

# Strategies for Energy Development in Central Asia: International Implications

**Pauline Jones Luong**  
**October 1997**  
**PONARS Policy Memo 22**  
**Harvard University**

The possession of rich reserves of oil and gas on their respective territories destines the Central Asian states neither for healthy market economies and democratic governance nor for the establishment of rentier economies and authoritarian rule. Rather, as we have seen in other parts of the world (such as Venezuela, Indonesia and Saudi Arabia), the economic and political outcomes in Kazakstan, Uzbekistan, and Turkmenistan clearly depend upon their strategies toward developing these resources. Likewise, although it is virtually impossible for the energy-rich states of Central Asia to avoid entanglement in international affairs, whether these relations are peaceful or conflictual also depends upon the particular strategies they choose to pursue.

In sum, the present direction of the Central Asian states' respective energy development strategies have several future implications that should be of great concern to US policymakers. Central Asian strategies for energy development are increasing tensions and the potential for conflict amongst themselves as well as with outside states. More specifically, the direct and prominent role of the international community is, perhaps unwittingly, contributing to both these rising tensions and the growing potential for violent conflict in the region.

## **STRATEGIES TOWARD ENERGY DEVELOPMENT IN CENTRAL ASIA**

Each of the energy-rich Central Asian states is actively searching for something--or someone--to ease the challenge of developing its resources. Each state has to look outside itself to exploit its oil and gas reserves since none possess the requisite technology, technical experience, and of course capital. Yet, they are appealing to external sources and actors in different ways and to different degrees. In the paragraphs that follow, I briefly describe their current strategies in terms of what they are seeking most from the development of their energy reserves, which I classify as the three "S"-es: they seek either Suckers (Kazakstan), Self-Sufficiency (Uzbekistan), or a Strategy (Turkmenistan).

### **Kazakstan: Desperately Seeking "Suckers"**

Currently, Kazakstan is engaged in the rapid privatization of state companies associated with the development of its energy resources, which include oil and gas as well as coal. As part of this privatization scheme, the Kazakh government expects--indeed insists upon making explicit in contracts--that the foreign buyers or investors are fully willing and able to take on the liabilities and social responsibilities associated with their new acquisition. These appear in the form of guaranteeing back-pay to workers, full retention of the existing labor force, building new or improving existing schools and hospitals, and promising to implement international

environmental protection standards. In addition, the government of Kazakhstan expects foreign companies that win tenders to develop Kazakh energy reserves to solve problems related to exporting them. These export problems directly involve the Russian companies Lukoil and Gazprom, both of which have blocked Central Asian access to pipeline routes. Foreign companies active in Kazakhstan's energy sector, therefore, often find themselves compelled to include Lukoil and Gazprom in their business ventures. This is true not only of the Caspian Sea energy reserves, but also of the Karaganchak gas field, for which British Gas was forced to give Gazprom a 15% stake in order to guarantee export through the only existing pipeline through Russia to the West.

Another component of the Kazakhstan government's strategy is to bring in as many companies as possible in order to promote competition between them and to ensure that no one company (or country) dominates the development of its energy reserves. It is therefore eager to sign as many deals as possible. In fact, the recent (March 1997) government reorganization was aimed in large part at making it easier for more foreign companies to invest, particularly "newcomers." This aspect of the Kazakhstan government's development strategy is directly linked to its desire to secure as many alternative pipelines as possible to the existing ones through Russia in order to reach Western markets, which also requires substantial foreign investment. In recent months, several pipelines have become real possibilities due to increased foreign interest and activity: (1) through Transcaucasia (Grozny and Baku) to the Mediterranean Sea via Turkey; (2) through Iran to the Persian Gulf; (3) through Turkmenistan and Afghanistan to Pakistan; and (4) through China to the Far East (primarily Japan).

### **Uzbekistan: Desperately Seeking Self-Sufficiency**

In contrast to Kazakhstan, the government of Uzbekistan's primary goal is to be completely self-sufficient in energy so as to maintain both economic and political independence from Russia, who it perceives to be its greatest competitor for influence in the region. As part of this strategy, Uzbekistan will continue to rely on cotton exports in order to generate hard currency and to conserve its energy for present and future domestic use. Revenues from the sale of cotton abroad are currently utilized to maintain the very large government budget, of which taxes make up only a very small part. The government thus retains social control over its subjects, rather than fostering a reciprocal relationship with its citizenry. In addition, Uzbekistan has implemented a policy of domestic energy conservation so as to keep open the possibility of acquiring revenue from selling reserves abroad and utilizing them in the same manner.

The government of Uzbekistan is also much more cautious than Kazakhstan with regard to privatization. It is reluctant to reduce state control over the economy to any degree. Moreover, it insists upon maintaining and protecting existing government monopolies over natural resource development. The government monopoly-turned-state company Uzbekneftegas still holds all shares and controls all production and flows of oil and gas. Thus, foreign investment has been minimal, and restricted primarily to reconstructing or building refineries.

### **Turkmenistan: Desperately Seeking a Strategy**

Unlike both Kazakhstan and Uzbekistan, the government of Turkmenistan has been more or less undecided about how to develop its energy reserves, which consist primarily of natural gas. Initially, Turkmenistan was content to continue "business as usual" by providing exports

primarily to other CIS countries via Soviet-era pipelines. This was largely due to President Niyazov's reluctance to open his unreformed country to foreign investors. This strategy, however, was no longer viable after 1993, when the Russian Federation claimed ownership over all Soviet-era pipelines on its territory. The Turkmenistan government's need to re-think its approach--including a greater role for foreign investment--became more pressing as its economy suffered due to a virtual halt in its gas exports and its hold over the population appeared increasingly tenuous as a result.

The Turkmenistan government's response to this situation was two-fold. First, it actively began to seek alternative pipeline routes for its gas to reach Western markets, including one through Afghanistan to Pakistan and another through Iran to the Persian Gulf. Secondly, it resigned itself to the need to develop relations with foreign investors. This was no easy task, since Turkmenistan had treated its first foreign investors (Argentina's Bidas and Holland's Larmag) with disdain--going as far as to unilaterally re-write their contracts without notice. Yet, beginning in the Spring of 1996 the government of Turkmenistan began making a concerted effort to assure new potential foreign investors that it had learned its lesson and would honor written contracts in the future. In addition, Turkmenistan has undertaken legal and structural reform (streamlining) in accordance with Western standards and decided to shift from issuing tenders to direct negotiations with foreign companies. With the US government's recent acquiescence to the pipeline through Iran, Turkmenistan also has potential new pipelines to attract foreign companies.

The Turkmenistan government has also been undecided about the key issues surrounding the development of Caspian Sea oil reserves. In fact, it has changed its position three times regarding the proper definition of this body of water as a "lake" or "sea" and its consequent division among the five littoral states, of which it is one. Most recently, it has sided with the position supported by Kazakstan and Azerbaijan--definition of the Caspian Sea as a "sea" and its division into five privately owned and operated sectors--in order to gain access to certain oil fields that lie between what would be declared Turkmen and Azeri waters (including Azeri, Chirag, and Kiapaz/Serdar). Currently, the Turkmenistan government seems more or less committed to this position, yet its close relations with Iran also make this strategy somewhat tenuous.

## **INTERNATIONAL IMPLICATIONS**

There are several serious implications for the future of foreign relations between the Central Asian states themselves as well as with other neighboring states, including the breakdown of regional integration within Central Asia, deteriorating relations with the Russian Federation, the growing influence of Iran and China in the region, and the direct role of the international community in exacerbating all of these developments. This should interest US policymakers who are concerned about trends toward increased hostilities in the region.

### **Relations Among the Central Asian States**

The most important implication for relations among the Central Asian states themselves concerns the future of regional integration. Up to now, the Central Asian states have been cooperating with regard to most economic development issues. Their strategies toward energy development,

however, are an exception to this rule and in fact are currently undermining economic regional integration. For example, Kazakhstan and Uzbekistan's energy development strategies of export and conservation, respectively, conflict with existing barter agreements whereby Kazakhstan and Uzbekistan provide their energy-poor neighbor, Kyrgyzstan, with coal and gas, respectively, in exchange for water. This is disconcerting, to say the least, because it increases the potential for conflict between these states over vital natural resources, such as water. There is precedent for this type of conflict, since several localized disputes over access to water and land have already occurred in the region. Moreover, the breakdown of regional economic integration decreases the Central Asian states' incentives for cooperation in other spheres--such as security.

Large-scale conflict between the Central Asian states may seem unlikely in the short term, given their ability thus far to settle resource-related conflicts peacefully and maintain civil relations. However, it is necessary to consider the fact that this may only last the terms of those now in office since they were educated and advanced politically within the same (Soviet) system, and happen to know one another personally. Moreover, the resolution to some of these conflicts requires the aid of international organizations; the temporary maintenance of pre-existing barter agreements, for example, is dependent upon international organizations paying the transaction costs of negotiating them annually as well as compensating each state.

### **Central Asian Relations with Russia**

Overall, relations between the energy-rich states of Central Asia and Russia have worsened as a result of these countries' respective energy development strategies. This is not surprising, since these strategies are either driven by a desire to achieve economic and political independence from Russia at any cost or are being undermined by Russian intransigence--with the latter reinforcing the former. This is particularly the case for those states which have chosen the development of energy for export as their primary strategy. Gazprom has done its best to cut off the Central Asian states from CIS and European markets by denying them access to pipelines, in an effort to eliminate its competition. As a result, Turkmenistan has lost up to 30% of its budget revenues, while Gazprom continues to dominate these markets and plans to increase its share by shipping its own gas out through Turkey via a pipeline under the Black Sea. Similarly, Gazprom has also blocked Kazakhstan's agreement with Hungary to ship gas to this East Central European country in exchange for its financial support to develop one of Kazakhstan's gas fields.

Contrary to conventional wisdom, tensions between these countries and the consequent deterioration in diplomatic relations will not be resolved merely by the construction of alternative pipeline routes. Central Asia is also held hostage by Russia, so to speak, due to its presumed military prowess, and indeed military presence (i.e. Tajikistan, Afghanistan) in the region. With the possible exception of Uzbekistan, none of these states have any real source of military strength with which to challenge or counter-balance Russia's influence in the region. They are therefore reluctant to antagonize Russia, which often comes in the form of encouraging deals that include Russian oil and gas companies. Turkmenistan is a case in point. The impetus for bringing Russia into the two latest pipeline deals--i.e. to Pakistan via Afghanistan and through Iran to the Persian Gulf--came from the government of Turkmenistan itself. This gives Russia a stake in maintaining peaceful relations both within and between the region and itself, if it wants to collect its share of the revenue. Even Kazakhstan--and Azerbaijan, for that matter--

have supported the participation of Russian oil companies in their developments in the Caspian Sea for similar reasons.

In addition, the Central Asian states need to develop institutions to manage foreign relations with Russia. Relations between the Central Asian states and Russia are relatively peaceful and civil now because the current leaders for the most part know one another, and have tacitly agreed to avoid violence. Yet the danger here is that no institutions are being constructed to manage foreign relations with Russia in the future. Rather, relations remain very personalized. Thus, there is no guarantee that violence will not become a viable strategy in the future; that is, once current leaders are replaced.

### **Central Asian Relations with other Neighboring States**

Another interesting and important implication stemming from Central Asian strategies toward energy development is their expanding ties with countries in the Middle East (esp. Turkey and Iran) as well as Asia (esp. China and Japan). For example, Kazakstan and Turkmenistan have both made pipeline deals with Iran and Turkey, and are both negotiating agreements to construct a pipeline through China to the Far East with China and Japan. Kazakstan has also struck a separate deal to ship its oil to northern Iran which, in turn, ships the equivalent amount of its own oil via the Persian Gulf on behalf of Kazakstan. Kazakstan, Turkmenistan and Uzbekistan have all already sold rights to Chinese and Japanese companies to build refineries or reconstruct existing ones. Nor does the cooperation stop at the development and export of oil and gas. China has also pledged capital to assist in the development of Kazakstan's economy in a variety of other ways. Toward this end, the two countries are developing a shopping center in Almaty, which will provide space for Chinese commercial representatives in anticipation that ties will continue to expand.

From the Central Asians' perspective, all of these countries are seen as partial alternatives to dependence upon Russia. From the perspective of Turkey and especially Iran, direct participation in the economic development of the Central Asian states provides a convenient alternative means of gaining influence in the region, since their initial cultural and religious overtures were met with great reservation. From the perspective of China and Japan, the Central Asian states' rich energy reserves provide a viable alternative to energy imports from their current, somewhat limited, options. Iran, however, seems to be the biggest winner in what some have called the new "Great Game" in Central Asia. In short, it has played its position very well as both a counterweight to Russian influence in the region and yet a close Russian ally in the Caspian Sea dispute. Thus, as US policymakers seem to have realized, continued resistance to a pipeline through Iran would both contribute to Russian dominance over Central Asian export routes and promote closer Russian-Iranian relations.

### **The Role of International Actors**

In sum, the emphasis on privatization and the need for foreign capital to develop whatever energy reserves exist in a given Central Asian state, have led to a dramatic increase in the role of international actors in the region's economic and political affairs--as advisors, mediators, and investors. Perhaps unwittingly, these international actors are actually contributing to tensions and increasing the potential for conflict in some specific and unanticipated ways.

First of all, international actors representing various organizations and governmental aid agencies often serve as "advisors" to Central Asian leaders, for whom both economic control over their natural resources and selling on the world market are entirely new experiences. Not surprisingly, many of these advisors are actively promoting the rapid and complete privatization of each country's energy reserves as well as supporting their drive for self-sufficiency (as a means of independence from Russia). At the same time, however, many programs sponsored by the international community are aimed at maintaining regional cooperation and integration in other related sectors. The two goals, however, are often contradictory. For example, cooperation over the region's most valuable and scarce resource--water--requires continued barter between the governments of Kazakstan, Uzbekistan, and Kyrgyzstan for coal, gas, and water, respectively. Once coal became privatized in Kazakstan and Uzbekistan shifted its strategy to domestic consumption and conservation of gas, however, such cooperative agreements became problematic, to say the least.

Secondly, international actors have served and continue to serve as "mediators," both between the Central Asian states themselves and between these states and Russian companies. As mentioned above, in Kazakstan foreign investors are essentially left to deal with the problem of exporting oil and gas through Russia and, as a result, find themselves compelled to include Russian companies in the deals that they strike with Kazakstan. Yet their role as mediators extends far beyond even this. Oil and gas companies operating in Uzbekistan, for example, negotiate between Uzbekneftegas and its Russian counterparts Lukoil and Gazprom on a regular basis since the Uzbek government literally refuses to do so. Similarly, international organizations such as the World Bank, USAID, and TACIS consistently mediate between Kazakstan, Kyrgyzstan, and Uzbekistan in order to create and maintain water sharing arrangements. While their role as mediators has thus far mitigated violent conflict in the region, there is reason to be concerned with the growing reliance on international actors to find peaceful solutions. What will happen when these international actors leave? Moreover, US policymakers should be especially wary of international actors increasingly playing this role due to the tendency in the region to see business and government as one in the same (because often times they are). This could lead, and indeed has led to the impression that US oil and gas companies are speaking for the US government when dealing with Central Asia as well as Russia.

Finally, and most importantly, international actors are playing a crucial role as "investors" in the region. Ironically, it is this particular role which exacerbates tensions and increases the potential of violent conflict in the region--both generally and specifically. In 1991, foreign oil companies turned their attention primarily to Russia, but this changed in 1992-93 when they began to shift attention to Central Asia as a result of the various "difficulties" (lawlessness and corruption) encountered in Russia. In general, this slowdown in investment contributed to Russia's desire to maintain its control over existing pipelines as a means of extracting revenue from foreign investment in the region. It has also contributed to Russian companies' zealotry in insisting that it participate in large consortiums for oil and gas development in Central Asia.

More specifically, the direct and prominent role of foreign companies in Caspian Sea exploration and development has exacerbated the controversy surrounding the definition and delimitation of the Caspian Sea. By striking deals, forming joint ventures, and beginning to exploit the Caspian basin's oil and gas reserves before clear property rights are established, international actors are

becoming enmeshed in an unresolved conflict that has great potential to turn violent. Consider, for example, Kazakstan's (as well as Azerbaijan's) strategy of "develop now, negotiate later." This assumes that all littoral states will accept another state's right to continue to exploit an oil reserve which it has already begun developing. The Russian government, however, has recently refused to recognize ownership of oil fields which were developed before an agreement is reached. Both Kazakstan and foreign companies involved in the Caspian, therefore, have a great deal to lose if any agreement reached does not allocate them property rights to these enterprises. Rather than promoting agreement over the definition and delimitation of the Caspian Sea, the role of international actors actually makes reaching an agreement even more difficult.

## CONCLUSION

Considering these growing trends toward potential conflict in Central Asia both amongst the Central Asian states themselves and between these states and the multiple international actors who are involved in developing the region's oil and gas reserves, there is good reason for US policymakers to be concerned. At the same time, however, several steps can be taken to alleviate building tensions and to avoid the outbreak of conflict in the region. First and foremost, the US should continue to insist upon the establishment of property rights in the Caspian Sea and, if necessary, to "force" the five littoral states to the bargaining table. In addition, it should actively discourage continued development of the oil fields within the Caspian until this issue is resolved. Secondly, US policymakers should make a painstaking effort to clearly separate the US government's stance from that of the US companies operating in Central Asia. Finally, US aid organizations should make a real commitment to promoting, rather than undermining, regional integration between the Central Asian states as a way of strengthening their position vis-à-vis Russia and other neighboring states.

© PONARS 1997