

Analysis

The Energy Dimension of Azerbaijani–Russian Relations: Maneuvering for Nagorno-Karabakh

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Abstract

Russian–Azerbaijani relations in the post-Soviet period have mainly been a function of two factors: The continuing non-solution of the Nagorno-Karabakh question, and the export of Azerbaijan’s petroleum resources. With the 2007 agreement to supply gas to Georgia and the December 2008 take-over of Georgia’s gas distribution networks, Azerbaijan is assuming the role of Georgia’s energy patron. This new function has important implications for both the Karabakh conflict and Azeri petroleum exports.

Azerbaijani Foreign Policy

When Azerbaijan declared its independence on 30 August 1991, it faced the choice of bandwagoning with Russia as the power center of the former Soviet Union, or balancing its relations with Russia and other major powers, notably the USA and the EU countries. After a short-lived nationalist government that championed an anti-Russian foreign policy line, the Aliyev dynasty has since 1993 conducted a more pragmatic foreign policy, seeking to tie the interests of foreign powers to Azerbaijan while managing to gain independence from Russia without needlessly antagonizing the Kremlin. The greatest asset at Azerbaijan’s disposal in terms of engaging European countries and the USA has been these actors’ interest in its petroleum resources. The main foreign policy challenge has been the conflict with neighboring Armenia for control over Nagorno-Karabakh.

Azerbaijan’s Perspectives on Russia’s Role in Nagorno-Karabakh

Azerbaijan views Russia as a party to the Karabakh conflict and the Russian co-chair in the OSCE Minsk Group, tasked with finding a negotiated solution to the conflict, as pro-Armenian. This is hardly surprising, as Russia is Armenia’s patron in international relations, and the two countries in 1997 signed a treaty ensuring mutual military assistance if either country should be attacked. Azerbaijani skepticism towards Russian motives has contributed to rendering the peace negotiation process difficult and created problems for bilateral relations between Azerbaijan and Russia. The belief that the conflict will remain unsolved as long as the Russians see it in their interest to use Nagorno-Karabakh to “divide and rule” the South Caucasus is widespread in Azerbaijan, resulting in an uncompromising stance which further complicates any resolution of the conflict.

Azerbaijan has since 2005 experienced considerable petroleum-driven economic growth, and has used its new wealth to strengthen its efforts to gain the return of Karabakh. The general Azerbaijani line is that the conflict should be solved peacefully, but that war may be necessary if all else fails. Parallel to statements on war as the last resort for solving the Nagorno-Karabakh conflict, President Ilham Aliyev has also pledged that the Azerbaijani military budget will reach the size of the Armenian state budget. As threats of war were accompanied by a dramatic increase in military spending, it seemed that Azerbaijan was using its petroleum-fuelled economic strength to gain clout at the negotiating table.

However, the events of August 2008 sent a strong signal to all involved in the South Caucasus security complex. First of all, they were reminded how destructive war can be. For the Azerbaijani side, the risks involved in challenging Russia’s allies militarily became evident. True, Nagorno-Karabakh (unlike South Ossetia and Abkhazia) does not have a common border with Russia; there are no Russian peacekeepers there, and President Aliyev probably would not have miscalculated as badly as Georgian President Mikhail Saakashvili, the prospect of waging a “short and victorious war” to take back Karabakh must have lost some of its attraction. The Georgian–Russian crisis may also have been decisive in forging the November 2008 Armenian–Azerbaijani joint declaration, the first of its kind since the ceasefire agreement of 1994. The declaration involved a minor concession from the Azerbaijani side – agreeing to confidence-building measures was unprecedented and represented a small step away from the uncompromising line Azerbaijan had previously adhered to in the negotiations. Prior to this, building confidence with “an occupying force” had been unthinkable for Azerbaijan. While the declaration is a positive step, in a context where setbacks are all too common, confidence-build-

ing measures are not a particularly costly concession for Azerbaijan to make. The credibility of the confidence building has also been seriously undermined by President Aliyev's resumption of belligerent statements in his 2009 New Year's address.

The events of August 2008 have also proven a point that the Georgian side has been eager to make to the international community, one that has its parallel in the Azerbaijani view on Russia's role in the mediation of the Nagorno-Karabakh conflict. That is the conviction that the Russians are not, and should not be perceived as, neutral in the mediation of the territorial conflicts in the South Caucasus. The bias is reflected in Russia's unilateral recognition of Abkhazia and South Ossetia as independent states. Despite the international criticism of Russia's policies, nothing has changed in the actual negotiation setup.

Russian Foreign Energy Policy

During the post-Soviet period, the Russian authorities have shown economic muscle in several ways, but it is particularly within the energy sector that they have employed market power to reach strategic aims. The current energy dependence of several former Soviet republics is partly a heritage from the Soviet period, partly a consequence of Russia's continuing subsidizing of energy for its neighbors during the post-Soviet period, and partly a result of strategic Russian acquisitions after 1991. The debates about foreign energy policies notwithstanding, it seems clear that Russia's energy trade remains entangled in multiple and complex ways with foreign policy issues.

The fact that several former Soviet republics are completely dependent on energy supplies from Russia has facilitated Moscow's ability to maintain economic and political leverage in what it sees as Russia's legitimate sphere of influence. As a major oil and gas producer, Azerbaijan (in contrast to Armenia, Georgia, Ukraine and Belarus) has been a net energy exporter since the break-up of the Soviet Union. Particularly since 2004, Azerbaijan has become increasingly independent of Russian energy imports. Also where former Soviet republics are net exporters of energy, Russia has taken advantage of the market power that follows from its control over important transit routes. For example, until a few years ago, Azerbaijan and Kazakhstan were dependent on energy transport through Russian pipelines, giving them a poor negotiating position over transit fees and prices. In terms of energy exports, Azerbaijan was dependent on the Russian pipeline network for its oil and gas exports until the BTC oil pipeline from Baku

via Tbilisi to Ceyhan went online in 2005, breaking Russia's monopoly on the transit of Caspian petroleum. The completion of the South Caucasus Pipeline in 2006, allowing for the export of Azerbaijani gas independently of Russia, further strengthened Azerbaijan's energy independence. In the first instance, this means that Azerbaijan need not defer to Russian pressure, whether in the form of a transit blockade or cutting off natural gas exports to Azerbaijan. For Russia, this means it is deprived of the energy tool in its relations with Azerbaijan and must rely on other methods to keep Azerbaijan within its fold.

Azerbaijan as Georgia's New Energy Patron

An analysis of Georgia's energy imports in recent years illustrates the perils of depending on Russia for energy, the Azerbaijani ambition to become a regional leader, and its will to use its energy resources and wealth towards this end. In 2006, Gazprom demanded a more than a doubling in the price of its natural gas (from USD 110 to 235 per 1000 bcm) from both Georgia and Azerbaijan, while Armenia managed to negotiate a continuation of the previous preferential rate of USD 110. Even before the proposed price hike, Georgia had sought unsuccessfully to negotiate an increase in the amount of additional Shah Deniz gas which it, as a transit country, could purchase from Baku. While Georgia was dependent on foreign gas supplies, Azerbaijan had the opportunity to choose between continued imports from Russia for domestic consumption and the export of its own Shah Deniz gas to Western markets, or meeting its own demands with the Shah Deniz gas and postponing the export of the gas. Azerbaijan initially planned to continue importing Russian gas to meet high domestic demands, but – possibly motivated by anger that Armenia still received the preferential rate – chose to intensify its gas production, so as to be able to stop importing Russian gas. The decision to cut Russian gas imports and to provide Georgia with natural gas at only USD 120 per 1000 bcm did not come without a price tag: Azerbaijan lost possible revenues from gas exports to Turkish markets. One could perhaps go so far as to argue that Azerbaijan has undertaken the cost of subsidizing Georgia, a task it has taken over from Russia, whose relations with Georgia have spiraled steadily downwards since 1988.

In a move that makes the Azerbaijani use of its energy wealth look even more like the Russian take-over of Armenian energy assets, the Azerbaijani state oil and gas company SOCAR purchased significant parts of the Georgian gas distribution network at the end of 2008,

and is contractually committed to supplying Georgia with natural gas for five years at a price that enables Georgia to maintain its current gas tariff for households unchanged. The combination of this asset acquisition with Azerbaijan's subsidies for Georgia raises the question of what political influence the country has gained in Georgia. Baku certainly has new possibilities available now that it is no longer dependent on Russia for transit. Also, Azerbaijan has showed both skill and caution in its own use of the energy card: While supporting Georgia through a difficult period in Georgian–Russian relations, Azerbaijan has managed to increase its regional strength by taking over the role as Georgia's energy patron. At the same time, striking a conciliatory tone and making its moves in Georgia with great caution and discretion, Azerbaijan has also largely managed to avoid antagonizing Russia.

Prospects for the Trans-Caspian Pipeline

At present, discussions concerning the possible construction of a Trans-Caspian Pipeline that would provide the BTC with Central Asian oil after the expected peak in Azerbaijani production represent a possible next standoff in Azerbaijani–Russian energy relations. Since the construction of the BTC pipeline, Kazakhstan and Azerbaijan have been negotiating the terms of transporting Kazakhstani oil. Feeding Kazakhstani oil into the pipeline would increase BTC profitability, as reserves in the Azerbaijani oil field Azeri-Chirag-Guneshli are projected to peak in 2010. Kazakhstan's 2006 pledge to provide 53 million barrels a year, with an eventual staged increase to 175 million barrels a year, is therefore vital to Azerbaijan as a transit country and to the BTC investors. However, as tanker traffic across the Caspian Sea since late 2008 has started transporting Kazakh oil to Baku ports for further export through the BTC, a costly pipeline no longer seems to be the only way to increase the volumes exported through the BTC. In fact, it seems that tanker traffic may give key actors on both the Kazakh and Azerbaijani sides a vested interest in maintaining such traffic, as the crony capitalism in both countries is shaping the politico-economic environment in which the future of the Caspian energy transport system is to be decided.

The Balance in Azerbaijani–Russian Relations

Russia is largely deprived of energy leverage vis-à-vis Azerbaijan, but still holds several other cards. The size-

able Azerbaijani diaspora working in Russia, whose members provide significant remittances, may become subject to Russian pressure, just as the Georgian one was in 2006. Also, Moscow's status as a Minsk Group co-chair means that it continues to play a key role in the policy area of greatest concern to Azerbaijan, thus reducing Baku's leeway to ignore Russian demands. These factors, however, do not change the fact that Azerbaijan is independent of Russia for the transport of its petroleum resources.

Conclusions

Azerbaijan's energy deals with Georgia since 2006 have given the latter a new energy patron. Due to its energy independence, Azerbaijan was able to do this without suffering any reprisals from the Russian side. It remains to be seen how Azerbaijan will employ the political leverage obtained through the energy deals with Georgia. Here we should note that Armenia is dependent on gas imports from Russia supplied through pipelines on Georgian territory. Whether or not this is possible at present through the Azerbaijani control of parts of the Georgian gas distribution networks, Azerbaijan may, through future asset acquisitions in Georgia, be in a position to block the transit of Russian gas to Armenia. It does not take much imagination to picture this as a way for Azerbaijan to put pressure on Armenia in the negotiations over Nagorno-Karabakh. Azerbaijan, which is likely unable to compete with Russia on military terms, might be able to use its energy wealth to gain an upper hand with regard to Nagorno-Karabakh.

Despite Azerbaijan's relative success in not antagonizing Russia until now, there is still a significant risk that Azerbaijan's energy interests and ambitions may collide with Russian ambitions and interests in the future. The most imminent risk is a controversy over the transport of Central Asian oil and gas across the Caspian Sea to Azerbaijan. However, the global credit crunch and falling commodity prices could work against the construction of the Trans-Caspian Pipeline – although these factors are just as likely to undermine Russia's competing South Stream project. If both are weakened, the consequence of the financial crisis will be to delay the geopolitical race surrounding Azerbaijan. If the financial crisis proves short-lived, both projects may stay on the table, and the game will go on.

Please see overleaf for information about the author, further reading, and a table.

About the author

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Further reading

- Farid Guliyev and Nozima Akhrarkhodjaeva, “Transportation of Kazakhstani oil via the Caspian Sea (TKOC). Arrangements, actors and interests”, RUSSCASP Working paper, 18 November 2008.
- Heidi Kjærnet, Indra Øverland, and Andrea Kendall-Taylor, eds., *Caspian Petro-Politics: Azerbaijan, Kazakhstan and Turkmenistan*, (Routledge, forthcoming 2009).

**Table 1: Azerbaijan: Energy and the Economy
(In Million Nominal USD unless otherwise indicated)**

	2003	2004	2005	2006	2007	2010
Oil Production ¹	320	319	441	648	860	1.300
Oil Exports ¹	215	204	314	521	721	
FDI ²	3.285	3.556	1.680	-219	-4.750	476
Oil Sector FDI ²	3.246	3.461	1.459	-573	-5.198	366
Oil Sector Revenue	886	946	1.337	2.921	5.272	19.417
as share of total rev (%)	42%	38%	39%	51%	59%	-
as share of GDP (%)	-	-	9.8%	15.0%	19.7%	43.3%
Oil Fund Assets	816	972	1.394	1.936	3.093	36.387

¹ Thousand barrels per day, ² Foreign Direct Investment

Oil Production Source: US Energy Information Administration, *Short Term Energy Outlook*

Other indicators from IMF, *Article IV Consultation – Staff Report, No. 07/191. June 2007.*

Retrieved from the U.S. Energy Information Administration:

<http://www.eia.doe.gov/cabs/Azerbaijan/pdf.pdf> (accessed 10 February 2009).

The articles in this issue of the Russian Analytical Digest were written as part of the research project “RUSSCASP – Russian and Caspian energy developments”, financed by the PETROSAM program of the Research Council of Norway. The project is carried out with the Fridtjof Nansen Institute, the Norwegian Institute for International Affairs and Econ Pöyry as consortium partners and also includes other institutions and researchers.