Oil and Power in the Caspian Region

Richard Pomfret

Before 1990 the Caspian Basin was not an important oil-producing region and the Caspian Sea was divided between the Soviet Union and Iran. In 1991 that all changed. The modern Caspian oil industry dates from the Tengiz agreement signed between Chevron and the USSR in 1990, the largest foreign investment deal in Soviet history. Before the oilfield could be exploited, the Soviet Union was dissolved in December 1991 and the project was inherited by the new independent state of Kazakhstan. At the same time there was growing interest in the possibility of rich offshore oilfields under the Caspian Sea, but the delimitation of the Caspian among Iran and the four littoral Soviet successor states was in dispute.

During the 1990s, domestic priorities in Azerbaijan, Kazakhstan, and Turkmenistan drove their differing eagerness to explore and exploit offshore oilfields. The technologically challenging fields would require participation by foreign companies with the expertise to find and recover the oil, but the leadership in the three countries differed in keenness to make deals with transnational corporations.

In Azerbaijan, independence was dominated by a disastrous war with Armenia, followed by a coup which brought to power former Soviet strongman Heidar Aliyev. Aliyev saw rapid realization of oil revenues as the key to his political survival and his country’s recovery. The “Deal of the Century” was signed in 1994 with a consortium led by BP. Exploitation of Azeri offshore oilfields coincided with the rise in oil prices which began in 1998 and accelerated in the early 2000s (Table 15.1).

President Nazarbayev of Kazakhstan was under less time pressure and much of the 1990s was spent in non-transparent negotiations with oil companies. The Tengiz agreement had already been signed, but through the 1990s there was continuous bargaining over the composition of the consortium, as the president played off foreign companies seeking a larger share; production did not begin to increase until 1999 (Table 15.1). Kazakhstan is fortunate in that the largest offshore oilfield, Kashagan, lies in its undisputed territory, but negotiating delays and perhaps a poor selection of lead companies meant that the oil did not flow before the oil boom ended in 2008. Nevertheless, Kazakhstan’s oil production based on Tengiz and several smaller oilfields did increase rapidly in the 2000s, and Kazakhstan became a significant oil producer, while its proven reserves far exceed those of Azerbaijan.

President Niyazov of Turkmenistan was least concerned about increasing oil production. Turkmenistan has substantial onshore natural gas reserves which had been developed in the 1980s,
and hence were reasonably modern facilities at the time of independence. Turkmenistan was also the world’s sixth-largest cotton producer in the early 1990s. After independence, President Niyazov was happy to live off the rents from cotton and gas, which funded populist policies and grandiose construction projects in support of an extreme personality cult. Just as those rents appeared to be declining due to poor maintenance of the irrigation channels essential for cotton and poor payment records of post-Soviet customers for gas, the increase in oil prices shifted the balance of economic power from gas consumers to gas producers and Niyazov (or Turkmenbashi the Great as he preferred to be known by then) enjoyed an increasing revenue stream until his death in December 2006.

These differing experiences were related to domestic power, primarily in terms of cementing the position of the incumbent. They have also dramatically changed the balance of power among the countries of Central Asia and the Caucasus, and affected their relations with countries outside the region. In Central Asia the 1990s witnessed a struggle for regional hegemony between Uzbekistan, the country with the largest population and a central location, and Kazakhstan, the country with the highest per capita incomes (Table 15.2). In the 1990s this

| Table 15.1 Production of crude oil and natural gas, Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan, 1985–2009 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **a Oil 1985–99** |
| Azerbaijan | 13.2 | 13.1 | 13.9 | 13.7 | 13.2 | 12.5 | 11.8 | 11.2 | 10.3 | 9.6 | 9.2 | 9.1 | 9.0 | 11.4 | 13.9 |
| Kazakhstan | 22.7 | 23.3 | 24.1 | 25.0 | 25.4 | 25.8 | 26.6 | 25.8 | 23.0 | 20.3 | 20.6 | 23.0 | 25.8 | 25.9 | 30.1 |
| Turkmenistan | 6.8 | 6.6 | 6.5 | 5.7 | 5.8 | 5.7 | 5.4 | 5.2 | 4.4 | 4.2 | 4.1 | 4.4 | 5.4 | 6.4 | 7.1 |
| Uzbekistan | 2.3 | 2.5 | 2.7 | 2.4 | 2.7 | 2.8 | 2.8 | 3.3 | 4.0 | 5.5 | 7.6 | 7.6 | 7.9 | 8.2 | 8.1 |
| **b Oil 2000–9** |
| **Oil** | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| Azerbaijan | 14.1 | 15.0 | 15.4 | 15.5 | 15.6 | 22.4 | 32.5 | 42.8 | 44.7 | 50.6 |
| Kazakhstan | 35.3 | 40.1 | 48.2 | 52.4 | 60.6 | 62.6 | 66.1 | 68.4 | 72.0 | 78.0 |
| Turkmenistan | 7.2 | 8.0 | 9.0 | 10.0 | 9.6 | 9.5 | 9.2 | 9.8 | 10.2 | 10.2 |
| Uzbekistan | 7.5 | 7.2 | 7.2 | 7.1 | 6.6 | 5.4 | 5.4 | 4.9 | 4.8 | 4.5 |
| **c Gas 1985–99** |
| Azerbaijan | 12.7 | 12.3 | 11.3 | 10.8 | 10.0 | 9.0 | 7.8 | 7.1 | 6.2 | 5.8 | 6.0 | 5.7 | 5.4 | 5.1 | 5.4 |
| Kazakhstan | 4.9 | 5.2 | 5.7 | 6.4 | 6.1 | 6.4 | 7.1 | 7.3 | 6.1 | 6.1 | 5.3 | 5.9 | 7.3 | 7.2 | 9.0 |
| Turkmenistan | 75.3 | 76.7 | 79.7 | 79.9 | 81.4 | 79.5 | 76.3 | 54.4 | 59.1 | 32.3 | 29.2 | 31.9 | 15.7 | 12.0 | 20.6 |
| Uzbekistan | 31.3 | 34.9 | 36.0 | 36.1 | 37.2 | 36.9 | 37.9 | 38.7 | 40.8 | 42.7 | 43.9 | 44.3 | 46.4 | 49.6 | 50.3 |
| **d Gas 2000–9** |
| **Gas** | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| Azerbaijan | 5.1 | 5.0 | 4.7 | 4.6 | 4.5 | 4.5 | 5.2 | 6.1 | 9.8 | 14.8 | 14.8 |
| Kazakhstan | 10.4 | 10.5 | 10.2 | 12.6 | 20.0 | 22.6 | 23.9 | 26.8 | 29.8 | 32.2 |
| Turkmenistan | 42.5 | 46.4 | 48.4 | 53.5 | 52.8 | 57.0 | 60.4 | 65.4 | 66.1 | 36.4 |
| Uzbekistan | 51.1 | 52.0 | 51.9 | 52.0 | 54.2 | 54.0 | 54.5 | 59.1 | 62.2 | 64.4 |

Table 15.2  Demographic data, output and income, 1990–1 and 2007

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (million)</th>
<th>GDP (USD billion)</th>
<th>GNI per capita (PPP in current international $)</th>
<th>Life expectancy (years – 1991)</th>
<th>Adult literacy (percent 1991)</th>
<th>Population (million)</th>
<th>GDP (USD billion)</th>
<th>GNI per capita (PPP in current $)</th>
<th>Trade/GDP (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>7.3</td>
<td>8.8</td>
<td>2,100**</td>
<td>65</td>
<td>97</td>
<td>8.6</td>
<td>33.0</td>
<td>6,630</td>
<td>97</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>16.5</td>
<td>24.9</td>
<td>4,680</td>
<td>68</td>
<td>98</td>
<td>15.5</td>
<td>104.9</td>
<td>9,520</td>
<td>92</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>3.8</td>
<td>3.2</td>
<td>2,200**</td>
<td>63</td>
<td>98</td>
<td>5.0</td>
<td>9.5</td>
<td>5,510</td>
<td>153</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>21.0</td>
<td>13.8</td>
<td>1,290*</td>
<td>69</td>
<td>97</td>
<td>26.9</td>
<td>22.3</td>
<td>2,430</td>
<td>71</td>
</tr>
</tbody>
</table>

Notes: * 1992, ** 1993.
contest went Uzbekistan’s way as it weathered the end of central planning and dissolution of the USSR better than any post-Soviet state, but with the rise of oil prices Kazakhstan has become the dominant economy in Central Asia. Uzbekistan does, however, also play a role in energy trade; as a substantial gas producer and minor oil producer it has been more or less energy self-sufficient, but as it starts to export gas its interests are becoming aligned with those of Turkmenistan and Kazakhstan, a pattern reflected in co-operation over the construction of a pipeline from Turkmenistan through Uzbekistan and Kazakhstan to western China which was completed in December 2009. The extremely rapid oil-powered growth of Azerbaijan after 1998 has substantially tilted the economic balance of power in the Caucasus, with implications for the frozen conflict with Armenia over Nagorno Karabagh, and for relations with other neighbouring states.

The next three sections of this chapter will analyse the domestic interaction of oil and power in Azerbaijan, Kazakhstan and Turkmenistan. This will be followed by analysis of the changing roles of the oil producers within their region, with countries beyond the region, and in the global economic and political system.

**Azerbaijan**

Azerbaijan was once the centre of the world oil industry. In 1901 the Baku oilfield produced 11m. metric tons, one-half of world output (Dorian and Mangera, 1995, 3). In the second half of the twentieth century output stagnated as Soviet oil investment focused on Siberia, and Azerbaijan’s facilities were in dilapidated state when the country became independent. For Azerbaijani dissolution of the Soviet Union was followed by a disastrous war with Armenia in 1992–93 over the disputed territory of Nagorno-Karabakh. Military failure contributed to the overthrow of the Popular Front government in June 1993 and election of Heydar Aliyev as president in October 1993. Aliyev negotiated a ceasefire in May 1994, and set about kick-starting the economy through the speedy increase in oil production, which by 1994 only just covered domestic demand (Dorian and Mangera, 1995, 8).

The ‘Deal of the Century’ was signed 20 September 1994 with a consortium of foreign oil companies (BP, Amoco, McDermott, Pennzoil, Exxon, Statoil, Ramco, TPAO, and LUKoil), who committed to invest US$7.4bn in three major offshore oil fields over 30 years. Foreign investment, which was almost entirely oil-related, increased in the second half of the 1990s (Table 15.3). Oil production rose rapidly in the late 1990s and early 2000s (Table 15.1), with oil accounting for almost 90% of exports by 2002. The Baku-Tbilisi-Ceyhan pipeline through Georgia and Turkey to the Mediterranean Sea was completed in 2005, providing an outlet independent of the Russian pipeline system.

In 2003 the terminally ill Heidar Aliyev named as temporary president his son, Ilham, who then won a controversial election in October 2003. Ilham Aliyev had close connections to the oil sector, having been vice-president of the state oil company, SOCAR, since 1994, participating in the Deal of the Century negotiations. SOCAR has a minority stake in all 13 Production Sharing Agreements (PSAs) currently operational in Azerbaijan, including the 2003 PSA for the Caspian Sea’s largest gas field, Shah Deniz, in which SOCAR is a partner with BP, Statoil, TotalFinaElf, LukAgip, OEIC and TPAO. The handover of power coincided with recognition that, apart from the oil fields covered by the Deal of the Century, Azerbaijan’s offshore energy wealth was likely to lie in gas rather than oil. A gas pipeline to link with the Turkish network at Erzurum was completed in 2006.

With increasing output of oil and gas and rapidly rising energy prices SOCAR’s financial position strengthened after 2003, as did the assets of the State Oil Fund (SOFAZ). The nature of SOCAR’s activities began to change around 2005 from resource-rent management to a more...
Table 15.3 Inward foreign direct investment, 1992–2008 (US$ m.)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>0</td>
<td>0</td>
<td>22</td>
<td>155</td>
<td>591</td>
<td>1,051</td>
<td>948</td>
<td>355</td>
<td>30</td>
<td>220</td>
<td>1,393</td>
<td>3,227</td>
<td>3,535</td>
<td>1,679</td>
<td>-601</td>
<td>-4,817</td>
<td>11</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>100</td>
<td>1,271</td>
<td>660</td>
<td>964</td>
<td>1,137</td>
<td>1,321</td>
<td>1,151</td>
<td>1,472</td>
<td>1,283</td>
<td>2,835</td>
<td>2,590</td>
<td>2,092</td>
<td>4,157</td>
<td>1,971</td>
<td>6,278</td>
<td>11,126</td>
<td>14,543</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>na</td>
<td>79</td>
<td>103</td>
<td>233</td>
<td>108</td>
<td>108</td>
<td>62</td>
<td>125</td>
<td>131</td>
<td>70</td>
<td>276</td>
<td>226</td>
<td>354</td>
<td>418</td>
<td>731</td>
<td>804</td>
<td>820</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>9</td>
<td>48</td>
<td>73</td>
<td>-24</td>
<td>90</td>
<td>167</td>
<td>140</td>
<td>121</td>
<td>75</td>
<td>83</td>
<td>65</td>
<td>70</td>
<td>187</td>
<td>88</td>
<td>195</td>
<td>739</td>
<td>918</td>
</tr>
</tbody>
</table>

proactive role in knowledge transfer and geopolitics. Ilham Aliyev appointed a younger cohort of senior officials, and oversaw a closer integration of state company and government, including use of SOCAR to promote foreign policy goals. The rising importance of gas after the Shah Deniz PSA and the limited flexibility of gas delivery modes contributed to the shift, for example, decisions to exclude Turkmen gas from Azerbaijan’s pipeline plans and to route pipelines through Georgia were politically driven. In 2007–8 SOCAR initiated international expansion, beginning with the acquisition and renovation of Georgia’s Kulevi oil terminal on the Black Sea, followed by the opening of offices in the United Kingdom, Romania, Switzerland and Turkey and plans to open 20 petrol stations in Georgia.

In the use of oil revenues, SOCAR’s role goes beyond that of a commercial company, being expected to make expenditures on hospitals, schools and other social welfare areas, which are usually made by the state rather than an employer. Oil revenues accruing to SOFAZ have also been used to support social welfare spending; in 2003 SOFAZ was used to finance resettlement and other assistance to people displaced by the Nagorno Karabakh conflict. By 2006 expenditures from SOFAZ amounted to $357m., including $40m. for housing of refugees and internally displaced persons (Lücke and Trofimenko, 2008). In consequence, Azerbaijan had by 2008 saved less than one-tenth of its oil windfall.6

In summary, the combination of pressing political and social demands and the geography of its oil deposits (the large field exploited by the Deal of the Century was known but no other major offshore oilfield has been discovered) contributed to a strategy of rapid exploitation and current use of revenues. Azerbaijan’s energy future will be more closely related to gas markets, which have a different structure in terms of pricing and delivery modes, which will be discussed in the section on Turkmenistan.

Kazakhstan

Kazakhstan has the Caspian Sea region’s largest recoverable crude oil reserves, and accounts for over half of the oil currently produced in the region (Table 15.1). During the 1990s, exploitation of the Tengiz oilfield and exploration for other potentially abundant oilfields was hampered by lack of technical expertise, lengthy negotiations with potential foreign partners, and Russian control over pipeline routes. These obstacles had been more or less overcome by the early 2000s, coinciding with the start of the rapid rise in oil prices. Kazakhstan’s oil exports drove growth rates of over 9% per year 2000–2007 (Table 15.4).

The 1990s in Kazakhstan were characterized by a series of deals between the President and the oil majors to revise the shareholdings in Tengiz and for the development of other large energy projects such as the Kashagan offshore oilfield and the Karachaganak gasfield. The process was extremely opaque, leading to drawn-out legal proceedings in New York and elsewhere (dubbed Kazakhgate by the media) and the imprisonment in the USA of a Mobil vice-president for failing to declare a ‘commission’ in his tax return (Hersh, 2001). Despite the corruption, Kazakhstan succeeded in involving foreign companies and developing energy resources, but the process was slower and less transparent than in Azerbaijan.7 Foreign participation also helped to ensure construction of new pipelines which reduced dependence on the Russian pipeline company, Transneft; the private CPC pipeline to the Black Sea opened in 2001 and the Baku-Tbilisi-Ceyhan pipeline to the Mediterranean opened in 2005.

Since 1997 there has been concern in Kazakhstan that Production Sharing Agreements (PSAs) gave too much to foreign partners at the expense of Kazakhstan. When such concerns were first voiced, and explained by the inexperience of Kazakh lawyers in the early post-independence years, foreign investors protested strongly and President Nazarbayev guaranteed that no existing
Table 15.4 Growth in real GDP 1989–2008 (%)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>-1</td>
<td>-23</td>
<td>-23</td>
<td>-20</td>
<td>-12</td>
<td>1</td>
<td>6</td>
<td>10</td>
<td>45</td>
<td>10</td>
<td>11</td>
<td>11</td>
<td>10</td>
<td>10</td>
<td>11</td>
<td>10</td>
<td>11</td>
<td>10</td>
<td>24</td>
<td>31</td>
<td>23</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>0</td>
<td>-13</td>
<td>-3</td>
<td>-9</td>
<td>-8</td>
<td>1</td>
<td>2</td>
<td>-2</td>
<td>2</td>
<td>63</td>
<td>-2</td>
<td>3</td>
<td>10</td>
<td>14</td>
<td>10</td>
<td>9</td>
<td>9</td>
<td>10</td>
<td>11</td>
<td>9</td>
<td>3</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>2</td>
<td>-5</td>
<td>-5</td>
<td>-10</td>
<td>-17</td>
<td>-7</td>
<td>-7</td>
<td>-11</td>
<td>5</td>
<td>16</td>
<td>64</td>
<td>7</td>
<td>17</td>
<td>19</td>
<td>20</td>
<td>16</td>
<td>17</td>
<td>17</td>
<td>10</td>
<td>11</td>
<td>12</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>2</td>
<td>-1</td>
<td>-11</td>
<td>-2</td>
<td>-4</td>
<td>-1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>94</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>8</td>
<td>7</td>
<td>7</td>
</tr>
</tbody>
</table>

PSAs would be amended without consensus. In 1999 amendments to the Oil and Gas Law strengthened local content requirements, and subsequent PSAs specified local sourcing elements. There has been a growing tendency to favour domestic partners, and the 2005 PSA Law mandated a minimum 50% participation of KazMunaiGas.

KazMunaiGas (KMG) was created in November 2002 by merging state corporations with a variety of oil and gas operations to form a 100% state-owned, vertically-integrated company, whose operations include exploration and production, transportation, oil refining, petrochemicals and marketing of oil and gas. Reflecting its close connection to government and role in policy implementation KMG is the government’s negotiating arm in PSA contracts, and is required to supply subsidised fuel to domestic markets and to provide some social services. KMG’s role also includes increasing rent extraction for the government. In this aggressive intent KMG has some resemblance to Russian state-owned energy companies, Gazprom and Rosneft, although unlike the latter KMG has acquired larger shares of energy projects in a straightforward and transparent manner by purchase or the transfer of state-held licences. By 2009 KMG owned about 30% of oil production and 40% of proved reserves in Kazakhstan (Kennedy and Nurmakov, 2010, 10). The government is promoting KMG as a national champion which will become a major international company in the mould of Statoil or CNPC (Olcott, 2007; Domjan and Stone, 2010).

In 2004 Kazakhstan began to revise the tax and other laws pertaining to PSAs more actively. Legislation tightened the definition by which development costs are covered by PSAs. The government also introduced a rent tax on oil exports in 2004 and increased royalty payments on oil and gas in 2005. In 2009 royalties were replaced by a natural resources extraction tax as part of a major tax reform aimed at easing the burden on small and medium-sized enterprises and on the non-extractive sector while increasing revenues from extractive industries (Kennedy and Nurmakov, 2010, 7).

The larger share for KMG in energy projects and deteriorating conditions for PSA partners built up tension between Kazakhstan and western energy companies. A flashpoint arose in 2007 when the development of the Kashagan megafeld ran into technical difficulties, cost overruns and revised projections of when oil exports would begin. The lead operator, Italian company Eni, announced that the costs of first-stage development had increased from $10 to $19bn, and production would be delayed from 2008 to 2010 with peak output being reached in 2019 instead of 2016. In January 2008 the foreign participants (Eni, Shell, Total, ExxonMobil, ConocoPhillips and Inpex) agreed to reduce their shares in order to permit KMG to increase its share to 16.8%. Meanwhile, adding to the pressure on the foreign companies, in September 2007 Kazakhstan’s parliament passed a law giving the government the power to renegotiate contracts deemed a threat to national security, although political leaders made clear that they were not intending to nationalize resources (as had happened in Venezuela, Bolivia and Russia).

Kazakhstan has also increased pressure on western participants in its energy sector by accepting Chinese participation. PetroKazakhstan, a Canadian company which in the 1990s had developed the second-largest oil and gas output after Tengiz, came into conflict with the government in 2005, including a fine for anti-competitive behaviour and protests against its environmental and labour record; in August 2005 China’s state energy company, China National Petroleum Corporation (CNPC), bought PetroKazakhstan for $4.18bn, and subsequently offered KMG a share in PetroKazakhstan. In 2009 China was allowed to significantly increase its interests in return for providing nearly $13bn in credits and loans to help Kazakhstan weather its financial crisis; CNPC bought the Kazakh oil producer MangistauMunaiGaz (MMG) in a joint deal with KMG worth $2.6bn, and China Investment Corp purchased 11% of the KMG Exploration and Production company for $939m. In June 2010 energy minister Sauat Mynbayev reported that China held a 50–100% stake in fifteen companies working in Kazakhstan’s energy sector, and that out of 80m.
tons of crude oil which Kazakhstan was expected to produce in 2010, some 26m. would go to China. The Kazakh-China oil pipeline, partly owned by CNPC and the first direct oil pipeline from Central Asia to China, grew an additional 762 kilometres from Kazakhstan’s Caspian Sea oilfields to western China’s in 2009. The Chinese and Kazakh presidents, together with their Turkmen and Uzbek counterparts, opened a gas pipeline in December 2009. Agreements have also been reached on joint uranium production, and Kazakhstan’s biggest copper mining company, Kazakhmys, and China’s Jinchuan Group created a joint venture to develop a major copper project at Aktogay.

Kazakhstan established in August 2000 the National Fund for the Republic of Kazakhstan (NFRK), into which extra revenues from oil, gas, copper, lead, zinc and chrome are transferred when world prices exceed reference prices. In late 2008 the government launched an anti-crisis plan for which $10bn or 9.5% of GDP, largely from the NFRK, was pledged. The plan focused on capital injections in four major banks (through the government holding company Samruk-Kazyna), support for construction and the real estate market, assistance to small and medium-sized enterprises and agriculture, and public investment in industry. At the end of 2009 the government announced that the need for crisis measures was past and tasked Samruk-Kazyna with promoting diversification and greater economic efficiency in firms; the future relationship between the NFRK and the funding of Samruk-Kazyna is unclear, but it will impact on KMG which is owned by Samruk-Kazyna.

The energy sector and its role in the national economy has evolved over the two decades since independence. Kazakhstan was fortunate to inherit the Tengiz project and to have the world’s largest oil discovery in the 1990s, Kashgan. President Nazarbayev faced difficult issues of nation-building and the transition from central planning, while cementing his own hold on power. Oil provided the lubrication for achieving all of these goals. In the 1990s the emphasis was on presidential control over potential rents associated with alienation of rights to develop the resources, and this led to lengthy and non-transparent negotiations and large-scale corruption. After the turn of the century, as the economic situation turned around and the country enjoyed a massive oil-led boom, the President pursued a more far-sighted strategy of increasing national control over the revenue streams and using oil revenues in support of better economic policies, albeit without any loosening of his hold on power.

Turkmenistan

The other major energy producer, Turkmenistan, was less eager to negotiate contracts with foreign energy companies. At independence the country’s resource base was cotton and a recently developed natural gas sector, neither of which was in urgent need of foreign expertise. President Niyazov relied on resource rents to fund populist policies and grandiose buildings (Pomfret, 2006, 89–103). Cotton provided the revenues in the mid-1990s, but the government offered little incentive to farmers and by the end of the decade the sector was languishing. As rents from cotton exports declined, revenues from gas exports began to increase after 2000, largely due to improved export market conditions; the volume of gas produced was lower in the 2000s than it had been in 1990 (Table 15.1).14 Despite mismanagement of resources and failure to develop new exports, the revenues continued to be sufficient for the President’s needs.

President Niyazov showed little interest in discovering and exploiting new sources of oil or gas, even though onshore and offshore reserves in western Turkmenistan were believed to be substantial. Initial involvement by large western firms gradually faded; Mobil and Monument cut their activities by half in the late 1990s due to high costs of extraction and transportation and to dissatisfaction with the tax regime (Lubin, 1999, 65).15 In mid-2000 Burren took over the interests of Monument, and ExxonMobil pulled out of Turkmenistan in 2002. After the turn of the century PSAs involved smaller companies such as Burren Energy, Dragon Oil and
Petronas, and in other oilfields small foreign companies (such as, Pado Oil and Chemical of Austria) became non-operating partners in joint ventures with TurkmenNeft. Schlumberger, the only foreign service company operating at oilfields in western Turkmenistan, helped oil production by servicing the fields’ wells and providing necessary equipment under a five-year contract, signed in February 1998, but Schlumberger’s work was hindered by government interference and TurkmenNeft failed to pay the company on time. The target for the Turkmen companies to raise their oil production to 10m. tons by 2000 was not reached; actual output of just over 7m. tons in 2000 was not much higher than in 1985 (Table 15.1), and less than the 1975 peak.

By the mid-2000s it was becoming clear that Turkmenistan needed foreign capital and know-how, if it were to increase oil and gas output. Only in the last year of his life, however, did Turkmenbashi become seriously concerned about increasing revenue, and in 2006 he made a trip to Beijing whose purpose was to involve China in Turkmenistan’s gas sector. This strategy was followed by his successor, Gurbanguly Berdymukhammedov, and culminated in the opening of a Turkmenistan–China gas pipeline through Uzbekistan and Kazakhstan in December 2009, breaking Russia’s quasi-monopoly on gas exports. The China deals improved Turkmenistan’s bargaining position relative to Russia, as did the opening in January 2010 of a pipeline to Iran. Russia and Turkmenistan remained mired in a price dispute for most of 2009, but President Berdymukhamedov seemed unwilling to antagonize Russia by bringing in western oil firms; despite strong lobbying by western majors, contracts worth $9.7bn to develop the South Yolotan gas field were awarded in December 2009 to firms from China, South Korea and the United Arab Emirates.

In summary, under President Niyazov, Turkmenistan did not create a positive environment for foreign investors in oil and gas. Rents on existing exports were sufficient to finance the president’s spending plans, and he was unwilling to allow foreign companies a significant role in the economy. Only when energy prices were well into the spectacular increase in the early 2000s did he turn to China for assistance in exploiting the country’s energy resources and reducing Russia’s monopoly over transit routes. Since Turkmenbashi’s death in December 2006, the signals are mixed: increased Chinese activity, ongoing tensions with Russia, and involvement of international oil companies limited to foreign investors from less powerful partner countries.

**International relations**

With the huge increase in energy prices between 1998 and 2008 Azerbaijan, Kazakhstan and Turkmenistan all assumed a higher profile on the world stage. Kazakhstan with the largest GDP (Table 15.2) has been the most ambitious, while Azerbaijan has geographically more limited perspectives focused on its immediate neighbourhood, and Turkmenistan remains largely trapped in its isolationist position of positive neutrality.

Since the dissolution of the Soviet Union, President Nazarbayev has assumed the position of international statesman. In December 1991 he played a crucial intermediary role in ensuring that plans to dissolve the USSR by the leaders of Russia, Ukraine and Belarus did not ignore the interests of the other non-Baltic Soviet republics. Kazakhstan had no history as an independent nation and in 1992 Kazakhs only accounted for two-fifths of the population, with Russians accounting for a similar proportion. President Nazarbayev had to tread a careful path of building a Kazakhstan nation while not providing incentives for the Russians, who were concentrated in the north, to secede or turn to Russia for support. In negotiations over oil contracts he appears to have been torn between maximizing revenues for the state (and for offshore accounts under his control) and ensuring financing for nation-building projects such as construction of a new capital located in the centre of the country. Within the Commonwealth of Independent States Kazakhstan remained aligned with Russia in the various arrangements that culminated in the Eurasian Economic Community.
Increasing oil revenues allowed a more assertive international stance in the 2000s, although Nazarbayev remains careful to retain good relations with Russia. Concern about the country’s international image was stimulated by the 2006 ‘mockumentary’ film Borat: Cultural Learnings of America for Make Benefit Glorious Nation of Kazakhstan, at which the leadership initially took offence (even though the film was not shot in Kazakhstan and its barbs were targeted more at the USA). Nazarbayev positioned his country as a hinge of Eurasia, but European rather than Asian.\(^{18}\) A highlight of this diplomacy was being Chair of the OSCE in 2010. In the same year Team Astana won the Tour de France, sporting jerseys in the distinctive pale blue and yellow national colours (although it is doubtful that many western European cycling enthusiasts understood the association).

Azerbaijan’s leaders have had narrower goals, centred on resolution of the conflict with Armenia. In 1992–93 Azerbaijan suffered decisive military defeats by Armenia, which was supported by both Russia and the USA, and the May 1994 ceasefire left Armenia in control not only of the disputed territory of Nagorno Karabagh but also a large swathe of undisputed Azeri territory linking the enclave to Armenia proper.\(^{19}\) In 1995 President Heidar Aliyev proposed to his Armenian counterpart that Azerbaijani oil exports to Armenia be linked to withdrawal from the occupied territories, and the USA offered support for a peace pipeline from Azerbaijan through Nagorno Karabagh and Armenia to Turkey; nothing resulted, and when the BTC pipeline to Turkey was built in the early 2000s it passed through Georgia, bypassing Armenia.

The international oil companies’ insistence on delinking the pipeline route from resolution of the Nagorno Karabagh conflict was a signal to Azerbaijan that it had to use the oil card in a different way, but completion of the BTC pipeline also signalled the increasing importance of Azerbaijan’s oil for US companies and for a major US ally, Turkey. The shifting weight of the Armenian and oil lobbies on US policy towards Azerbaijan after the turn of the century was reflected in the substantial softening of Section 907 of the Freedom Support Act under which sanctions had been imposed on Azerbaijan.\(^{20}\)

Since assuming the presidency in 2003, Ilham Aliyev has consistently strengthened SOCAR’s position in the oil and gas sector making it a more focused instrument of state policy. After 2007 SOCAR’s investments concentrated on Georgia and Turkey, making it by 2010 the largest energy actor in Georgia and a significant player in Turkey. EU concerns about energy security and dependence on Russian gas supplies also provided Azerbaijan with leverage, as the feasibility of any southern pipeline routes bringing Caspian or Central Asian gas to the EU depend critically on Azerbaijani participation. In 2009–10, when the USA supported a Turkey–Armenia rapprochement, Azerbaijani opposition led to a passive EU position. Only after the rapprochement collapsed did Azerbaijan sign a new gas transit agreement with Turkey.\(^{21}\) By becoming a shareholder in Georgia’s North-South pipeline, which links Russia and Armenia, SOCAR has influence over Armenia’s only remaining energy link.\(^{22}\)

Under Turkmenbashi, increasing energy-driven wealth had minimal impact on Turkmenistan’s international relations. The counterpart to the autocratic President’s complete autonomy in domestic policymaking was a foreign policy of neutrality, based on aversion to any foreign interference. However, as the economy became more and more dependent on revenues from gas exports, Turkmenbashi’s prized neutrality in effect left the country dependent on Russia which controlled all the country’s important transport and pipeline outlets (Anceschi, 2009; Pomfret, 2011). Only in the last year of his life did he make any effort to use Turkmenistan’s potential energy wealth to diversify markets and external relations with his trip to Beijing.

Turkmenbashi’s successor, President Berdymukhamedov, brought the China initiative to fruition. He has cautiously opened up energy exploitation to foreign companies, but avoided upsetting Russia by only involving non-western companies. Nevertheless, Turkmenistan’s small shift to greater engagement had a regional implication insofar as co-operation with Uzbekistan and
Kazakhstan was required for a pipeline to China to be built. The pipeline project engendered sufficient trust among previously frosty partners that in 2009 the Presidents of Turkmenistan, Kazakhstan and Uzbekistan for the first time jointly negotiated with Russia prices for future gas deliveries.

In the Turkmenbashi era, relations between Turkmenistan and Azerbaijan were soured by disputes over demarcation of the southern Caspian, which at times led to shooting incidents, and over debts arising from gas shipped from Turkmenistan to Azerbaijan as far back as 1991. Turkmenistan’s Embassy in Baku was closed in 2001. Under President Berdymukhamedov, relations warmed as Turkmenistan reopened its embassy, and in June 2007 proposals were announced for joint exploration of the Serdar/Kapaz field under the South Caspian Sea. The debt dispute was settled in March 2008 when a high-level delegation from Turkmenistan visited Baku.23 The rapprochement clears the way for future construction of a Trans-Caspian pipeline through which Turkmen gas could be supplied to Europe.24

Conclusions

For Azerbaijan, Kazakhstan and Turkmenistan exploitation of oil and gas reserves and the contrast between stagnant world prices in the 1990s and the boom of 1999–2008 have been determining forces in their post-independence history. The speed and nature of energy development have been primarily determined by domestic political considerations (primarily regime survival), as well as by resource endowments (oil versus gas and onshore versus offshore). For all three countries, being energy-rich has had important consequences for national power and foreign policy.25

Kazakhstan has assumed a higher profile position as an emerging market economy, to the extent that commentators have discussed whether it should be linked with Brazil, Russia, India and China as the BRICKs (Olcott, 2008). More concretely Kazakhstan has sought to establish itself as a significant player in Eurasia, as its position of regional hegemon in Central Asia has become incontrovertible. Azerbaijan has had more limited international aspirations, using its newfound economic strength to influence relevant outside powers’ positions on the frozen conflict with Armenia. Reflecting the extreme policies of Turkmenbashi’s idiosyncratic dictatorship, Turkmenistan has been least active in international relations, but this is changing under President Berdymukhamedov.

For all three countries, increasing export revenues and economic power have been intimately connected to the energy boom in the first decade of the twenty-first century, and the future oil-and-power nexus will depend critically on global energy market trends. Azerbaijan’s position is the most vulnerable, insofar as its oil reserves are limited; it has committed itself to rapid exploitation of known reserves and time will tell whether that was a serendipitous choice if prices never regain their 2008 high or whether it was over-hasty depreciation of natural capital. In the second decade of the twenty-first century Azerbaijan will come to rely increasingly on gas rather than oil. Both Azerbaijan and Turkmenistan could be crucial players in alleviating EU concerns about access to gas supplies, or they could be sidelined by a shift to LNG which will favour suppliers such as Qatar and Australia with ocean ports. Kazakhstan’s future energy revenues appear most secure, with large proven oil and gas reserves and a variety of available export routes.

In all three countries, the political system concentrates power in the hands of the president. Both the strength of the leader’s position and the weak pressures for greater democracy are intrinsically related to energy abundance, which provided resources to ensure the incumbent’s position and also freed the leader from any need to seek the population’s acquiescence in how the state raises revenue. Autocracies are the norm, but not universal, in oil-exporting countries, so there is little reason to expect imminent regime change, but the dependence of economic and political decisions on the wisdom and health of the leader may be a source of future instability.
Notes
1 On the economies of Central Asia, see Pomfret (1995; 2006) and Gleason (2003). Uzbekistan, like Turkmenistan, has been reluctant to involve foreign firms in its resource sectors, but the economy is better managed than that of Turkmenistan and cotton remains a major export. Uzbekistan’s second largest export is gold, in whose production foreign partners have played a role, but the arrangements and gold output are not publicized by the government.
2 Azerbaijan’s crude oil production declined from just under 15m. metric tons in 1980 to 11m. in 1992 (IMF Economic Survey Azerbaijan, April 1993, 53), i.e. back to 1901 output levels. Kaluyzhnova (2008, 77–78) provides an eyewitness account of the dilapidated state of some oil facilities over a decade after independence.
3 Aliyev had been appointed First Secretary of the Azerbaijan Soviet Socialist Republic by Brezhnev in 1969 and promoted to the Soviet Politburo in 1982 by Andropov, but was forced to resign by Gorbachev in 1987. He became leader of the Nakhchivian Autonomous Republic (a non-contiguous part of Azerbaijan), where he reinvented himself as an Azeri nationalist while avoiding association with the political disarray and military disasters of the early 1990s.
4 Since the ceasefire Armenia has occupied both the disputed territory and 9% of Azerbaijan’s territory lying between Nagorno Karabakh and the Armenian border. Economic support for the 600,000 internally displaced Azeris placed a large burden on the state budget.
5 SOFAZ was established in 1999, and became operational in 2001. SOFAZ transfers a portion to the government budget and invests the remainder overseas to mitigate Dutch Disease effects, but from the start disputes arose over the use of funds. In 2002 SOFAZ, contrary to its statutes, supported a commercial venture, the Baku–Tbilisi–Ceyhan pipeline. There was also debate over the extent to which the fund should support social welfare spending.
6 CASE (2008, 121) contrasts this with Kazakhstan and Russia, which both saved over half of their 2003–7 windfall in their oil funds. However, SOFAZ assets increased significantly in 2008 due partly to the oil price peak, but more to PSAs reaching the point where the operators had recouped up-front costs and a larger share of revenues accrued to the host country.
7 In contrast to Azerbaijan, whose main PSAs have been published, Kazakhstan’s remain secret, although according to Muttitt (2007) the terms are known to all major oil producers.
8 However, the use of environmental regulations to push out PetroKazakhstan’s Canadian owner was reminiscent of Russian policy in Sakhalin, and the disposal of MMG had echoes of the Yukos affair (see below). Karachaganak is the only major energy project in which KMG does not have a share; a government threat to halt production if increased export duties are not paid (putting pressure on the existing partners British Gas, Eni, Chevron and Lukoil to give a share to KMG) is under arbitration.
9 KMG’s substantial 2006–8 investments in Georgia were negatively affected by the August 2008 Russia-Georgia war. KMG has also invested in Romania, buying the country’s second largest oil company, Rompetrol, for $3.6bn in 2007.
10 PSAs acknowledge a potential time inconsistency problem (Pomfret, 2011). Foreign partners have the technology to explore and exploit natural resources, and they incur large development costs in doing so, but their presence is less essential once production is under way, and the foreign companies then face a threat of expropriation. Under a PSA the foreign companies take a larger share of the revenue stream until their up-front costs have been covered; the precise shares and definition of development costs required are PSA-specific.
11 The exceptionally large cost over-runs threatened to reduce Kazakhstan’s state revenues by as much as $20bn over the decade 2007–17 (Kennedy and Nurmakov, 2010, 5–6). The dispute was sufficiently serious that successive Italian prime ministers, Prodi and Berlusconi, flew to Astana to negotiate with President Nazarbayev.
12 It was also reported that Eni and its partners would make an additional payment to Kazakhstan of $5bn in compensation for lost revenue due to the delays.
13 The MMG case was complicated by the involvement in MMG of President Nazarbeyev’s estranged son-in-law, who was under investigation for criminal activities. Domjan and Stone (2010) likened the case to that of Yukos in Russia, where a previously powerful oligarch was displaced after falling out of political favour, but the MMG takeover was conducted by a more accepted legal process and did not result in a simple state takeover (although KMG’s share of the deal was 51% and CNPC’s 49%).
14 The exceptionally low output in 1997 and 1998 was due to Turkmenistan cutting supplies to Ukraine in a dispute over unpaid bills.

15 Investor confidence was not helped by doubts over the government’s commitment to contractual obligations, which were highlighted when a trans-Afghanistan pipeline contract with Bridas was terminated in favour of one with Unocal. Bridas initiated proceedings in international courts, and Turkmenistan gained nothing as anticipated US support for a Unocal-led pipeline was withdrawn in 1997 when US relations with the Taliban government deteriorated.

16 In 2003 Turkmenbashi signalled an intention to sign a PSA with a consortium of Russian companies, Zarit, to exploit offshore oil and gas fields, but did not finalize the deal. Kaluzhnova (2008, 83–86) emphasises lack of technical skills after the departure of Soviet specialists as the cause of falling revenues per cubic metre of gas exports (e.g. due to poorly maintained pipelines), and highlights how much time in exploring offshore oil reserves (as of 2007) had been wasted due to lack of technical expertise.

17 Eni purchased Burren Energy in late 2007, but this may have been primarily to acquire Burren’s African interests. The Turkmen government was annoyed that it had not been involved in the negotiations and in 2008 refused to issue visas to Eni personnel. The bad blood reportedly also reflected information-sharing between Kazakhstan and Turkmenistan, with Kazakhstan voicing disappointment with Eni’s performance as lead operator of Kashagan.

18 In international soccer, the most popular sport in Central Asia, Kazakhstan plays in European tournaments, whereas the other Central Asian countries play in the Asian region. Kazakhstan does, however, keep a foot, or a skate, in both continents, e.g. hosting the Asian Winter Games in January–February 2011.

19 In 1992 under Section 907 of the Freedom Support Act the USA denied economic and humanitarian aid, including most-favoured nation treatment, to Azerbaijan, alone among all Soviet successor states. The measure, ostensibly in response to Azerbaijan cutting the rail link to Armenia, reflected the strength of the influential Armenian lobby in the USA and, ironically, was implemented when Azerbaijan had one of the most democratic governments in the former Soviet Union. Azerbaijan’s sole ally, Turkey, provided little support beyond blockading the Armenian border. Armenia still has land routes through Iran and Georgia.

20 After 11 September 2001 the US Executive pushed strongly for a Section 907 waiver, which it linked to Azerbaijan’s cooperation in the war on terror. Congress granted annual waivers, which were bitterly opposed by the Armenian National Committee of America and were supported by the oil lobby.

21 Lussac (2010) analyses this episode. By increasing contracted gas sales to Russia for 2011 Azerbaijan signalled to the EU that it had alternative gas markets, and by pushing ahead with studies of the Azerbaijan-Georgia-Romania Interconnector (AGRI) project Azerbaijan indicated to Turkey that alternative transit routes to Europe were possible.

22 At the time of writing it is difficult to predict where this pressure will lead. Increased isolation and desperation for an Armenia that considers itself still militarily superior to Azerbaijan, but facing a deteriorating bilateral balance of power, is a combustible situation, and it is not helped by uncertainty over how far Russia or the USA would go in support of Armenia. Hopes that a peaceful solution might be found during Kazakhstan’s OSCE chairmanship were shattered by the failure of a June 2010 peace conference in Almaty.

23 Although both countries acknowledged the debts incurred in 1991–93, at that time they both still used the rouble, whose hard-currency value was disputed; Turkmenistan sought $56m. while Azerbaijan offered $18m. Under the March 2008 agreement, Azerbaijan agreed to pay $44.8m.

24 This would require still closer co-operation between Azerbaijan and Turkmenistan, as well as expansion of Turkmenistan’s production capacity. Long-term commitments to Russia, China and Iran exceed current capacity, but Turkmenistan’s untapped reserves are considered to be large. EU demand for Turkmen gas depends upon relations between Russia and the EU, and related concerns about EU energy security, as well as on the viability of other options for the EU such as delivery of liquefied natural gas (LNG) by sea. Despite the uncertainties, Berdymukhamedov has signalled to the EU and to Russia and China that western pipeline routes have not been ruled out.

25 This view is not universally shared. In a recent collection of articles by international relations and security specialists (Kavalski, 2010), oil is just one among several major interests (geographical proximity to many important powers, the threat of Islamic terrorism, and energy and other raw material resources) that external actors have in Central Asia, while for the Central Asian leaders internal stability is considered to be the all-consuming concern.
References


Kalyuzhnova, Y. (2008): Economics of the Caspian Oil and Gas Wealth: Companies, governments, policies (Basingstoke UK, Palgrave Macmillan).


