Analysis

Turkmenistan's Relations with Russia

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Abstract

This article analyses the interaction of domestic and external considerations in determining Turkmenistan's choice of routes for its natural gas exports and the implications of this for Turkmen-Russia relations. Turkmenistan has abundant supplies of natural gas, possessing the largest reserves in the former Soviet Union with the exception of Russia. As a result, Turkmenistan plays an important role in CIS gas supplies and issues surrounding gas dominate Turkmen-Russian relations. Turkmen gas bought at below EU prices traditionally has enabled Gazprom to balance low domestic prices with lucrative exports to the EU. This situation has, however, been under challenge since 2006: intra-CIS gas trade is becoming more transparent, Central Asian suppliers have bargained for higher prices from Russia, and there is competition to build pipelines for exporting Turkmen gas to non-CIS markets. These developments promise to weaken Turkmen-Russian links, but their effects could be negated by technical developments which may undermine Turkmenistan's competitiveness as a gas supplier to non-CIS customers.

Turkmenistan under Turkmenbashi

Economic development of the Turkmen Soviet Republic centred on replacing its population's nomadic lifestyle with collective farms, primarily to grow cotton, and on investment in natural gas production during the 1980s. In the early 1990s, Turkmenistan's newly independent and nationalistic leadership blamed Soviet planners for the lack of diversification in its economy, whereby only about ten percent of the workforce were employed in manufacturing. Nonetheless, with readily exportable cotton and gas, the new, independent country was able to survive the dissolution of the USSR with minimal economic change.

Saparmurat Niyazov, or Turkmenbashi the Great as he preferred to be known, established a highly centralized regime. Major decisions at all levels of government had to be cleared by the President's office, and any opposition was ruthlessly suppressed. The economy continued to be highly regulated, and remains essentially unreformed. Apart from cotton and gas revenues, the economic goal was self-sufficiency reflected in increased output of wheat and promotion of import-substituting industrial projects. In conjunction with the aim of self-sufficiency, Turkmen foreign policy was defined by neutrality, formally recognized in a 1995 UN resolution.

Turkmenistan's national economy remained the simplest of all the Soviet successor states. Rents from cotton and gas exports accounted for between two and three-fifths of GDP in the 1990s. In 1990–2 Turkmenistan was the world's sixth largest cotton producer with an average harvest of around 1.4 million tons, but a mixture of policies to divert acreage from cotton to wheat, poor maintenance of the irrigation system, and lack of incentives for cotton farmers, to whom the monopoly state marketing board paid well below the world price for their production, led to stagnation of cotton output. Annual gas production fell from around 60 billion cubic metres (bcm) in 1992–3 to 30–33 bcm in 1994–6 and to half of that in 1997 and 1998, when supplies were cut in response to non-payment by Ukraine.

Turkmenbashi created an aura of benevolent autocracy with free provision of gas, electricity, water and salt for residential use, plus low cost public housing, and other subsidized goods and services. However, a considerable amount of gas royalties and cotton revenues went to off-budget funds under the President's personal control; much was spent on monumental projects, mostly to honor the President and to reinforce a personality cult. The 1997–8 shocks of Ukraine's non-payments for gas and of Russia's financial crisis coincided with increasingly authoritarian rule in Turkmenistan. Despite the inefficiencies, the system which looked to be in trouble in the late 1990s was sustained by rising energy prices. After 1999 the state focussed exclusively on maintaining the flow of gas exports, which strengthened dependence on Russia because, apart from a small pipeline to Iran opened in 1997, all of Turkmenistan's gas exports went north through Russian-controlled pipelines. No reforms were envisaged before December 2006 when Niyazov died.

Turkmenistan's Natural Gas

Turkmenistan's Soviet era gas fields are in the east of the country, connecting it to other parts of the former USSR via the Central Asia – Centre pipeline network. Russia refuses to allow Turkmenistan's gas to

transit to the lucrative European markets, restricting Turkmenistan's gas exports to CIS markets. Increased exploitation of western gas fields highlighted the need for new pipelines, and in the 2000s rising energy prices brought Turkmenistan into greater international focus. The temptation to find new customers for Turkmen gas became overwhelming; the reclusive President Niyazov rarely travelled after 1997, but even he made an official visit to Beijing in April 2006 to discuss the construction of a new pipeline.

Imports from Turkmenistan are a key item in Russia's demand/supply equation, and the price paid for those imports impact on Gazprom's profitability. The delivery price of Russian gas to Western Europe varies according to a formula which includes (lagged) oil prices. Gas prices paid by the EU tripled after 2002, peaking at $500 per 1,000 m^3 in the last quarter of 2008, before falling to a 2009 range of $250–300. Prices in Russia are much lower: in 2006 Gazprom's domestic industrial consumers paid an average $44 per 1,000 m^3 and residential consumers much less, while the price paid by the EU averaged $240. Turkmenistan's sales to Russia free up Russian gas for export to Europe; the lower the price paid for Turkmen gas and the greater the amount of Turkmen gas that could be sold to Russian domestic consumers, the higher Gazprom's profitability.

Until 2005 Turkmenistan's gas exports were non-transparent, with payment by barter to shady intermediaries. In the 2003–5 contract with Russia, for example, half of the price of $44 per 1,000 m^3 was to be paid by barter, with potential for large-scale corruption through arbitrary valuation. Following the 2004 Orange Revolution, Ukraine announced that its July 2005 contract with Turkmenistan would not involve barter terms, and in April 2005 Russia and Turkmenistan agreed that Gazprom would make all payments in cash. The role of intermediaries in gas transactions involving Russia, Ukraine and Turkmenistan was terminated in an agreement in March 2008. Intra-CIS trade was largely insulated from the rapidly increasing EU gas prices until 2006. However, since then the price Turkmenistan charges for its gas has increased. Turkmenistan's price from Gazprom, $44 per 1,000 m^3 in 2003–5, was increased to $65 in January 2006. In September 2006 Turkmenistan negotiated a further increase to $100 per 1,000 m^3 for 2007–9, and in November 2007 this was raised to $130 for the first half of 2008 and $150 for the second half of 2008.

Thus, Russia has been prepared to increase the price paid for Turkmen gas in order to secure gas supplies for the domestic market and to discourage Turkmenistan from non-Russian pipeline projects. Russian production from its Siberian fields is past its peak; future output will be from Arctic gas fields, which will not come online before 2011, and the difficult conditions in this region could delay development. Meanwhile, Russia is looking to Central Asia for gas, which primarily means Turkmenistan. Uzbekistan will supply about 12bcm a year to Russia until 2012; Uzbekistan's production is not much lower than that of Turkmenistan, but with a much larger population most is consumed domestically. Kazakhstan's gas production is lower, but large new gas fields are coming into production, which are located close to the Russian border. In March 2008 Gazprom announced that it would pay 'European' prices for Central Asian gas in 2009, i.e. in the range of $200–300 per 1,000 m^3. The announcement was part of a strategy of encouraging Central Asian countries to retain Russia as their principal market and not to agree to new pipeline routes.

Pipeline construction is often politicized as, for gas even more than for oil, it is by far the most efficient means of transport; infrastructure determines the direction of trade flows. Non-Russian pipelines could run south to Iran, southeast to Pakistan and India, east to China or west across the Caspian Sea to Turkey and the EU, but pipelines are expensive. The high fixed cost of pipeline construction made investment in new routes unattractive in the 1990s, but as energy prices rose after 1998 the share of transport costs in the delivered price declined and non-Russian buyers and sellers began to investigate new pipelines. To some degree, choices are mutually exclusive; pipelines are large-scale projects with economies of scale, and the amount of gas available for shipment limits the number of viable pipelines.

Turkmenistan's first non-Russian gas pipeline was built to Iran in 1997 with an annual capacity of 8 bcm, but larger projects through Iran have been stymied by US threats of sanctions against companies doing business with Iran. Negotiations in 1997 with Unocal to construct a pipeline through Afghanistan to South Asia collapsed as the US government drew back from relations with the Taliban government; this route is still on Turkmenistan's agenda, but until Afghanistan's (and Pakistan's) government can provide reasonable security guarantees it remains a distant prospect. Following Turkmenbashi's April 2006 visit to Beijing, construction began on a 7,000 kilometre long pipeline to China via Uzbekistan and Kazakhstan, which was formally opened in December 2009; China has committed to buy 30 bcm a year, a target which should be reached in 2011.

In May 2007 Russia, Turkmenistan and Kazakhstan signed an agreement to build a 10 bcm a year pipeline along the eastern coast of the Caspian, the Prikaspiisky route, feeding into the Russian pipeline network. In December 2007 the proposed capacity of the Prikaspiisky pipeline was doubled, to carry 10 bcm from both Kazakhstan and Turkmenistan, and in 2008 it was increased further to accommodate larger deliveries from Turkmenistan. Construction has, however, not begun and critics question whether the pipeline will ever be built. The December 2007 agreement also called for modernization of the existing Central Asia – Centre pipeline from Turkmenistan through Kazakhstan to Russia, intended to increase its annual capacity from the current 50+ bcm a year.

Several proposals to construct a gas pipeline under the Caspian Sea and then to Turkey were aired during the 1990s and early 2000s, but the project was limited to the Baku-Erzurum pipeline from Azerbaijan to Turkey which opened in 2006. The TransCaspian portion was resurrected when relations between Turkmenistan and Azerbaijan warmed after Turkmenbashi's death, and in August 2007 the USA granted $1.7 million to Azerbaijan for a feasibility study. The TransCaspian would link up to the Baku-Erzurum pipeline and the proposed Nabucco pipeline from Turkey to Hungary. The feasibility of the TransCaspian and Nabucco projects is linked, because Turkmen supplies are needed to justify Nabucco's capacity.

Turkmenistan's leadership knows that pipelines through a greater variety of countries will increase its bargaining power, but the Prikaspiisky project offers an advantage when it comes to timing. Rather than waiting until 2012 (or later) for Nabucco and an unknown gas contract with European buyers, the Prikaspiisky project offers an earlier inflow of cash from Russia. With two major pipeline routes running north, however, Turkmenistan would remain dependent on Russia as the main purchaser of its gas.

Turkmenistan after Turkmenbashi

After the death of President Niyazov in December 2006, Gurbanguly Berdymukhamedov became President, and in 2007 consolidated his power. The change of leader created the prospect of policy change, although to date reforms have been minimal. Heavy-handed regulation continues to characterize almost all of economic life.

In foreign relations the new president made a cleaner break. In 2007 President Berdymukhamedov visited New York, Brussels, Moscow and Tehran, welcomed Recep Tayyip Erdogan, Vladimir Putin and Hu Jintao to Ashgabat, and sent observers to meetings of regional organizations. Despite the greater engagement with the wider world, the substance of Turkmen energy policy has not yet changed much. Turkmenistan's gas pipelines still pass overwhelmingly through Russia, with the proposed Prikaspiisky and upgraded Centre pipelines promising to increase annual capacity to over 80bcm. The 30 kilometer pipeline to the Iranian border opened in December 2009 will increase export capacity to Iran to perhaps 20 bcm. China is the new variable in the equation since its pipeline from Turkmenistan opened in December 2009, but the projected flow of 30 bcm in 2011 will be well below the capacity of Turkmenistan's pipelines to Russia.

Western plans to construct a TransCaspian pipeline to access Turkmen gas without transiting Russia are threatened by the prospect that Turkmenistan will have insufficient natural gas to supply a TransCaspian pipeline, as well as meeting other existing commitments. Turkmenistan has agreed to supply 80 bcm a year through Russia and 30 bcm to China by the 2020s, as well as up to 14 bcm to Iran which could increase to 20bcm, and perhaps to the EU and South Asia. If gas production (82 bcm in 2008) can be doubled over the next decade and a half, then these commitments and dreams might be satisfied. Otherwise, Russia is in the pole position due to its control over the established pipeline, with China well-placed, having completed the construction of a pipeline, and other potential buyers nowhere as they will not build pipelines without gas to fill them.

Russia will resist a TransCaspian pipeline, and it has more leverage in the Caucasus than China. However, two forces favor western pipelines. First, Western influence in Turkmenistan may be strengthened by the technical edge of its energy sector firms, as the technically difficult exploitation of offshore fields highlights the need for cooperation with foreigners with the necessary expertise. Second, in 2008 President Berdymukhamedov hired a British firm to conduct an independent audit of Turkmenistan's gas reserves; the firm's initial reports suggest that previous estimates of reserves totalling 3–5 trillion cubic meters are far below the mark, and that there is plenty of gas to fulfil Turkmenistan's existing obligations and to fill new pipelines to the West – as long as it can be exploited. The first contracts to exploit the South Yolotan field, projected to produce 30 bcm per year, were allocated in December 2009 to firms from China, South Korea and the United Arab Emirates. US and EU firms were disappointed to be excluded, but the Turkmenistan gov-

ernment has stated that it would prefer western firms to exploit the abundant, but more technically challenging, offshore fields.

Conclusions

Turkmenistan has been poorly run since independence. The inherited natural resource wealth has been dissipated by mismanagement and by misuse of the rents from cotton and natural gas. Turkmenbashi's prized neutrality left the country dependent on Russia, which controlled the pipeline outlets. Whether his successor, President Berdymukhamedov, is serious about reform is of great importance, because without reform the economy will remain dependent on revenues from gas exports and without reform Turkmenistan will be less able to increase gas production and hence improve its pipeline options.

The external situation is in a state of flux. In CIS gas markets, greater transparency since 2006 has been accompanied by price increases, as the gap between prices paid by the EU and prices on intra-CIS sales have narrowed. Gas deals have often had a geopolitical component, with Russia more willing to put pressure on Georgia or Ukraine after the Rose and Orange revolutions of November 2003 and November 2004, and to keep Central Asia within its sphere of influence. So far Russia has remained Turkmenistan's major market, even though it has had to accept the opening of pipelines from Turkmenistan to China and Iran.

The increase in prices offered by Russia for Central Asian gas was poorly timed as world energy prices and EU demand both dropped substantially in 2008–9. In the short-term, Russia reacted by reducing its gas purchases from Turkmenistan; supply was first reduced by an April 2009 explosion in the pipeline which Turkmen sources believed to be a deliberate disruption and then cut as part of a pricing dispute which lasted for most of the remainder of the year. These episodes confirmed Russia's willingness to play hardball and sidestep contractual commitments when it saw an economic advantage in doing so. Under current market conditions and in light of Gazprom's dubious technical capacity, several observers question whether the Prikaspiisky pipeline will be built as planned. Nevertheless, in the longer term Russia will aim to keep Turkmenistan in its sphere of interest and oppose pipelines that threaten its monopoly power.

Finally, Turkmenistan's future prospects as a gas exporter could be affected by new technical developments in transporting liquefied natural gas (LNG). Advances in liquefying gas, in specialized LNG ships and in degasification terminals are eroding the position of pipelines as the least-cost delivery method for gas, and this will benefit suppliers with ocean port access, such as Qatar or Australia, at the cost of landlocked suppliers, such as Turkmenistan. Russia itself is embracing LNG as the delivery mode from its newest gas fields in the Far East and the Arctic. In the EU, large new regasification facilities in Spain, the UK, Italy and elsewhere allowed gas importers to buy LNG on the world spot market in 2009. Even if Turkmenistan can increase its gas production substantially, the development of an LNG spot market will undermine the rationale for investing in expensive pipelines such as the TransCaspian-Nabucco route. In this scenario, Turkmenistan, as a high-cost supplier to the world market, would most likely return to being a poor isolated economy under Russian hegemony.

About the Author

Richard Pomfret is Professor of Economics at the University of Adelaide in Australia. His most recent book is *The Central Asian Economies since Independence* (Princeton University Press, 2006).

Further Reading

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- Gregory Gleason, Turkmenistan under Niyazov and Berdymukhamedov, in Robert Rotberg(ed.) *Worst of the Worst: Dealing with repressive and rogue nations* (Brookings Institution, Washington DC, 2007), pp. 115–34.
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- Richard Pomfret, Turkmenistan's Foreign Policy, *The China and Eurasian Forum Quarterly 6(4)*, November 2008, pp. 9–34 – available at http://www.isdp.eu/cefq
- Richard Pomfret, "Turkmenistan and EU Gas Supplies," in Pascaline Winand (ed.) *Securing Sustainable Energy Supplies in Europe and Australia* (Peter Lang, Bern, forthcoming)