"Its the economy stupid," was US President Bill Clinton's simple core message in the run up to the 1992 Presidential elections; alas if only things were so simple in the Caspian region. Unresolved regional conflicts and a wide range of political interference mean that economically sensible positions are difficult to establish or maintain in this part of the world. The two "contracts of the 20th century," the Azeri, Chirag and deep water Gunashili field project (ACG) and Baku-Tbilisi-Ceyhan (BTC) combined Shah Deniz and Southern Caspian Pipeline (SCP) project are by contrast largely rational endeavors allowing Azerbaijan access to international markets. The projects would not have happened without massive support from Western players, and for that Azerbaijan is very grateful. However, securing the country's future involves continuing to deal with a number of pressing national and regional challenges: Nagorno-Karabagh, Iran, and the continuing aftermath of the collapse of the USSR, only to name a few. There is little wonder, then, that Azerbaijan looks to Europe and the stability that could result from forging much stronger connections there. However, the actual practice of partnership with Europe has been thus far a little disappointing; like the Minsk process, there is a lot of talk and pious hope, but precious little delivery. What can be done to improve this situation over the next 5 plus years?

Azerbaijan is an island of stability in the volatile Caucasus region. Fortunately or unfortunately Azerbaijan is geographically located in one of the most volatile and vulnerable regions in the world—the South Caucasus and the Caspian Sea. There are internal factors, but possibly the main driver for the volatility of the region is the emerging and intersecting political and economic interests of the big powers—Russia, the US, Turkey and Iran—in the wake of the collapse of the USSR. The part of Russia closest to Azerbaijan is the Caucasus region, which is wracked by ethnic, religious, and criminal violence. The entire Caucasus region—primarily the North Caucasus, situated between the Caspian and Black Seas—is a focus for intense economic and political problems. For Russia the Caucasus is the region separating it from economically and politically important Turkey, the Middle East and Iran. The US has established a strong relationship with Azerbaijan, and in recent years with Georgia; after the collapse of the USSR both states became important for energy—Azerbaijan as an energy exporter and Georgia as the key transit state to deliver Caspian oil and gas to the European market.

For Turkey it is extremely important to maintain its closely aligned relations with oil and gas rich Azerbaijan. Exportable energy resources can play a significant role in realizing Turkey's strategic aim to become an energy hub in the region and thus to strengthen its political levers, especially toward Europe. Moreover, the South Caucasus could be a bridge between Turkey and energy rich and no less strategically important Central Asian states on the other side of the Caspian. Except for Tajikistan, those states all have Turkic origins, so Turkey is highly interested in having access to and influence on them.

Iran is yet another large and influential neighbor. It is fearful of losing its economic regional and global dominance due to the sanctions imposed by the EU and the US on its energy industry. Iran has sought to align itself diplomatically and economically with Armenia and Russia to counter Azerbaijan's new pro-western policies and rising economic power. Moreover, Azerbaijan is considered by Iran as a potential problem. The presence of a large ethnic Azerbaijani population in the north of Iran (there are more ethnic Azerbaijanis in Iran than there are in Azerbaijan) ensures that Iran and Azerbaijan conduct quite a cautious policy towards

each other.

Maneuvering between the larger powers for influence in this strategically important region has ensured that conflicts or ethnic tensions between regional states in the Caspian have been sustained or, as in some cases, exacerbated. The Nagorno Karabagh (an Azerbaijani enclave occupied by Armenian separatists) conflict between Azerbaijan and Armenia is the main reason for instability and volatility, which ultimately affects all of the region's states beyond Azerbaijan and Armenia themselves. Elsewhere Georgia is trying to resist the charms of Russia in Abkhazia and South Ossetia. In Ingushetia, Dagestan and Chechnya the insurgent Islamic movements and other armed entities are actively functioning.

Role of oil and gas in the economy of the country

Despite political complications and the conflict with Armenia over the last two decades, Azerbaijan has succeeded in stabilizing and modernizing its economy through the development and export of energy resources. While in general the various unresolved regional conflicts and wide range of political interference mean that economically sensible positions are difficult to establish or to maintain, the Azeri-Chirag-Guneshli (ACG) Pipeline and the Baku-Tbilisi-Cheyhan (BTC), Shah Deniz and South Caspian Pipeline (SCP) stand in complete contrast. Initiating and launching new energy projects in the region and establishing gas pipelines in different directions including the south-north, the east-west and the north-south axes remains a key objective of the Azerbaijani state. Very significant revenues from oil and gas have been flowing into the country in recent years, allowing the state to develop and reform the non-oil sector. The World Bank named Azerbaijan "Top Reformer" in its "Doing Business 2009" report, reflecting the state's significant efforts in simplifying its domestic regulatory requirements.

The Azerbaijani economy is one of the fastest-growing in the world and, amongst the CIS countries, has been leading in GDP growth rate over the last five years. From oil and gas revenues Azerbaijan currently has assets of USD 30 billion of foreign exchange and gold reserves. From this approximately USD 22 billion is saved in the State Oil Fund (SOFAZ) and nearly USD 8 billion in the National Bank of Azerbaijan. According to the Azerbaijan National Bank report for 2010, Azerbaijan is the leading country measured by per capita reserves of foreign exchange and gold reserves of all the CIS countries (approximately USD 3333/per capita [USD 30 billion : 9 million population]). In comparison, Russia for the year of 2010 measured USD 2850/per capital (USD 444 billion : 156 million), Ukraine 673 USD/per capita (USD 31 billion : 46 million), Kazakhstan USD 1705/per capita (USD 29 billion : 17 billion) and Turkmenistan USD 2200/per capita (USD 10,51 billion (2009) : 5 million). SOFAZ as an extra-budgetary fund that plays a leading role in safeguarding these financial resources for future generations. The fund was established to ensure macroeconomic stability and transparency in the management of oil revenue. In comparison with other energy rich CIS countries Azerbaijan is the best positioned in terms of using or investing oil and gas revenues

for social programs and non-oil sector development efficiently. Among many other social programs, the “State Program on Poverty Reduction and Sustainable Development in the Republic of Azerbaijan for 2008-2015” has seen tangible results since it was initiated. Azerbaijan’s poverty level has been reduced from 45% in 2003 to 13% in 2008. The overall objective of the program is to reduce poverty in the country to zero.

Thanks to the wise and effective policy of oil and gas revenue management, Azerbaijan has become a self-sufficient state providing itself with financial, energy and labor resources. As such it has strengthened its position in the region and serves as a stabilizing factor in the economy. All of this has given good cause to believe that the country has now completed its initial economic transition and is entering a new phase of development. According to the World Economic Forum's "Global Competitiveness Report 2010 - 2011", Azerbaijan ranks 61 among 139 countries in the world, and second in the CIS (after Russia) for innovation. It is considerably ahead of its neighbors in the Caucasus and Central Asia.

Energy strategy of Azerbaijan

It is well known that for natural gas exports to be successful and economically profitable there needs to be a strong bond between producers and consumers. Without some guarantee of demand it does not make sense to provide supply. Thus Azerbaijan's export of gas needs sound, lucrative, stable and profitable markets. However, geographic proximity and political necessity also help determine export routes. For example, Georgia in 2007 found itself in political confrontation with Russia when Azerbaijan started to produce its own gas and export it. Also Turkey was confronted with a gas demand of 43 billion cubic meters (bcm) annually while having only two suppliers—Iran and Russia.

Azerbaijani gas exports to Iran are another local necessity. It is common knowledge that since 2004, Azerbaijan has realized a natural gas swap with Iran, transferring about 1 million cubic meters of gas daily from Azerbaijan through Iran to the Nakhchivan Autonomous Republic of Azerbaijan; this contract runs for 25 years. Additionally, in November 2009, a memorandum between the State Oil Company of Azerbaijan (SOCAR) and National Iranian Gas Export Company (NIGEC) was signed in Baku for delivering Azerbaijani gas to Iran from 2010 on. Azerbaijan and Iran are connected via the Qazimammad-Astara gas pipeline, which has a maximum capacity of 10 billion cubic meters per annum. Both sides are expected to sign a long-term contract on increasing the volume of exported gas—eventually reaching (maybe) two bcm annually.

In accordance with its diversification strategy, Azerbaijan has made efforts to widen its export options and to access as many markets as possible. The states to which Azerbaijan currently exports its gas—Russia, Georgia, Turkey and Iran and in the near future the EU—have conflicting energy interests, which makes the region more complicated and strategically important in terms of energy security. Azerbaijan has already defined its energy interest towards

the Caspian states, and Iran does not play a key role in that energy policy. Despite the fact that during recent years four gas pipelines linking Iran with Armenia, Iran with Nakhchivan Autonomous Republic of Azerbaijan, and Iran with Turkmenistan were constructed, it is nonetheless the case that the main energy projects of the Caspian states all bypass Iran. However, one should not forget that Iran holds the world's third-largest proven oil reserves and the world's second-largest natural gas reserves after Russia.

Russia, as a traditional gas provider to Europe, as well as other real and potential Caspian gas exporting countries may come to consider Iran as a rival state in the long run. Both Moscow and Tehran have maintained an identical position on the development of a Trans-Caspian pipeline, which is that it should not be built. In a broader sense, both energy-rich states are keen to use their natural resources to realize economic modernization and are interested in political stabilization, security, and lessening the influence of external forces in the Caspian region. History shows that Russia and Iran have understood each others' interests and ambitions. The Russian-Georgian war and the fragility of the pipelines going through the region show that in all the spheres, and in energy related issues in particular, "harmonization" of interests—defining the concordance of the aims and interests of all the players and searching for mutually beneficial resolution—is the most appropriate policy between the complicated neighbors. This is especially true when a country like Azerbaijan has an unresolved protracted conflict such as Nagorno-Karabagh, which sometimes can be used by its powerful neighbors as leverage over foreign policy decision making.

To prosper in this complicated region one needs a multilateral and balanced policy. Given this necessity to harmonize the interests of all the players in the region, Baku is trying to court Russia, Iran and the EU at the same time. The Azerbaijani delivery of gas to Iran—despite Iran's energy interests in hostile Armenia—must be seen in that context. Moreover, a company linked to the Iranian National Oil Company has a 10% stake in the development and exploration of the first stage of the Shah Deniz gas project. Iran also expressed its interests in the second phase of development of the Shah Deniz gas field. In January 2009 Deputy Minister of Oil of Iran Husain Shirazi stated that Iran is intending to invest USD 1.7 billion in the further exploration and development of the Shah Deniz II project.

In Armenia, Iran has the Kadjarat-Ararat pipeline with the total capacity of 2.3 bcm, which delivers gas from Iran to Armenia. Some amounts of Iran's exported gas are used in Armenia's domestic market and some are used to produce electricity that is re-exported back to Iran.

With regards to any Trans-Caspian gas project, Iran and Russia are completely aligned. They oppose the building of any new gas transit infrastructure that would give Azerbaijan the status of a transit country. This opposition hinders Azerbaijan's ability to provide its population with stable gas transit revenue for years to come. Without such a Trans-Caspian project, Azerbaijan will remain solely an energy resource exporting country.

Azerbaijan’s interests in the West

The most lucrative and stable gas market Azerbaijan can access is Europe with its 500 million consumers. Nabucco is so far the most expensive project proposed to achieve such access. While this may seem to make the project unlikely ("it’s the economy, stupid"), Azerbaijan could be interested in filling the pipe if the conditions Baku has put forward to the Nabucco Consortium are fulfilled. According to SOCAR’s top official Elshad Nasirov, the Nabucco project cannot be limited to transporting gas from Baku to Baumgarten in Austria. Azerbaijan demands from the consortium access to the nearby markets as well, not simply limited to the countries participating in Nabucco itself. This is to say, the Nabucco pipeline goes through Bulgaria, Romania, Hungary and Austria, but Baku would also be interested in having direct access to the nearby gas markets of Slovenia, Slovakia, Croatia, Czech Republic, Macedonia, Albania, Serbia etc.—countries with the lowest level of diversification in gas supply in Central and Southeastern Europe. This will further be possible if a united, single gas grid in Europe is constructed. So far there is much talk but little implementation of such a grid—a project which makes absolute sense in European terms with or without additional gas from projects such as Nabucco.

Moreover, Azerbaijan has promised to supply the Nabucco project with some 10 bcm of gas annually. The question remains, however, how much will be demanded ultimately from Azerbaijan and under what conditions. For Baku the main concern is the potential revenue that the country will receive from its European exports and how these exports will continue to strengthen and bolster Azerbaijani independence, thereby allowing the country to keep its doors open to future alternative markets. In short, Baku can physically provide gas to Nabucco more than the promised 10 bcm. Gas production in Azerbaijan is expected to reach some 55 bcm or even up to 70 bcm once the Shah Deniz second phase comes on stream after 2016. However, it will not dedicate more gas to Nabucco, as Baku also envisages the development of other transportation routes and markets, including those along the Turkey, Italy, Greece (ITGI) pipeline and the Trans-Adriatic Pipeline (TAP) routes.

Between USD 20 and 22 billion will be invested in the development of the second phase of Shah Deniz. To reimburse all of these costs Azerbaijan has to choose the most valuable commercial offer amongst all the alternatives. Currently Azerbaijan is conducting negotiations with potential buyers, and a final decision will depend on the net price after deducting transit costs, taxes etc. that Azerbaijan will receive from its gas, in addition to other considerations such as the efficiency, transit viability and transportation tariffs and conditions that gas importing countries will offer.

The other major concern of Azerbaijan in regards to Nabucco is the availability of other sources to feed the pipeline. Baku firmly stated that the country will not pay for empty capacity in Nabucco. Baku will pay transport costs for only 10 bcm if the pipeline is full. The EU has to work more actively in finding and committing second and third producer sources for the project. Azerbaijan will not join a project and provide gas if its delivered cost is high due to paying for unused pipeline capacity, thereby rendering significantly reduced economic returns to Azerbaijan.

This Azeri perspective is based on hard economic realities and is well understood in Brussels. On January 13, 2011 President of the European Commission José Manuel Barroso and energy commissioner Gunter Ottinger visited Baku and Ashgabat and signed a joint declaration on the Southern Gas Corridor. However, the signing of the declaration also demonstrated that the EU is not ready to sign any agreement or contract at this point with Caspian gas producers that would commit those producers to deliver negotiated gas to the European market.

As mentioned earlier, a Trans-Caspian pipeline, which could deliver Turkmen gas to a project such as Nabucco, is opposed by Russia and Iran mostly for political and commercial reasons. In public statements, both countries have focused on environmental issues, but traveling inside Russia and Iran reveals that both governments are apparently significantly more concerned about environmental issues in the Caspian than they are about the environmental performance of projects inside their own borders. In addition, Russia has tried to use disagreement between Azerbaijan and Turkmenistan on the delineation of the Caspian Sea to stop the realization of any Trans-Caspian gas line. However, Ashgabat recently announced that building such a pipeline would not require the consent of all five littoral states, pointing out that such a development is the internal business of two states—Azerbaijan and Turkmenistan—as the pipeline would pass through their national sectors. Ashgabat has further stated that it is committed to building the necessary cross-country infrastructure that could bring up to 40 bcm of gas to the shores of the Caspian.

Conclusion

"May you live in interesting times" is a friendly Chinese saying. Azerbaijan also lives in an interesting neighborhood. Azerbaijan has done well since dramatic changes were unleashed across the Caspian, occasioned by the dissolution of the USSR. Its strategy now needs to focus on its medium and long term future. At the top of the agenda for long term prosperity is neighborhood stability. To this end, the results so far of the Minsk process, focusing on the settlement of the Nagorno-Karabakh conflict, have been extremely disappointing. Those in the West who care about the future of this region need to ask themselves "will the continued failure of Minsk result in a sensible future for the region?" The answer to this question is an obvious "no", nevertheless concurrent with a resounding "yes" for the growing reality of Azerbaijan's becoming a contributor to enhanced European energy supply security.

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