.57.

[290]Dikkaya, Mehmet, and Adem Çaylak. "Haydar Aliyev Döneminde Azerbaycan'ın Ekonomik ve Politik Dönüşümü: Fırsatlar ve Sorunlar." Uluslararası Stratejik Araştırmalar Kurumu. 3.5 (2008): p.138.

[291]Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011. p.29

registered as participants of economic activity in the country of their citizenship or permanent residency, foreign states and international organizations[292]. As can be understood, there is a variety of definitions regarding the types of foreign investors and this provides flexibility to the partners of the FDIs in Azerbaijan.

On the other hand, FDIs in the country are covered by certain guarantees of the government and as well for a foreign investment; it is guaranteed that there will be no risk of change in the legislation for the subsequent ten years[293]. In fact, Azerbaijan succeeded to be the leading country in attracting FDIs in the Caspian region. On this way, Azerbaijan has been adopting more appropriate legal structure and liberal rules regarding doing business in its investment environment for foreign investors.

> The country created a one-stop shop for company registration, cutting the number of procedures from thirteen to six and reducing the time required by half. In terms of registering property, a new unified property registry was introduced, reducing the number of procedures required to register property from seven to four. The tax burden was reduced by introducing an online filing and payment system with advanced accounting software for calculating taxes due…Another important reform introduced in 2010 was to improve trading across the borders, the time required to clear goods and get them across borders was shortened by regrouping various agencies into a single customs service unit.[294]

In addition, Azerbaijan's liberal exchange system and the freedom of converting or transferring funds with an investment are the other major competitive advantage of the energy market[295]. However, according to the Energy Charter Secretariat Review, Azerbaijan is claimed to be underdeveloped to attract FDIs other than concluding Production Sharing Agreements as a result of the problematic areas including arbitrary structure of the tax and customs administration system, lack of independence in the court system and the monopolies in the energy market[296].

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[292] *Ibid*

[293] *Ibid*, p.30

[294] *Ibid*, p.9

[295] *Ibid*, p.10-11

[296] *Ibid*

However, the rank of Azerbaijan has been improving according to the World Bank Doing Business 2011 Report and in the year 2011 it was ranked 54 out of 183 countries regarding the ease of doing business[297]. However, this ranking does not represent the energy sector because of the more efficient procedures and implementations in this sector when compared with the rest of the economy in the country. Many years after the exploration of the ACG field and Shah-Deniz, in October 2010 BP and SOCAR concluded a new PSA regarding the development of the Shafag-Asiman structure of Azerbaijan in the Caspian Sea; on the other hand, there are more prospective fields of Azerbaijan including Muradkhanly, Kyursangy, Kurovdagh, Gobustan and Inam and they expected to contribute to increase the oil production of Azerbaijan[298].

As a result, as one of the major countries of Caspian attracting FDIs, Azerbaijan has gained many successful experiences from its deals with international oil companies in energy market. At the same time, the country has gained a lot confidence and this situation has also motivated the country to open up the other sectors for foreign investors[299].

6.3 The Extractive Industries Transparency Initiative

Corruption is a remarkable problem for Azerbaijan. According to Transparency International's Corruption Perception Index[300], Azerbaijan ranks 139th out of 176 countries with a score of 27[301]. On the other hand, countries like Denmark, Finland

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[297] *Ibid*

[298] *Ibid*, p.53

[299] *Ibid*, p.11

[300] The Corruption Perceptions Index ranks countries and territories based on how corrupt their public sector is perceived to be. A country or territory's score indicates the perceived level of public sector corruption on a scale of 0 - 100, where 0 means that a country is perceived as highly corrupt and 100 means it is perceived as very clean. A country's rank indicates its position relative to the other countries and territories included in the index.

[301] "Corruption Perception Index 2012." Transparency International. Transparency International, http://cpi.transparency.org/cpi2012/results/, (accessed on 6 June 2013)

and New Zealand with scores of 90 are at the top meaning very successful regarding the elimination of corruption[302]. On the other hand, according to the database of the Economist Intelligence Unit (EIU), in overall Azerbaijan's risk rating in the oil and gas sectors is 56.5 (100 is the most risky.)[303]. If the details are analyzed, the most risky points for the country are government effectiveness risk, legal & regulatory risk and political stability risk.

Table 7: Risk Ratings of Azerbaijan in Oil and Gas Sectors

RISK RATINGS	Current Score	Previous Score
OVERALL ASSESSMENT	56.5	56.5
Security risk	46.9	46.9
Political stability risk	75.0	75.0
Government effectiveness risk	96.2	96.2
Legal & regulatory risk	76.3	76.3
Macroeconomic risk	27.8	27.8
Foreign trade & payments risk	48.1	48.1
Financial risk	62.5	62.5
Tax policy risk	25.0	25.0
Labour market risk	49.0	49.0
Infrastructure risk	58.8	58.8

Note: 100=most risky.

The operational risk model is run once a quarter.

Source:"Azerbaijan Oil and Gas: Risk Table." Energy Briefing and Forecasts. The Economist Intelligence Unit, http://www.eiu.com/index.asp?layout=ib3Article&article_id=950209879&pubtypeid=1142462499&country_id=1420000342&page_title=, (accessed on 6 Feb 2013)

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[302] *Ibid*

[303] "Azerbaijan Oil and Gas: Risk Table." Energy Briefing and Forecasts. The Economist Intelligence Unit, http://www.eiu.com/index.asp?layout=ib3Article&article_id=950209879&pubtypeid=1142462499&country_id=1420000342&page_title=, (accessed on 6 Feb 2013)

Against corruption and the other risky points determined by the EIU sources, Azerbaijan took a positive step with the decision of implementing the recommendations of the Extractive Industries Transparency Initiative (EITI) and in November 2004, a Memorandum of Understanding was signed between the State, oil and gas companies in Azerbaijan and national NGOs in order to ensure that proceeds from the oil and gas sectors flowing into the oil fund of Azerbaijan should be transparent and accounted for[304]. This was the first document in the world in this category[305].

Firstly raised by Tony Blair as the previous Prime Minister of England, in 2002, as a voluntary initiative EITI was announced with the aim of increasing transparency and accountability in the extractive industries and organized its first conference in London on 2003[306]. The major principles of EITI as determined in the I International EITI Conference on June 2003 were 'Publish what you pay' for the foreign and local companies and 'Publish what you receive' for the host governments[307]. In other words, it is planned to increase transparency regarding the bills and revenues of the energy sector.

Moreover, the first conference is also significant for Azerbaijan because the country declared its participation to EITI at that time. In this framework, Azerbaijan is represented on EITI with a high level - the Director of SOFAZ as Chairman of the Committee on EITI showing the importance of the country for the implementation of EITI[308]. Besides, during the first years of the independence, in the context of the

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[304]European Union.European Commission. European Neighborhood Policy Country Report Azerbaijan. p.6 http://ec.europa.eu/world/enp/pdf/country/azerbaijan_country_report_2005_en.pdf, (accessed on 20 June 2013)

[305]Republic of Azerbaijan.Extractive Industries Transparency Agency. EITI Azerbaijan Annual Report 2011. 2011. p.13

[306]Republic of Azerbaijan.State Oil Fund of the Republic of Azerbaijan. Annual Report 2011.State Oil Fund of the Republic of Azerbaijan, p.64 http://www.oilfund.az/uploads/annual_2011en.pdf, (accessed on 10 Apr 2013)

[307]Republic of Azerbaijan.Extractive Industries Transparency Agency. EITI Azerbaijan annual Report 2011. 2011. p.11

[308]*Ibid*, p.15

Azerbaijan's National Oil Strategy, major foreign oil companies were invited to the country[309]. By the time, the country noticed the importance of the efficient management of the accumulated oil revenues coming from extraction of the country's oil fields together with foreign companies and the need to channel these assets to the improvement of progressive areas and implementation of important socio-economic tasks[310].

In this regard, Azerbaijan makes regular publication of its oil, gas and mining payments in an open, comprehensive and understandable way and an independent auditor also complete the reconciliation of payments and revenues via applying international auditing standards with the auditor's own opinion about reconciliation[311]. Furthermore, almost all of the companies operating in the oil and gas sectors of Azerbaijan joined EITI voluntarily and their current numbers of these companies are 31 as in the Table 8[312].

Table 8: List of the foreign and local companies operating in the sphere of extractive industries of the Republic of Azerbaijan

BP	Karasu Operating Company
State Oil Company of Azerbaijan Republic	Shell
Total	Middle East Petroleum
ITOCHU Oil	Ansad Petrol JV
Statoil	Shirvan Oil JV
TPAO	Azgerneft JV
Gobustan Oil & Gas	Inpex
Exxon	Binagadi Oil Company
ConocoPhillips	Rafi Oil F.Z.E.
Hess	NaftiranIntertrade Co. (NICO)
Devon Energy	Absheron Investments
Lukoil	GDF Suez
Chevron	Azerbaijan International Mining Company
Petro-HongKong-Pirsaat Oil Limited	Neftchala Operating Company
Salyan Oil	Shirvan Operating Company
Bahar Energy	

Source:Republic of Azerbaijan. Extractive Industries Transparency Agency. EITI Azerbaijan annual Report 2011. 2011. p.61

[309]*Ibid*, p.7

[310]*Ibid*

[311]*Ibid*, p.13

[312]*Ibid*, p.50

Indeed, Azerbaijan is very successful regarding the actions performed in the context of EITI in a short period; therefore, the country is awarded with United Nations Public Service Award in 2007 in the category of 'Improving Transparency, Accountability and Responsiveness in the Public Service' and EITI Award in 2009 since Azerbaijan is the first EITI compliant and reporting country on EITI implementation[313]. At that point, it should be mentioned that SOFAZ is the first governmental organization in the Eastern Europe and CIS region winning the 'United Nations Service Award' which is considered the most respected global appreciation of excellence in Public Service[314].

Indeed, the efforts of Azerbaijan are significant regarding to increase transparency and the ease of doing business inside the energy sector of the country for the foreign investors[315]. This can also be seen from the increasing amount of FDIs in the country. As well, Azerbaijan has also succeeded to increase the transparency on publicizing its oil and gas revenues after the establishment of SOFAZ. All these developments are noteworthy and welcoming by the foreign investors in oil and gas markets.

6.4 Major Impediments on the Way of Azerbaijan's Alignment to the EU's Energy Rules and Regulations

Azerbaijan has taken very important steps after establishing SOFAZ in order to use of the oil and gas revenues more effectively, increasing the FDIs in the country and joining EITI to enhance the transparency and the predictability of the investment environment[316].

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313 *Ibid*, p.7

314 *Ibid*, p.18

315 *Ibid.*

316 *See*, Republic of Azerbaijan. State Oil Fund of the Republic of Azerbaijan. Annual Report 2011. State Oil Fund of the Republic of Azerbaijan

On the contrary, after the analysis of the domestic energy market of Azerbaijan, it can mostly be considered that although Azerbaijan is successful regarding the external compatibility of the country to the EU's rules and regulations on energy markets, the country is not so successful concerning the internal alignment of its energy markets to the EU's[317]. Obviously, there are several reasons of that; however, the two issues attract more attention.

Firstly, when the monopolistic structure of SOCAR is taken into account, it can be seen that the company's power in the economy is more than any other company in the country[318]. As well, the company has the major voice over the foreign policies of Azerbaijan. However, this is contrary to the EU's standards and regulations; the European energy companies do not have such a dominant power over their countries' foreign policies. Thus, the dominance of SOCAR is one of the major impediments of the country's alignment to the EU.

Secondly, the structure of the general economy and specifically the foreign trade of the country are not compatible with the EU's standards[319]. In other words, with its rentier structure, Azerbaijan is almost completely dependent on exports of oil and natural gas that makes the country vulnerable to the shocks on the prices of these two commodities in the world markets. In this context, although the EU's standards support the diversified type of foreign trade, with the current situation of the foreign trade, Azerbaijan is not approaching to the EU's standards. This is also another impediment on the europeanization process.

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[317] *See,* "Azerbaijan Oil and Gas: Risk Table." Energy Briefing and Forecasts. The Economist Intelligence Unit, http://www.eiu.com/index.asp?layout=ib3Article&article_id=950209879&pubtypeid=1142462499&country_id=1420000342&page_title=, (accessed on 6 Feb 2013)

[318] *See,* Energy Charter Secretariat. Azerbaijan Follow-up In-depth Review of the Investment Climate and Market Structure in the Energy Sector.Energy Charter Secretariat, 2011.

[319] *See,*Trademap, http://www.trademap.org/index.aspx?ReturnUrl=%2fCountry_SelProductCountry_TS.aspx, (accessed on 1 June 2013)

As a result, at present Azerbaijan seems to be far away from being compatible to the EU internally. However, whether this situation will continue in the future cannot be predicted yet.

To conclude, the chapter examines the domestic energy reform in Azerbaijan in the context of SOFAZ, FDIs and the membership of EITI and the next chapter is the conclusion part of the thesis.

CHAPTER 7

CONCLUSION

The collapse of the Soviet Union resulted in an intense change in relations of the energy-rich ex-Soviet countries with the rest of the world. The structural change in these countries provided a unique chance both for the regional players and the global powers regarding the utilization of the vast reserves of oil and natural gas especially in the Caspian basin.

As a natural consequence, an intensified competition has existed in these ex-Soviet lands since the beginning of 1990s. On the one hand, Russia tried to maintain its influence on these lands and reserves, on the other side, Western powers like EU and the USA supported other alternative pipeline projects which were planned to transport oil and gas of the region to the Europe.

Accordingly, the thesis aimed to analyze the bilateral relations between Azerbaijan and the EU based on the 'complex interdependence theory'. The theory is used as a frame and a base to analyze and explain the bilateral relations between Azerbaijan and the EU especially from an economic aspect. As it has been mentioned in the second chapter of the thesis, on the contrary to the assumptions of the traditional approaches that defines the economic, commercial and financial relations as the low politics and military force as the major deterrent tool when a conflict occurs between two states, Azerbaijan and the EU have various strategic connection channels such as MoU on Strategic Partnership, PCA, ENP and the other unilateral financial funds provided by the EU.

Indeed, military force is almost irrelevant as in the case of the bilateral relations between Azerbaijan and the EU because most aspects of their bilateral relations are related with energy and economics and to some extent social issues. In this framework, military force is usually not enough to resolve the disagreements between the states in the economic area.

Moreover as mentioned in the first chapter, public and private oil companies and consortiums including AIOC, SOCAR, BP, ENI and Total etc. are too communicate as a normal process of their business and become effective on the policies of their governments contrary to the traditional approaches' claims that states act the only units.

As well the thesis argued that the establishment of good bilateral relations between Azerbaijan and the EU is the central concern since the independence of Azerbaijan in order to make best use of the mutual interests of both parties. Since the beginning of 1990s, there have been numerous opportunities to further increase the cooperation between Azerbaijan and the EU, thanks to the developments in the oil and natural gas reserves and production of the Azeri fields. Under a win-win position, both Azerbaijan and the EU have the chance to fulfill their priorities.

In this respect, Azerbaijan has been successful to improve its economic indicators through its energy exports to the EU and become the leading country in its region in the context of FDIs in the energy sector; on the other hand, the EU has succeeded to diversify its energy routes and to some extent eliminate the Russian dominance in its energy markets.

As it is mentioned in the first chapter, without doubt, in its region Azerbaijan has a significant level of oil and natural gas reserves that results in an increase in the importance attributed to the country by the EU. Starting from the first important deal namely, 'Contract of the Century', Azerbaijan has made good progress regarding the exploitation and exploration of its energy reserves and also pursuing coordinated production and pipeline projects with the energy giant firms all over the world. As mentioned in the third chapter, this is a natural consequence of the consistent politics followed by both Haydar Aliyev and his son Ilham Aliyev as the two successive leaders of the country.

On the other side, Azerbaijan has also established strategic partnerships with important global players including the EU, Russia, United States while setting up good relations with its neighbors around the Caspian basin including Iran, Kazakhstan and Turkmenistan as discussed in fourth chapter. In this framework, it can be clearly stated that Azerbaijan followed a balanced approach regarding its foreign relations on energy issues.

The balanced approach in the foreign policy is a natural consequence of the fact of ‘realism’, ‘States act according to their interests.’ In this respect, Azerbaijan has succeeded to prevent the Russian oppositions to some extent by giving Russia the shares of some important energy projects in Azerbaijan; on the other hand, Azerbaijan has also succeeded to attract the FDIs of the important Western companies to the energy fields of the country and become one of the most vital alternative for the energy security of European countries.

Furthermore, although Azerbaijan’s oil reserves are less than the reserves of Kazakhstan and its natural gas reserves are less than the reserves of Turkmenistan, Azerbaijan has converted these types of disadvantages to the advantage for the country via highlighting the geographical proximity of its reserves to the Western markets and the convenience of the investment environment for the foreign investors.

In accordance with that, Azerbaijan followed alignment policies to both the international standards and the standards of the EU regarding the energy market. In this respect, Azerbaijan joined the EITI and has made public the information of the oil and gas revenues of the country and the proceeds of the operating companies that is also very important for the foreign investors. On the other hand, Azerbaijan established variety of platforms with the EU about the alignment of the Azeri energy sector to the EU’s regulations on the energy sector.

Moreover, as discussed in the fifth chapter, like for any other energy producing countries, for Azerbaijan, energy is the main motive of the trade and general economy that makes volatile the economic figures of the country. In other words, the resource curse effect has become one of the most important risks for the Azeri policy makers to deal with. In this respect, Azerbaijan took smart steps and established SOFAZ as the major authority to reuse the oil and gas revenues effectively in the non-oil sector and the welfare of the citizens of the country.

In this framework, after the prospective alternative pipelines going to Europe from Azerbaijan became costly and the discussions on Nabucco failed then turned into a shorter version, Nabucco-West, Azerbaijan has lead its own pipeline project with Turkey, TANAP. This fact is very important from the point of view that Azerbaijan started to invest its oil and gas revenues effectively not only in the non-oil sector of Azerbaijan but also in the abroad pipeline projects. Moreover, this shows the improvement in the Azeri energy sector plus economy in general and the ability of the country to take initiative on the global issues. After these developments, although there are additional dynamics and the interference of Russia in the alternative routes throughout the Southern Corridor, TAP's chosen as the first route to transport Azeri gas from TANAP is again somehow related the ability of Azerbaijan to decide and act independently.

So far, to an important extent, Azerbaijan seems to align its energy markets externally meaning that Azerbaijan improved the conditions of investment i.e. doing business in Azerbaijan for the foreign investors. In other words, Azerbaijan has succeeded to have a somehow predictable investment environment for the FDIs coming from the energy giants. In this context, Azerbaijan has become successful enough to have important exploration, exploitation and transportation projects with important international oil and gas companies as in the cases of BTC, BTE, TANAP and TAP. In addition, it is also expected that there will be a significant increase in the number of the alternative pipeline projects transporting Azeri energy resources to the Western energy markets through the Southern Gas Corridor in the medium and long term.

However, the internal energy strategy and the practices of Azerbaijan is mostly found to be non-aligning to the EU regulations because of the various problems in the energy market including corruption, nepotism, semi-authoritarian regime type, the monopolist structure of the energy market inside the country and the lack of privatization as demanded by the EU. This is also expected to affect the investment decisions of the international oil companies which look for the convergence of the Azeri energy markets to the EU's rules and regulations and the increase in the predictability of the business environment in the country.

In most of the literature, Azerbaijan is criticized because of the deficiencies in its internal policies and energy markets that are also mentioned as one of the biggest deterrents for the foreign energy investors. On the other hand, in the other parts of the literature, Azerbaijan is mainly defined as very successful regarding the effective usage of its energy resources and the effective engagement of the country in the international energy projects. However, the most important issue is to harmonize these two aspects in other words, Azerbaijan's alignment both externally and internally and have a balanced perspective while analyzing this matter.

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APPENDIX

TEZ FOTOKOPİSİ İZİN FORMU

ENSTİTÜ

Fen Bilimleri Enstitüsü	
Sosyal Bilimler Enstitüsü	x
Uygulamalı Matematik Enstitüsü	
Enformatik Enstitüsü	
Deniz Bilimleri Enstitüsü	

YAZARIN

Soyadı : TAYTAŞ ÖZTÜRK
Adı : Özlem
Bölümü: Avrasya Çalışmaları

TEZİN ADI (İngilizce): EXTERNAL AND INTERNAL ASPECTS OF AZERBAIJAN'S ENERGY POLICY: EUROPEANIZATION PROCESS AND ITS LIMITATIONS

TEZİN TÜRÜ :Yüksek Lisans [x] Doktora [ ]

1. Tezimin tamamından kaynak gösterilmek şartıyla fotokopi alınabilir. [ ]
2. Tezimin içindekiler sayfası, özet, indeks sayfalarından ve/veya bir bölümünden kaynak gösterilmek şartıyla fotokopi alınabilir. [ ]
3. Tezimden bir (1) yıl süreyle fotokopi alınamaz. [x]

TEZİN KÜTÜPHANEYE TESLİM TARİHİ: