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THE IMPACT OF THE RUSSIA-GEORGIA WAR ON THE SOUTH CAUCASUS TRANSPORTATION CORRIDOR



By Mamuka Tsereteli

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“What doesn’t seem to be much appreciated is that the main problem isn’t really Georgia. It’s that Georgia is the thread hanging off the tattered sweater; you pull it, and the sweater falls apart.”

– Steve LeVine, “The Sweep of Georgia’s Impact,” BusinessWeek.com, September 11, 2008

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Published in the United States by

The Jamestown Foundation

1111 16th St. N.W.

Suite 320

Washington, DC 20036

<http://www.jamestown.org>

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Executive Summary

The August 2008 war in the Caucasus revealed the new strategic realities that have emerged in the Black Sea / Caspian Region in recent years. These realities have been driven by overly ambitious Russian policies and have weakened Western strategic interests in the region. The conditions created immediately after the war appeared more favorable to Russia and less favorable to other nations in the region, most notably Armenia, Azerbaijan, Turkey, and Ukraine.

But the world economic crisis and its impact on Russia, as well as the Russia-Ukraine gas dispute in January 2009, have diminished Russia's gains and further damaged Russia's reputation as a reliable energy supplier to Europe. In the long run, Russia may face very serious problems of separatism on its own territory due to Russia's recognition of the breakaway provinces of Georgia. Given these uncertainties, it may be natural to expect that there will be stronger drive to get away from: 1) dependency on Russian energy in Europe; and 2) dependency on Russian transit infrastructure in Caspian /Central Asia region. In the long run, that may be reflected by Russia's weakened strategic position in Europe and Central Asia.

The August war in Georgia demonstrated some risks associated with the functioning of the transit energy corridor in the southern Caucasus. It also demonstrated the need for broader security guarantees for a region that is vital to European and global energy security. The most important finding of the paper is that while the corridor has a tremendous potential to augment its transit capabilities with new pipelines, railroads, marine and air ports, the security of the South Caucasus transportation corridor cannot be taken for granted. Moreover, Western countries will need to ensure stability and security in the region in order for the corridor to meet its full potential.

The Russian invasion of Georgia established new strategic realities in Eastern Europe and Central Eurasia. It was the culmination of Russia's impressive comeback in Eastern-European and Central-Eurasian affairs that has occurred in response to high energy prices, a weak US strategic position, European division and uncertainty in Turkey's strategies. The war made clear that Russia is willing to use force to deepen and promote its interests, while western powers are not. This fact was predictable, but not certain to some. The war in Georgia helped firmly establish this reality and may also indicate that even NATO members may not be fully protected by their commitment to that organization. As the Russia-Georgia conflict demonstrates, military force has once again become a major factor in Russian foreign policy. Nevertheless, economic provisions and energy incentives are still the primary tools employed by Russia to further its foreign policy interests abroad. At the same time, the weak Western response to Russian actions may send the wrong signal to the Russian leadership about the level of freedom it has to use force in what Russia considers its sphere of influence. Furthermore, the weak economy and the declining popularity of Russian leaders may create internal instability within Russia and tempt Russian leaders to once again utilize force to further their objectives. Europe and the United States need to carefully consider their policy response to such scenarios.

Another major finding of this paper is that energy is an important factor in the stability of any country and, in Georgia's case, domestic energy security is also the

foundation for stability of transit, and development of the entire regional infrastructure. The physical damage to the infrastructure and the environment in Georgia as a result of the war was tangible but not large. The damage to Georgia's transportation system is repairable in a relatively short period of time. The pipelines are gradually approaching pre-conflict volumes of the oil and natural gas shipments although the shipments via railway, ports, and air have all shown signs of decline. Instead, the key problem emerged with the malfunctioning of the largest energy facility in the country - the Enguri hydro power plant. The reservoir for the power plant is located on Georgian-controlled territory while the actual electricity production plant is located on Abkhaz/Russian controlled territory. The Georgian leadership had to make a very difficult political decision in accepting the offer of the Russian company Inter RAO (the subsidiary of the giant Russian state-owned energy monopoly Inter RAO United Energy Systems (UES)) on joint operation of the power plant. While there is a positive history of activities of the Inter RAO UES in Georgia, the Russian state-owned company's control of a key electricity supplier for the entire country is not the best political and economic security outcome for Georgia.

Lastly, the paper argues that the initial damage that the war inflicted upon the political reliability of the transit corridor is gradually diminishing and that new opportunities are emerging. The complete reversal of this damage can be possible but will depend on U.S. and EU policy, the role of Turkey, internal stability in the Caucasus region, and Russian policy in Central Asia and the Caucasus. It is important to remember that when the initial decision to revitalize the energy corridor through Georgia and Azerbaijan was made in the mid 1990s, the security environment was extremely difficult and there was no infrastructure to support shipment of oil through the corridor, yet leadership of the United States and Turkey supported that decision and helped to implement it. Today's environment is much more favorable considering the functioning infrastructure and greater demand for Caspian energy. New natural gas discoveries in Turkmenistan and the next stage in oil and gas developments in Kazakhstan and Azerbaijan will require additional export capacity and a tough battle is ahead between the different export options, each supported by state sponsors with competing interests. It is significant in this context that Kazakhstan and Azerbaijan signed an agreement on November 14, 2008, to develop a Trans-Caspian oil transportation that will include onshore oil pipeline in Kazakhstan and a tanker fleet in the Caspian Sea to ship Kazakh oil to the Baku-Tbilisi-Ceyhan (BTC) pipeline and on to the world markets. As it was indicated at the Budapest summit devoted to the Nabucco pipeline project on January 27, significant progress has been made on the development of a natural gas link between the Caspian and Europe, and Georgia has an important role to play.

These developments indicate that the energy producing countries of the region are determined to seek the diversification of export options, but they need to be supported by the United States, and in particular European, NATO, or Turkish security guarantees. After all, Western Europe and Turkey are the major consumers and beneficiaries of Caspian energy resources.

Key Elements of the Transit Infrastructure Before August 2008

By the summer of 2008 the transit infrastructure of the South Caucasus Corridor had achieved substantial transit potential. Energy transit infrastructure has reached a point at which about 1.5 million barrels of oil and oil products per day (bpd) can be shipped through the corridor. Out of this 1.5 million, about 1 million barrels can be shipped through the BTC pipeline. If the corridor undergoes minor upgrades then there is the potential to ship 1.2 million bpd. With major upgrades and additional pumping stations, the corridor can deliver up to 1.8 million bpd. More than 100,000 bpd can be shipped through Baku-Supsa pipeline, while the Azerbaijan-Georgian railway can handle about 250,000 bpd. The Georgian railway transported 22 million tons of freight in 2007. Sixty-five percent of the freight was transit traffic, primarily oil and gas products. For comparison, the Azerbaijani rail system transported about 28 million tons of various kinds of cargo in 2008.

The transit infrastructure of the South Caucasus became the vital export line for Azerbaijan, Turkmenistan and Kazakhstan. Initially, it was oil and oil products, but recently cargos such as grains, minerals, and fertilizers have also constituted substantial volumes of shipment. In the case of Kazakhstan, the Russian policy of delaying CPC expansion forced Kazakhstan and Chevron to resort to railroad shipments, a difficult and costly process that can only ship some 250,000 barrels a day. Kazakhstan is also looking for transportation options necessary to transport the additional volumes expected to be produced from the Kashagan offshore oil field in the northern part of the Caspian Sea. In the case of Turkmenistan, about 70,000 barrels of oil were shipped through the South Caucasus to western and Mediterranean markets in 2008 and plans still exist to ship large volumes of the natural gas to the west through Azerbaijan and Georgia to Turkey. For Azerbaijan, Georgia is a very important export outlet. Until the events of last August, almost the entire Azeri export of oil and natural gas took place through Georgian territory.

The current backbone of the South Caucasus Transportation System includes the following components:

- **Baku-Tbilisi-Ceyhan pipeline**, with the current throughput capacity of 1 million barrels a day, capable of carrying 1.2 million barrels a day with minor upgrades, and 1.8 million barrels a day with additional pumping stations.
- **Baku-Supsa oil pipeline**, with the initial throughput capacity of 120,000 barrels a day, capable of carrying larger volumes with additional pumping stations. The pipeline represents a particular interest for those producers who have limited access to the BTC pipeline.
- **Baku-Tbilisi-Erzerum** natural gas pipeline has the potential capacity to ship 30 billion cubic meters of natural gas annually. Currently the pipeline is operating below its capacity, but it will ship larger quantities of natural gas after the second phase of development of the Shah-Deniz field in off-shore Azerbaijan is completed. The increased production capacity from Shah-Deniz will allow Azerbaijan to supply natural gas via Turkey to Greece and Italy through the already constructed Turkish-Greek interconnector and newly constructed pipeline connecting Greece with Italy. In addition, the existing or parallel new pipeline from Baku to Turkey via Georgia

can supply natural gas for the Nabucco project designed to supply gas to Eastern and Central Europe.

- **The South Caucasus railroad system** connecting the Caspian Sea and Port of Baku to the Georgian ports on the Black Sea and other key elements of the transit infrastructure. The Georgian railroad system is vital for Armenia's transportation as well, providing important access to Georgian ports.
- **The Georgian port of Poti** is the key port facility for the entire region. Poti handled 7.7 million tons of general, liquid and dry cargos and 185,000 containers in 2007. Poti terminal is capable of handling 45,000 ton tankers and has a capacity of 60,000 bpd.¹ Some of the facilities of the Georgian naval base located next to the cargo and passenger port were bombed on August 9 by Russian aviation. Poti seaport suffered only minor physical damage, but it endured substantial revenue and reputation losses, leading to a sharp rise in insurance costs. Georgia is developing a free economic zone on the territory of Poti and the surrounding area. Poti is estimated to be able to carry 15.5 million tons by 2010 and 19 million tons by 2015.²
- **Port of Batumi** is one of the deepest water ports in the Black Sea, and is located on a bay just northeast of the city. Following a modernization program, the terminal is capable of handling tankers of up to 130,000 tons and has a capacity of 240,000 b/d of oil. The terminal belongs to Kazakhstan's state-owned company KazTransGas. During the conflict the company reported that it had halted exports and was storing received crude. The Port shipped 11.2 million tons in 2007, out of which 9.6 million ton was oil or oil products. It is estimated that the port of Batumi will have the capacity to handle 33 million tons of oil and other cargo by 2015.³
- **Port of Supsa** is a part of the Western export pipeline system that connects Azerbaijan's producing oil fields to the Black Sea via Georgia, and it can receive more than 100,000 bpd. The port was constructed in the late 1990s and is operated by British Petroleum (BP).
- **Kulevi** port is located to the North of Poti Port and is owned by Azerbaijan's state-owned company SOCAR. The company planned to ship 100,000 bpd from the port in an initial phase before doubling its capacity in 2009 or 2010. SOCAR pulled out its staff from Kulevi after Russia bombed Poti. However, oil exports resumed on 13 August.

One important element of the energy and transportation picture in the South Caucasus is that Russian companies are actively present in the region, a fact that is neither widely known nor adequately appreciated. The extremely tense bilateral relationships over the course of recent years, including the economic embargo on Georgian products imposed by the Russian Federation in 2006, has created an assumption that there is not much Russian economic

¹ Georgian National Investment Agency, <http://www.investingorgia.org/sectors/infrastructure/> (visited on January 22, 2009).

² Ibid.

³ Ibid.

presence in Georgia, but in reality the opposite is true. As mentioned earlier, Russia's Inter RAO UES owns and operates the electricity distribution company that supplies electricity to the Georgian capital Tbilisi. In fact, about 25 percent of electricity generation and 35 percent of the distribution is controlled by Inter RAO UES. In addition, the presence of Russian companies increased in the banking, telecommunications, and mining sectors of Georgia in recent years.

Furthermore, the Russian economic presence in the South Caucasus has a potential to grow. Just before the start of the August war, the Russian Railway Company (RRC) assumed management of the Armenian Railway. The RRC's fully owned subsidiary, South Caucasus Railways, has operated the Armenian railway under the concession agreement since June, 2008. The concession agreement outlined a time period of 30 years, with a right of extension for another 20 years after the first 20 years of operation. The company name indicates the ambitions of the RRC in the region. The case of transfer of management of Enguri Hydro Power Station indicates that unless balanced properly, Russia may be able to create the circumstances for greater control over the entire railway system of the Caucasus.

Impact of the War on Georgia's Transit Infrastructure

The symbolic culmination of the developments in the Caucasus and Turkey last August occurred when, for several days, the only pipeline carrying Caspian oil from Azerbaijan to the world markets was the pipeline going through Russia by means of the so-called Northern Route Export Pipeline (NREP).

BTC, Western and Northern Export Pipelines (WREP, NREP) (source: BP)



Impact on the Energy Sector and Pipelines

The war caused no critical damage to the physical infrastructure of the Georgian energy sector, nor was there any damage to the pipeline sector. Total conflict-related damage to the energy infrastructure was estimated at \$38 million. The damage is largely fixed but there are still elements in the electricity sector that require upgrading. However, the major issue now is the status of the Enguri hydropower plant, the major supplier of electricity in the country.

The key problem of Georgia's electricity sector is that despite the major improvements in electricity supply in recent years (Georgia became a net exporter of electricity in 2007), the system is still very vulnerable and substantially dependent on one large hydropower plant - Enguri, located in the conflict zone. The dam and reservoir are under the control of the central authorities, but turbines and generators are on Abkhazian-controlled territory. The Georgian government had to sign the memorandum of understanding (MOU) with the Russian Inter RAO, the subsidiary of state-owned electricity

monopoly Inter RAO UES, on December 28, 2008, on joint management of the power plant. The Enguri HPP's five generators have the total capacity of 1,300 megawatts.⁴ According to the Georgian government, 100 percent of the Enguri HPP's shares remain under Georgian state control. As far as joint management is concerned, it envisages creating a joint board with the involvement of representatives from Inter RAO and the Georgian side on a parity basis.

The Georgian Minister of Energy cited three major reasons for why Georgia had to agree to the shared control of the Enguri station. These are, in no particular order: financial interest, security of Enguri HPP, and security of the entire energy system of the country.⁵ Inter RAO will be paying for the consumption of electricity. According to the Ministry of Energy, the Russian company's involvement would alleviate potential "security risks posed to the Enguri HPP by the Abkhaz separatists". He also said that Inter RAO's assets in Georgia would represent a guarantee behind the Russian company's commitments in connection to Enguri HPP. Inter RAO UES owns 75 percent of Telasi (Tbilisi electricity distribution company) as well as two thermal power generating plants – unit number 9 and unit number 10 (the latter is currently not functioning). Inter RAO UES also has the management right of two hydro power plants – Khrami I and Khrami II. In fact, the decision of the Georgian government regarding the shared management of the Enguri power plant is a pragmatic step dictated by the de facto realities on the ground as a result of the war in August. At the same time, this is an unpopular decision with potential political backlash for the Georgian government.

The other weaknesses of the Georgian electricity sector are its dependence on imported natural gas to fuel thermal power plants in the winter and that the transmission grid is short of capacity and prone to technical breakdowns (partially because the 500 kV backbone grid traverses the Caucasus Mountains). The war elevated the importance of a near term investment in a 500 kV transmission line from Azerbaijan through Georgia to Turkey (Black Sea Regional Transmission Project). This line would expand the country's limited transmission capacity and enhance the regional cooperation in the electricity sector.⁶

The war also demonstrated the necessity for the construction of an underground natural gas storage that would mitigate the risk of interruptions of supplies from Russia. Despite the increased supplies of natural gas from Azerbaijan, Georgia still needs more than 1 billion cubic meter of natural gas annually from Russia in order to meet its internal demands. The natural gas storage with the capacity equal to at least three months of import needs would provide Georgia with greater energy security. In the longer term, Georgia will need to strengthen its energy security by continuing to develop domestic hydro energy

⁴ "OAO 'Inter RAO EAS' podpisalo memorandum ob effektivnoy ekspluatatsii Inguri GES" (Open Joint Stock Company Inter RAO UES signed the memorandum on efficient exploitation of the Inguri HPP), Press Release, December 31, 2008, Inter RAO UES website, <http://www.interrao.ru/news/company/212/>.

⁵ "Russia, Georgia to Jointly Manage Enguri Power Plant," Civil.ge, January 12, 2009, <http://www.civil.ge/eng/article.php?id=20257>.

⁶ "Georgia: Joint Need Assessment," The United Nations-World Bank Document, p. 27.

<http://siteresources.worldbank.org/INTGEORGIA/Resources/301645-1224598099977/GEJNA2008.pdf>.

resources. The priorities should include small, medium, and large hydropower plants. The key projects among these are the Khudoni hydropower plant (\$800 million), the Namakhvani hydropower cascade (\$540 million), and the Oni hydropower cascade (\$525 million), with the total program amounting to \$2.7 billion.⁷

The impact of the war on Georgia's pipelines was more limited than on the energy sector. During the war, shipment through the Georgian pipeline system was suspended, but resumed operations soon after the end of the actual military confrontation. In fact, the biggest impact on Georgian pipelines may have actually occurred before the war started with the PKK attack on the BTC pipeline which disabled it and accentuated the problems caused by Russian bombardment. Problems started with the explosion on the evening of August 5th on the Turkish section of the pipeline, which was transporting 850,000 b/d of Azeri-Chirag-Guneshli (ACG) oil and Shah-Deniz condensate. Kurdish separatists from PKK claimed responsibility, and oil exports were suspended immediately. BP started re-routing oil by rail, and about 50,000-70,000 bpd ACG crude via rail to Georgian ports. Additional volumes were directed through the Baku-Supsa pipeline that came back on stream on 7 August 2008, after 19 months of repair. According to the host government agreements on BTC, the financial liability for the closure of the pipeline for the reasons not related to technical problems is the responsibility of the host government, in this case Turkey. Accidents like this cost Turkey \$300,000 a day. Following the terrorist attack oil had to be taken from the Ceyhan terminal stockpile which was to a great extent depleted as a result.

Even a brief disruption of the sizable transit revenue flow is difficult to absorb for any economy. Turkey has already experienced a serious loss of revenues from the transit of Iraqi oil due to sanctions in the early 1990s. The sanctions imposed on Iraq at that time cost Turkey \$80 billion due to the loss of transit revenues from the Kirkuk-Ceyhan pipeline and to the loss of trade with Iraq.⁸ Turkey also had to worry about the needs and reaction of the Kazakh and Azerbaijani exporters. Azerbaijan had to open negotiations with Russia's Transneft for additional pipeline quotas in order to send its oil via Russian territory to the Novorossiysk seaport. The Baku-Novorossiysk pipeline shipped 20,000 bpd of oil before the damage of BTC, and starting from August 6 Transneft offered to increase the quota for Azeri oil to 40,000 bpd. The capacity of that pipeline is 100,000 bpd, but needs major renovations in order to approach that level. As previously mentioned, starting on August 7th the Baku Supsa line was used for the shipment of 90,000 bpd of BTC volumes.⁹

After the BTC pipeline explosion, production from the ACG field was reduced from 850,000 bpd to 250,000 bpd. Production from the Shah Deniz field, which normally supplies 40,000 bpd of condensate to the BTC pipeline, was reduced as well. The closure of these routes denied Azerbaijan and its international partners close to 1 million bpd of oil and 500

⁷ Ibid, p. 28.

⁸ Igor Tomberg, Impact of Five-Day War on Global Energy, September 3, 2008, <http://www.globalresearch.ca/index.php?context=va&aid=10042>.

⁹ Conversation with Georgian government transport official, October 2008.

million cubic feet per day of gas exports. Experts estimate that likely loss of oil revenue through the month of August was around \$1.9 billion.¹⁰

Impact on Georgian Railways

The Russian invasion of Georgia and the subsequent occupation of two breakaway provinces caused substantial, but not decisive, physical damage to the transportation infrastructure of Georgia. The bulk of the damage was caused to the Georgian railroad and aviation industries. Russian aerial attacks damaged the railway stations, rail tracks, and an important bridge on the major transit railway. Russian bombs also destroyed two major radar systems providing safety for the landings and take-offs as well as aircraft over-flights. Railroad traffic started to decline from August 9, and trains were stopped altogether from August 16th to the 25th. Operations were partly restored for freight on August 25 and for passengers on September 1, but took until November to be restored to their full capacity. The first damage to the railways was inflicted on the 9th and 12th of August when the Senaki station (east of Poti) and the Kaspi station (east of Gori) were damaged by bombings. The explosions damaged the tracks, signaling, and electrical equipment. These stations have been repaired and are now fully operational.¹¹

The most important damage was caused by the explosion of the Grakali-Metekhi bridge on August 16, 2008. The explosion damaged the physical elements of the bridge, as well as communication, electrical and signaling equipment. To restore service as quickly as possible, the Georgian government constructed a one-kilometer detour to an older, single-track bridge that had been out of service since 1982. The main bridge was reopened on September 11, but it currently has a slightly lower than regular capacity until all the repairs are completed. This damage caused delays in transportation of Caspian crude, including BTC volumes, diverted after the explosion in Turkey.¹²

Another explosion on August 24, 2008, damaged the track and electrical lines of railways. The oil cars derailed and some of them caught fire, destroying their cargo and causing environmental damage. CNN and other international cable news channels have shown the footage with burning oil cars belonging to Azpetrol, the Azeri state company. The track has been repaired and is now fully operational.

In addition to the cost of repairing specific railways, Georgian railways lost traffic that it would otherwise have carried. After several years of solid growth in transportation volumes there was a slight decline in 2007 from 22.6 million tons to 22.2 million tons. This decrease was due largely to the commissioning of the BTC pipeline and the re-direction of some oil. At the same time there was a significant increase in shipment of dry cargoes and containers from 9.1 million tons to 10.7 million tons in 2007. As for 2008, the total number of transported commodities is expected to decline to 21.5 million tons and daily shipments were below expected levels in August, September and October of 2008.¹³

¹⁰ "The Caucasian Energy Corridor Suffers a Reality Check," Upstream Insight, Wood Mackenzie, August 2008.

¹¹ "Georgia's Joint Need Assessment," p. 27.

¹² Ibid.

¹³ Georgian National Investment Agency, <http://www.investinggeorgia.org/sectors/infrastructure/>.

Impact on Highways

The major highways suffered only minor damage from the military conflict and repairs have already been carried out. Some road construction machinery and equipment was looted during the war. The conflict has, however, highlighted the vulnerability of the Georgian highway system, and especially the East-West freeway, Georgia's strategic backbone. An upgrade of the alternative highways will have a significant security, developmental, and economic impact on Georgian transportation.

Serious damage was also inflicted on the Georgian air transport and aviation infrastructure. The destruction of the primary and secondary radars in Tbilisi caused serious damage to the safety of the system. There is now no primary radar coverage of the Georgian air space. As reported, other radars are being used at the moment, but they handle fewer flights, leading to a loss of revenue. Moreover, the Tbilisi airport runway is in need of urgent repair. Immediate investments, including the acquisition of replacement radar, are necessary to ensure the safety of take-offs and landings and the passage of over-flights through Georgian airspace.

Impact on Future Infrastructure Projects

As mentioned earlier, the impact of the war on the existing transportation infrastructure and current transit volumes was important, but limited. At the same time it is of utmost importance to assess the impact of the war on the future of the corridor, since substantial volumes of both oil and natural gas are expected to be shipped despite all the disruption and damages caused by the war.

First of all, it is important to realize what is at stake here. In terms of the oil, it is the potential flow of an additional 1.5 million bpd. In terms of natural gas, it is at least 30-40 billion cubic meters of natural gas from Turkmenistan and perhaps from Kazakhstan to feed pipelines destined for Europe. This is also about the transportation of grains, ferrous and non-ferrous metals, and many other products and commodities.

Grain

The first announcement came from the Kazakh Agriculture Minister Akylbek Kurishbayev, who told lawmakers at the hearing in Astana that Kazakhstan had dropped plans to build a grain terminal in Georgia's port town of Poti.¹⁴ The agriculture minister cited "the current situation in Georgia" after the August war with Russia as the reason for the decision. Kazakhstan, one of the main foreign investors in Georgia, signed a deal with the Georgian government in June 2007 on the construction of the terminal. The project cost was estimated at about \$10 million.

¹⁴ Civil Georgia [Tbilisi], September 22, 2008.

Oil Refinery

Additional negative news came on September 24 when it was reported that Kazakhstan dropped its oil refinery plans in Georgia.¹⁵ The representative of the KazMunaiGas stated that decision was not linked to politics and was strictly based on commercial merits. The \$1 billion refinery project was supposed to be located in the port of Batumi, which is already controlled by the KazMunaiGas subsidiary KazTransOil.¹⁶

The conflict created a window of opportunity for other potential transit alternatives. Iran immediately came up with statements promoting its territory as a potential transit for Azeri and Kazakh oil. Several Iranian officials declared that Iran's Neka-Jask export pipeline could serve as a viable alternative to BTC pipeline. Iran's Deputy Oil Minister, Hossein Nogrekar-Shirazi said that a feasibility study for the project is underway.¹⁷ The Iranian Minister of Foreign Affairs, Manouchehr Mottaki stated that “the Caspian - Persian Gulf pipeline is profitable and secure” although he did not elaborate on the estimated cost, sources of the funding, or the expected capacity of the pipeline.¹⁸ As noted earlier, Russia’s Transneft also suggested that Azerbaijan should use the Northern route for transportation of oil, and Gazprom even offered for the Azerbaijani government to purchase all the natural gas that the country can produce.

Oil Exports

On the positive side, there was a statement from KazTransOil, broadcast by BBC and the Russian news agency Interfax, confirming that KazMunaiGaz has not abandoned its plans to invest in the port of Batumi and an oil terminal in Georgia in order to achieve the planned volumes of 9.2 million tons of oil and oil products.¹⁹

Even more importantly, on November 14, 2008, the State Oil Company of Azerbaijan (SOCAR) and the Kazakh oil company KazMunaiGaz signed an agreement on basic principles of implementation of the Transcaspian project (TCP). The document defines the basic conditions and principles of joint implementation of the project and outlines a stage-by-stage development of the Transcaspian system. According to KazMunaiGaz president Kaïrgeldy Kabyldin, the creation of the Transcaspian system is preliminarily estimated at \$3 billion. He also noted that this system consists of several segments and envisages construction of a pipeline on the territory of Kazakhstan, development of the infrastructure on both sides of the Caspian Sea, and a fleet of tankers. The network will at first be able to ship 500,000 bpd, eventually growing to 1.2 million

¹⁵ “Kazakhstan Drops Oil Refinery Plans in Georgia,” Reuters, September 24, 2008, <http://uk.reuters.com/article/worldNews/idUKTRE48N0Z720080924>.

¹⁶ Ibid.

¹⁷ Igor Tomberg, “Impact of Five-Day War on Global Energy,” September 3, 2008, <http://www.globalresearch.ca/index.php?context=va&aid=10042>.

¹⁸ “Iran Offers to Build ‘the Caspian – Persian Gulf’ Pipeline,” Ministry of Energy and Mineral Resources, Kazakhstan http://www.memr.gov.kz/?mod=news&year=2008&lng=eng&cat_id=3&id=1352.

¹⁹ Ibid.

barrels per day. A joint venture company created by Kazakhstan and Azerbaijan will work out the financial and technical details of the project.

It is no secret that Kazakhstan currently relies almost exclusively on Russian routes for oil exports and Moscow has been reluctant to expand its pipelines. Kazakhstan is expected to start production at its giant Kashagan field on the Caspian shore by 2013, thereby increasing demand for export routes. “Kazakhstan needs the creation of the Transcaspian system in connection with growing volumes of oil production and its transportation,” Kabyldin noted. In this context, he said that in 2008, 70 million tons of oil (1.4 million barrels of oil a day) were produced in Kazakhstan for the first time. By 2015 that number will reach 100 million tons or 2 million bpd. The key contributor to that growth will be the Kashagan offshore oil field with the potential output of 1.5 million barrels a day.²⁰ Successful implementation of the Transcaspian project will make it possible to “create a reliable system of long-term tanker transportation of our oil via terminals on the Kazakh and Azerbaijan’s coast of the Caspian Sea and its subsequent export through the Baku-Tbilisi-Ceyhan pipeline,” said the president of KazMunaiGaz.

The agreement was announced at the sidelines of the energy summit in Azerbaijan which was attended by the presidents and other senior officials from nations including Turkey, Georgia, Poland, Ukraine, Lithuania, Estonia, Bulgaria, Hungary, and the United States. The U.S. Department of Energy expressed confidence in continuing U.S. government support in the next administration to diversify export routes for the region's oil and gas — still dominated by Russia.

Natural Gas

Another significant development was the November 14 agreement between Georgia and Azerbaijan on the supply of Azeri natural gas to Georgia for the next 5 years. This agreement demonstrates Azerbaijan’s decision to decline the Russian offer to purchase all of Azerbaijan's gas production, despite the obvious commercial attractiveness of the offer. Azerbaijan’s decision had profound political significance for both the current developments in the region and the future of Caspian natural gas supplies to Europe.

The recent announcement of the British consultancy firm Gaffney, Cline & Associates (GCA) in Ashgabat regarding the preliminary results of its audit of Turkmen gas reserves creates an additional opportunity for the Transcaspian development and a greater transit role for existing and future pipeline systems. According to the announcement, the Yoloten-Osman field, in the southeast of the country, has a minimum of 4 trillion cubic meters of gas and as much as a staggering 14 trillion cubic meters. This makes Yoloten-Osman Turkmenistan's biggest gas field, with a potential capacity four times that of Dowalatabad, itself a giant natural gas field. More evaluations are expected in other areas of the country and this vast potential creates additional opportunities for consumers and transit

²⁰ “Sustainable Growth in Caspian Offshore Production,” Upstream Insight, Wood Mckenzie, September 2008.

countries. These recent discoveries could make Turkmenistan's natural gas reserves second only to those of the Russian Federation.²¹

Railroad

There are no signs at this point that plans to link the Georgian railway system to the Turkish city of Kars through the Kars-Akhalkalaki railroad will be affected in any way. The idea of the project is to shorten the railway links between greater Central Asia, China, and Europe. This project, when completed, will substantially increase the transit potential of the region and reduce shipment time, which has huge importance not only for Central Asia but for Europe and the Middle East as well. Once completed, cargos could be shipped from the China-Kazakhstan border to Istanbul and beyond. Azerbaijan's government is already working on an upgrade of its rail system to accommodate additional cargos. Azerbaijan has also provided 200 million dollars of concession loans to Georgian Railways for the construction of the Georgian section of the line. The railroad is planned to become operational in 2011 and by 2012 the volumes of shipment through the corridor are expected to grow by 15-20 percent.²²

With all the existing and planned infrastructure projects, the goal for the South Caucasus is to use the regional cooperative effort to create a fully integrated transport network that will include upgraded highways, pipelines, railroads, ports, ferries, and fiber-optic and electricity transmission lines. This will make it easier for the Central Asian and South Caucasus countries to trade with one another, with Europe, and with the rest of the world. By providing access to important markets and vast resources, this system has the potential to become a very important element in the international economic security network.

²¹ M. K. Bhadrakumar, "Energy Superpower Emerges in the Caspian," *Asia Times*, October 17, 2008, http://www.atimes.com/atimes/Central_Asia/JJ17Ag04.html.

²² "Azeri, Georgian, Turkish Leaders Speak of 'Historic' Rail Link," *Civil Georgia*, November 21, 2007.

Implications of the War for Georgia

The Georgian government needs to make the reconstruction and stabilization of transportation infrastructure its top priority, second only to aiding internally displaced persons. **Nothing makes Georgia more important to the world than its transit function and transportation infrastructure.** According to the *Georgia Joint Needs Assessment Report* conducted by the World Bank after the war:

Energy and roads would remain vulnerable to exogenous shocks which could lead investors to search for opportunities elsewhere in the region. A sharp reduction in investment, compared to pre-conflict levels, is being experienced. These effects could combine to stunt the long-term development potential of the country.²³

A rapid and calculated effort is required to help Georgia recover from the transportation setbacks caused by the war. The government has taken immediate measures to rehabilitate physical damage to railroad and electricity lines. As mentioned earlier, Georgia has signed a 5 year deal with Azerbaijan on natural gas supply that will provide the basic energy security for the country. But much more needs to be done to meet all the challenges ahead.

Georgia needs to focus on new security measures guaranteeing physical security of the key transit infrastructure: pipelines, railroads and highways, air and seaports, as well as electricity transmission lines. Georgia should work also with the EU to provide security guarantees for the transit infrastructure by engaging with the EU monitoring mission in the areas close to conflict regions. The security and stability of the transportation infrastructure is in European interests as well, so monitoring missions should include the transit infrastructures in the areas of coverage. EU needs to provide increased manpower and surveillance equipment for this purpose and broadly communicate the increased guarantees for security to existing and potential future partners. Such an action would send the positive signals to transportation companies and traders.

Key security challenges lie ahead for Georgia in the upcoming years. Georgia needs to ensure its energy security: dependency on imported Russian gas, as well as electricity in the winter, makes the country extremely vulnerable to physical damage, as well as price shocks from Gazprom. The natural gas storage is an absolute necessity. In addition, more incentives need to be created to utilize Georgia's enormous hydro energy potential that the country has. The Ministry of Economic Development has already presented an attractive package of potential projects. The alternative backbone power transmission line is also required to guarantee national security. These projects, as well as the attractiveness of the current level of energy tariffs in Georgia require a high amount of publicity.

Alternative transportation links connecting Tbilisi and its eastern borders with Azerbaijan and Armenia to the ports also need to be developed. Furthermore, special

²³ "Georgia: Joint Need Assessment," p. 5.

security arrangements need to be put in place for protection of those new linkages in times of trouble.

Georgia needs to increase its coordination with partner countries, in particular with Azerbaijan and Turkey, as well as with Armenia, on all the issues related to transit and transportation. Georgia also needs to take a pro-active position in negotiations on natural gas transit, similar to its role in the development of the transportation corridor in the 1990s, in order to facilitate the project. Lastly, Georgia needs to creatively approach potential linkages in transportation. For instance, an increase in the output capacity of the BTC or the linkage of the BTC with Israel's Ashkelon-Eilat pipelines could open new opportunities for Caspian producers in Asian energy markets.

Georgia should demonstrate that the security and safety of its rail transportation and port operations are guaranteed. Georgia should rebuild the confidence of the transportation companies to attract the cargoes that were lost during and after the war. Georgia may need to reconsider its tariff policy and work in coordination with its partner countries in order to achieve this goal.

In addition, Georgia needs to focus on domestic economic security issues in light of the world economic crisis. Despite Georgia's high rankings in the "Doing Business Report" of the World Bank, there still exist substantial problems in taxation and administration, as well as protection of property rights of individuals and businesses. The freedom of business activities in Georgia, fair business dispute resolutions, and contract enforcement environment will help to deal with the credit crisis, contracted consumption and the recent decline in construction.²⁴ In the current environment, the best economic security policy that the government can pursue is granting full freedom to small and medium size entrepreneurial activity. This will not only support social stability, but also promote the efficient functioning of the transit system.

Implications of the War for Turkey

No other country is a better example of the success of Russian foreign economic policy than Turkey. At the same time, no other state has as much at stake as Turkey in the successful development of the transit corridor through the Caucasus and the so-called fourth energy corridor to Europe.

However, in recent years the Turkish-Russian relationship has changed dramatically. Today, Russia is Turkey's largest trading partner with trade between the two countries expected to reach \$38 billion this year, up from \$27 billion the year before. Russia also supplies close to half of Turkey's crude oil and 65 percent of its natural gas, which are used to heat Turkish households and to run many of the country's power plants.²⁵ It is important to mention that Russia exercises different levers over Turkey's exports to Russia, restricting the export of some of its products, like the ban on Turkish poultry in recent months, while

²⁴ "Doing Business in Georgia," World Bank Group, <http://www.doingbusiness.org/ExploreEconomies/?economyid=74>.

²⁵ "Turkey: Caucasus Crisis Leaves Ankara Torn between US and Russia," Eurasianet, <http://www.eurasianet.org/departments/insight/articles/eav091108.shtml>.

Russian energy exports to Turkey are not contested by any other player. And while the total volume of trade looks very impressive, Turkish exports to Russia are modest relative to Russian energy exports to Turkey.

However, Turkey has several important strategic advantages that it can capitalize on. The new U.S. administration must have a much larger interest in Turkey than did the previous one. Turkish help is needed for strategic and military reasons, as well as for transit purposes and Turkey should capitalize on this new position. On the other hand, if Turkey remains handicapped by energy dependency on Russia and strengthened by the non-transparent natural gas deals, it may lose the strategic advantage it has. Instead of becoming the hub of natural gas from the entire region, including the Middle East and Caspian, it may become the hub of Russian gas with a very limited ability to influence the directions of that flow.

Russia's primary target in the natural gas "game" is the Nabucco pipeline project, designed to bring 31 billion cubic meters annually of Caspian – and potentially Iranian and Iraqi – natural gas to Europe via Turkey, Bulgaria, Romania, Hungary, and Austria. The logical end point of this pipeline is envisioned in the future natural gas hub in Baumgarten, Austria.²⁶ Over the past two years Russia has moved swiftly to set up obstacles to the realization of the Nabucco project. It has proposed its own "South Stream" pipeline under the Black Sea and has tried to play the national interests of EU members against one another. Gazprom's "special" relationship with European energy companies is also a major factor preventing pan-European cooperation necessary to realize Nabucco from materializing.

For the purposes of this paper, however, it is far more important that at the present Turkey appears to be emerging as a key stumbling block for the project, independent of Russian moves. According to press reports, as a transit country for Nabucco gas, Turkey is insisting on purchasing, at discount prices, a portion of the gas transiting via Nabucco, for domestic consumption.²⁷ In case of the BTC pipeline, the deal was only possible because of the concessions of the parties participating in the project with the United States playing a key role in the facilitation of the deal. Based on the current level of the U.S.-Turkish relationship and the uncertainty of European policy towards Turkey, it is not clear who could create incentives necessary to facilitate the negotiations between Nabucco, Azerbaijan, and Turkey and to achieve the desired deal. In absence of the strong facilitator, the project may become delayed and lose momentum.

Implications of the War for Europe

Europe needs the natural resources of Central Eurasia, new markets for its goods, and a relatively cheap and better educated labor force in order to maintain its competitiveness in the world economy. At least two key factors have great importance for Europe. The first is that Ukraine, the South Caucasus, and the Central Asian states together

²⁶ Nabucco Gas Pipeline Project website, <http://www.nabucco-pipeline.com/>.

²⁷ Robert M. Cutler, "Euro-Caspian Energy Plans Inch Forward," *Asia Times*, November 27, 2008, http://www.atimes.com/atimes/Central_Asia/JK27Ag01.html.

have a combined population of nearly 130 million people, thus offering substantial markets for European goods and services, as well as a potential source of labor in light of the aging population in Europe. The second is that Caspian energy resources have the potential to substantially diversify Europe's energy supplies away from a current over-dependence on Russia. A quarter of Europe's gas needs and almost half of its natural gas imports come from Russia, 80 percent of which transits Ukraine. If supported by the appropriate policies, Europe has the potential in several years to emerge as better-situated and stronger vis-à-vis Russian energy dominance, as well as other economic security challenges. The Nabucco project can be the first step in that direction and other steps need to follow.

But until recently Europe has demonstrated no ability to provide leadership in the issues of energy and transportation. Since the mid-1990s when the EU initiated and supported TRASECA and IMOGATE projects, the EU has turned into a passive player in Central Asia and Caucasus. The war in Georgia and active engagement of the EU, chaired by France/Sarkozy, provided the opportunity for EU to elevate its importance in the region. So far, however, even the presence of EU monitors has been unable to ensure Russia's fulfillment of its obligations under the August and September agreements. The EU has an opportunity to not only play an active role in the peace process in Georgia, but also to facilitate the transit of energy resources by providing security guarantees for the transit infrastructure – a factor essential for the majority of EU members.

The EU proactively responded to the crisis in Georgia. At the time, France held the rotating EU Presidency and Nikolas Sarkozy brokered the six-point ceasefire agreement between Georgia and Russia. Although the terms of the agreement were very difficult for Georgia, the agreement was successful in stopping the active military engagement. During the conflict both the EU and NATO halted its relations with Russia. The EU's pre-condition for the resumption of the partnership dialogue with Russia was the return to pre-August 7 status-quo and the fulfillment of all six points of the ceasefire agreement. While not all the pre-conditions were met, EU has resumed the formal dialogue with Russia in November and President Sarkozy stated that pre-conditions for the dialogue were "mostly" met. The EU's desire to maintain a level of dialogue with Russia is understandable, but concessions on important issues like the terms of the EU-brokered ceasefire agreement sent both Russia and the countries of Black Sea / Caspian Sea region the wrong signal. The perception in Russia is that life is back to business as usual, while Ukraine, Georgia, Azerbaijan and others feel that the EU is not capable of defending its own position vis-à-vis Russia. At least in the short run, Russia's calculation that Europe will accept the new realities created by the war is proving to be correct.

While the EU has been moderate in its political demands for Russia to fulfill its commitment to the agreed points of the ceasefire agreement and to reverse the recognition of the independence of Abkhazia and South Ossetia, the European Union has been more generous in its pledge to increase economic assistance to Georgia. This generosity was on display at the donor conference in November where the total pledge of the \$4.5 Billion was made to support the reconstruction of Georgia. In addition, the EU is planning to actively engage in the region with the new Eastern Partnership initiative offering deeper ties to six eastern European states, including Georgia. The President of the European Commission, Jose Manuel Barroso and the Commissioner for External Relations, Benita Ferrero-Waldner, said at a news conference in Brussels on December 3 that the bloc planned to

allocate a total of 600 million Euros for the period of 2010 and 2013 for this “ambitious initiative.”²⁸

As envisioned, €350 million will be in fresh funding, while the rest will come as a result of redeployment of funds from already existing EU aid projects in the region. The Eastern Partnership, which targets Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine, intends to upgrade the EU’s political engagement with these countries in a number of areas, including the prospect for association agreements, integration into the EU economy and easier travel to the EU. European Commission President Barroso said that the August war in Georgia prompted the European Union to act in this direction. He, however, repeated several times during the press conference that the initiative “does not aim at building spheres of influence, drawing any kind of new division line in Europe.”²⁹ Barroso said that the initiative was a demonstration of the European Union’s “soft power.” “Stability and prosperity in the 21st century will be brought about by economics, not by missiles; by dialogue, not by demonstration of force; by partnerships and multilateralism and not by unilateralism,”³⁰ he said. EU is offering five major initiatives, so-called “flagship initiatives” that involve border management programs; programs for small and medium-size enterprises; integration of electricity markets, energy efficiency and renewable energy; and developing plans for a Southern Energy Corridor. The European Commission said in a statement that the European Neighborhood Policy has been an important platform and the backbone of EU-Georgia relations: “however, the conflict in Georgia in August 2008 has shown the need for a deeper and more intensive EU involvement in the South Caucasus region, with a need of stronger regional cooperation.”³¹ In November, the EU decided to start visa facilitation talks with Georgia. These talks will also involve matters related to the readmission agreement with Georgia.

The war in Georgia resulted in some positive policy decisions on the energy side as well. They were included in the EU’s Second Strategic Energy Review, which states: “With respect to the EU, this is of most concern with respect to gas, where a number of Member States are overwhelmingly dependent on one single supplier. Political incidents in supplier or transit countries, accidents or natural disasters, the impacts of climate change, all remind the EU of the vulnerability of its immediate energy supply.”³² The core of the document is the EU Energy Security and Solidarity Action Plan, designed to help Europe achieve its three strategic energy objectives: reducing greenhouse gas emissions by 20 percent (these dictate the need for larger natural gas imports to Europe to replace coal-based energy generation); increasing the share of renewable sources in the energy consumption to 20 percent (compared to 8.5 percent today); and improving energy efficiency by 20 percent. The EU intends to accomplish all of these initiatives by 2020.³³

²⁸ “EU Offers Close Partnership to its Six Neighbors,” Civil Georgia, December 4, 2008, <http://www.civil.ge/eng/article.php?id=20070>.

²⁹ “The Eastern Partnership – an ambitious new chapter in the EU’s relations with its Eastern neighbours,” Brussels, December 3, 2008, <http://www.delgeo.ec.europa.eu/en/press2008/2dec2008.html>.

³⁰ Ibid.

³¹ Ibid.

³² *European Strategic Energy Review*, EU Publication, page 3, http://news.bbc.co.uk/2/shared/bsp/hi/pdfs/14_11_08euenergy.pdf.

³³ Ibid, page 4.

The first element of the five-point action plan is to meet “infrastructure needs and achieve the diversification of energy supplies”. Together with some other interesting initiatives (such as the Baltic Interconnection Plan covering gas, electricity and storage in 2009) the Commission came up with an initiative to promote a so-called southern gas corridor to supply Europe with the gas from the Caspian Sea and Middle Eastern sources. The commission is planning to “work with the countries concerned, notably with partners such as Azerbaijan and Turkmenistan, Iraq and the eastern Arab countries that make up the Mashreq, amongst others, with the joint objective of rapidly securing firm commitments for the supply of gas and the construction of the pipelines necessary for all stages of its development. In the longer term, when political conditions permit, supplies from other countries in the region, such as Uzbekistan and Iran, should represent a further significant supply source for the EU.”³⁴

This marks the first time the EU has come up with the feasibility of a block purchasing mechanism for Caspian gas (Caspian Development Corporation), which may significantly facilitate the private sector investments in exploration and transit infrastructure: “The Commission will invite representatives of the countries concerned to a ministerial level meeting where they can secure concrete progress and agree on a timetable to reach agreement. This commission will seek to identify, by mid-2009, any remaining obstacles to the completion of the project which will be the subject of a Communication on the Southern Gas Corridor to the Council and Parliament.”³⁵

These policy initiatives are steps in the right direction. The issue now is how to correctly implement mechanisms that would ensure that real progress is made on the ground in terms of the negotiation of the deals for commercial players. In the end, it is the individual states that are going to implement and manage the infrastructure projects designed to assist Europe in gaining access to secure and reliable energy resources.

At the same time, past experience shows that decisions and policies set up in Brussels do not guarantee their realization. Since their implementation depends on autonomous policy decisions by the EU member states, some of these proposals are implemented and others are not.³⁶

Implications of the War for NATO

While NATO took pro-active political steps in response to the conflict in Georgia, the organization failed to move forward with a Membership Action Plan for Georgia and Ukraine and did not demonstrate a clear response strategy to similar acts of aggression in the future.

NATO on different occasions stated its support to Georgia’s territorial integrity and reaffirmed the commitments undertaken in Bucharest in April 2008. The NATO-Georgia

³⁴ Ibid, page 5.

³⁵ *European Strategic Energy Review*, EU Publication, page 3, http://news.bbc.co.uk/2/shared/bsp/hi/pdfs/14_11_08euenergy.pdf.

³⁶ Robert M. Cutler, “Euro-Caspian Energy Plans Inch Forward.”

Commission (NGC) was created immediately after the conflict and the first meeting of the commission, at the level of Foreign Ministers, took place in Brussels in December 2008. They reviewed the progress of the NATO-Georgia relationship since the Bucharest Summit in April 2008 and welcomed the deepening political and practical cooperation between NATO and Georgia. They noted with satisfaction the successful visit of the North Atlantic Council to Georgia in September 2008, the first meeting of Defense Ministers in NGC format in October 2008, and the concrete assistance that NATO provided to Georgia in a number of areas following the August conflict.

The US attempt to move forward with a statement of membership pledge to Georgia and Ukraine despite the absence of a Membership Action Plan, did not receive any support from other members and at this point the roadmap for the eventual acceptance of these two countries into NATO remains unclear.

NATO's potential engagement in energy security issues, actively promoted by Senator Lugar and Vice President Cheney a few years ago, failed to receive any conceptual or practical follow up. Although NATO did not express any position during the recent Russian-Ukrainian Gas dispute, NATO's role in creating security guarantees for the functioning of the energy supply routes to Europe may become substantial elements in the renewed mission of the organization. Having Russian tanks and artillery located within shooting range of key pipelines and railroad systems of Georgia is not an acceptable status-quo for NATO, the EU, or even Turkey.

Implications of the War for the United States

The new strategic realities created by the war require integrated policy solutions from the Obama administration. The U.S.-Georgia treaty provides the framework for deepening of US-Georgian cooperation. The agreement also states U.S. support to Georgia's energy sector and Southern energy corridor for Europe, noting that:

Recognizing the importance of a well-functioning, market-oriented energy sector, the United States and Georgia intend to explore opportunities for increasing Georgia's energy production, enhance energy efficiency, and increase the physical security of energy transit through Georgia to European markets. We intend to build upon over a decade of cooperation among our two countries and Azerbaijan and Turkey, which resulted in the Baku-Tbilisi-Ceyhan and Baku-Supsa oil pipelines and the Baku-Tbilisi-Erzurum natural gas pipelines, to develop a new Southern Corridor to help Georgia and the rest of Europe diversify their supplies of natural gas by securing imports from Azerbaijan and Central Asia.³⁷

The United States always had a greater interest in the development of the oil fields and oil pipelines in Caspian than in developing natural gas. As a result, the United States has been able to achieve greater success in oil projects. Oil has been an attractive commercial product

³⁷ United States-Georgia Charter on Strategic Partnership, Civil.ge, January 9, 2009, <http://www.civil.ge/eng/article.php?id=20249&search=US-Georgia%20Treaty>.

for producer countries and a strategic commodity for transit states, yet the natural gas business in the Caspian never transformed into the type of strategic initiative that could unite different players. As the current difficulties in negotiations on transit via Turkey prove that gas, unlike oil, has so far served as more of a divisive product for the regional countries than a unifying one. A greater US role in implementation of the regional natural gas projects, supported by a joint effort with the EU to build incentives for all producer, transit and consumer countries may help to achieve a positive outcome.

In supporting the stability of Georgia and the entire Caucasus region, the United States will need to work harder toward reaffirming the strong commitment of the international community and to preserving the territorial integrity of Georgia. It needs to do so in order to avoid the negative domino impact of aggressive separatism in the region. The United States should also continue to support the Membership Action Plan (MAP) for Georgia and Ukraine. It is very important for the credibility of Euro-Atlantic initiatives to keep NATO's door open for countries that want to join and qualify for the Alliance.

Washington needs to re-establish its leadership in the Caspian energy race, or face the reality that Russia will be able to channel entire export volumes of the natural gas produced in the region through Gazprom-controlled pipeline systems. Unfortunately, the US Government cannot rely on the market forces to prevent this from happening. Natural gas is the regional commodity attached to pipelines and players like Gazprom, who inherited a Soviet-style monopoly over the pipeline system of Russia, possess far too much power for the West to rely solely on market forces and fair competition principles.

The United States should work more closely with the EU to make sure that Russia has no exclusive access to Central Asian gas. The current financial crisis and decline in energy prices will inevitably result in higher dependency of Gazprom, and consequently Europe, on Central Asian gas. Both Eastern and Western European countries must have competitive access to that gas.

The U.S. needs to elevate its energy policy in the Black/Caspian Sea region and in Central and Eastern Europe. It needs to work in close cooperation with the EU and Turkey and lead the effort to create the consortium of consumer countries with high aggregate demand on natural gas. That effort has to help conclude the purchasing agreements that would allow the additional investments in development of the large existing deposits in Azerbaijan and Turkmenistan, and maybe Kazakhstan as well. Ultimately, this has to lead to the financing and construction of the dedicated infrastructure.

The United States should seriously focus on its policy towards Turkey. Turkey and its interests were largely ignored in recent years and the consequences of that policy were felt during the war in Georgia. Turkey is extremely important to the United States from a strategic, military, and energy security perspective and needs be treated with respect. Turkey is also very important for independence and economic growth of all three Caucasus states. The strategic transit potential of Turkey for the energy resources in the Caucasus should be reexamined and U.S. policy towards Turkey reactivated. Under the new administration the United States also needs to play a more active role in facilitating dialogue between Turkey and the EU.

Conclusion

Georgia is an important strategic link between Central Asia/Caspian and Europe. The existing volumes of shipments of energy and other resources already make the Trans-Caucasian transportation infrastructure a vital element of European economic security. But more resources are becoming available in the region and the stability of the transit infrastructure will be crucial in determining the ultimate direction in which these resources will flow. Russia still tries to channel all Caspian resources through its own infrastructure networks, but the reliability of the Russian option is questioned by yet another Russian oil dispute with the Ukraine.

The need for alternatives has been recognized and certain policy prescriptions have been planned, but the security of those alternative lines cannot be taken for granted. The Russian military incursion into Georgia and subsequent increase of the Russian military presence in Georgia challenge strategic interests of both Europe and United States in the region. As a result of the war, the following are at stake:

- Current shipments of more than one million bpd to world markets from Azerbaijan, Kazakhstan, and Turkmenistan
- Existing flow of natural gas with the potential to grow to 20 billion cubic meters annually and supply not only Georgia and Turkey, but Greece, Italy, and Eastern European states as well
- 1.5 million barrels of additional oil from Kashagan and other Kazakh fields
- Potentially 30-40 billion cubic meters of natural gas from Turkmenistan
- Access to NATO and US military bases in Central Asia/Afghanistan
- Stability in Georgia, one of the key transit countries for Caspian resources

In aggregate, these stakes provide enough incentives for Western interests in this pivotal region to take a more proactive security position and balance the pressure from Russia. Georgia or Azerbaijan independently cannot guarantee the security of the transit lines. Only a strong European and American presence would prevent disruptive actions that sabotage the transit infrastructure. It is important that the United States play an important role in the protection of the aforementioned infrastructure because energy security and military access to Central Asia are both at stake.

APPENDIX A:

Historical Background to the Corridor

Historical Evolution and Development of the South Caucasus Transportation Corridor

Transportation and transit through the South Caucasus is a functioning system that allows for millions of barrels of oil and oil products, billions of cubic meters of natural gas, and millions of tons of other mineral resources to be transported from the Caucasus to world markets. Naturally, the corridor is a two-way street and also allows for the delivery of equipment and other goods from Europe to the countries of the Caspian and South Caucasus.

The South Caucasus transportation corridor has been an important transportation link for countries of Central Asia and the Mediterranean for centuries. The decline of the Georgian kingdom in the fourteenth and fifteenth centuries, the Turkish advance into Byzantium, and Russia's annexation of the South Caucasus in the mid 19th century turned the region into the periphery of the largest territorial empire in the world. The history of the region directly affected the functioning of the trade routes, by reducing the role of the South Caucasus in the regional trade and transit. But new realities emerged after the discovery of oil in the Baku area in the late 19th century. The Russian empire became one of the largest exporters of the oil in the world and a need for export infrastructure emerged.

The port of Batumi, Baku-Batumi railroad, and later the Baku-Batumi pipeline became the regional anchor for the transit infrastructure of oil exports thereby boosting the development of the entire region. The international significance of the South Caucasus trade and transportation routes was reopened with the completion of the Baku-Batumi railroad in 1883, and the first commercial flow of oil. Later the rail system was complemented by a pipeline, and the South Caucasus became one of the first oil corridors in the world. The opening of the port of Poti, serving the shipment of Georgian manganese, and the subsequent increase of shipments through the rail system gave an important new impetus to the South Caucasus.

During the turbulent times of World War I and the Russian Civil War, the corridor once again became the subject of international rivalry. The newly created state of Transcaucasian Republic soon disintegrated into Georgia, Azerbaijan, and Armenia. Turkey advanced militarily into the Transcaucasian Republic, with primarily Baku's oil and the Georgian railroads in mind. The Turkish-Georgian agreement of 1918 included a special clause regulating the use of Georgian railroads by Turkish troops and in support of Turkish economic interests. German-Georgian agreements³⁸ also included important clauses on the use of the rail system and ports of Georgia. However, Azerbaijani oil and other resources of the Caucasus were too important for the nascent Russian revolutionary state to give up. In 1921, Russia attacked Azerbaijan – and later Georgia and Armenia – once again occupying the entire South Caucasus. The Caucasian states were too weak to resist the Red Army

38 Firuz Kazimzadeh, *The Struggle for Transcaucasia*, Philosophical Library, NY, 1951, p. 123.

military machine and after several military defeats, the governments went into exile. European states, preoccupied with the division of the German and Ottoman lands and property, let the Caucasus fall into the hands of the Soviet empire.

During the first several decades of the Soviet era, Azerbaijan became the primary producer of oil and the key target of the southern German offensive during World War II. However, in the 1960's the existing oil fields declined due to a lack of investment and relevant technology. They were first supplanted by the Volga region and then Western Siberia as the major oil producing areas of the Soviet Union. As the role of Azeri oil declined, so did the role of Batumi as an oil hub. However, the South Caucasus transportation corridor continued functioning as oil and oil product transportation and other types of raw materials passed through.

The collapse of the Soviet Union and the creation of the three newly independent states in the Caucasus – Armenia, Azerbaijan, and Georgia – gave these nations a chance to independently develop their own resources. The new oil discoveries in the Caspian Sea created a necessity for new transportation networks, and today the South Caucasus transportation already ships tens of millions of tons of Caspian oil to the markets via its existing pipelines and railroad system. No outside state should ever again be allowed to gain control over this region. Energy is the factor of supreme concern, but other security considerations are also at stake.

The last years of the Soviet Empire were very painful for the region due to manipulated ethnic and political conflicts. The first and most serious was fought by Armenia and Azerbaijan over the Nagorno-Karabakh region in the late 1980s. The war finally came to an end with 20 percent of Azeri territory under Armenian control by 1994. The conflicts in South Ossetia and Abkhazia in the early 1990s also resulted in the de-facto loss of control over those territories by Georgia.

The instability in the Caucasus in the early 1990s caused major damage to the transportation system of the region. Since 1994 there was no transportation link between Azerbaijan and Armenia, as well as Turkey and Armenia. The railroads connecting Azerbaijan to Armenia and Turkey to Armenia were closed, as were the railroads connecting Georgia and Armenia to Russia. The other elements of the transportation infrastructure such as power lines and highways also became dysfunctional. It was in this phase of devastation and chaos that the so-called “Deal of the Century” was announced between Azerbaijan and a consortium of several major international oil companies - Azerbaijani International Oil Corporation (AIOC). The deal envisaged the development of three major Azeri offshore fields: Azeri, Guneshli, and Chirag - with combined potential reserves of 6.4 billion barrels of oil.³⁹

Once the deal was announced there was intense competition over transportation options. The South Caucasus corridor seemed a very distant possibility at that time. Nothing supported it as a secure option for transportation of Caspian hydrocarbons; there was no existing infrastructure and the region was torn by conflicts and problems. Additionally, the

³⁹ “Azerbaijan: Production-Sharing Agreements,” *Azerbaijan Country Analysis Brief*, U.S. Department of Energy, <http://www.cia.doe.gov/emeu/cabs/Azerbaijan/azerproj.html>

idea faced strong geopolitical resistance from the major regional players, Russia and Iran, who wanted their own infrastructure for transit in order to obtain a greater role in the global energy supply picture. Most experts did not believe in the potential of the infrastructure projects through the Corridor, and many politicians were skeptical about success. At the same time, there was political will in the United States and Turkey to help the newly independent states of the former Soviet Union gain the economic basis for their independence, to cooperate with each other, and to ensure diversified supply of energy resources to the world markets. The diversification of market access for Caspian oil and gas would prevent Russia and Iran from obtaining exclusive control over the Caspian resources. The leaders in Azerbaijan, Turkey and Georgia saw the political and economic opportunity and seized it.

That is when the Clinton administration came up with its multiple pipeline strategy that included a set of pipelines that would ship Caspian oil via several existing and newly developed routes through the so-called Western and Northern directions. The multiple pipeline strategy initially supported two early pipeline solutions: the northern route from Baku to Novorossiysk completed in 1997, and the western route from Baku to Supsa, the newly constructed Georgian port in the Black Sea, completed in 1999. The U.S. played a very active role in the decision of the Azerbaijani International Oil Consortium (AIOC) and Azerbaijani government to build the western route to Supsa. Since its commissioning, the Northern route did not, for the most part, operate at full capacity because of the conflict in Chechnya as well as the disagreements between Azerbaijan and Russia on customs and other commercial considerations. In fact, since the end of 1999, the Baku-Supsa pipeline has been the only stable transportation option for AIOC oil. In this case, the so-called “political decision” of taking oil to the Western direction has turned out to be of great economic advantage for AIOC member companies. But in relative terms, the early oil pipeline projects were of limited scale and had little impact.

The most important projects for U.S. strategy were the *CPC* and *BTC* pipelines. The *Caspian Pipeline Consortium* is the first and only independent pipeline in Russia that currently operates outside of the direct control of the state pipeline monopoly Transneft. It has been operational since 2001 and it ships oil from the Kazakh oil field Tengiz to the Russian port of Novorossiysk on the Black Sea. Along with the three founding states (Russia with 24 percent of the shares; Kazakhstan with 19 percent; and the Sultanate of Oman with 7 percent), this consortium includes private companies led by the Chevron.

The *Baku-Tbilisi-Ceyhan* pipeline is the first infrastructure project that connected the Caspian Sea with the Mediterranean Sea via Azerbaijan, Georgia and Turkey. This pipeline system connects the Caspian Sea oil fields with Ceyhan, a deep-sea port on Turkey’s Mediterranean coast. It allows the shipment of one million barrels per day of Azerbaijani light crude to mostly European refineries. On June 2, 2006 the first oil tanker filled with Azeri oil from the newly constructed Baku-Tbilisi-Ceyhan pipeline departed the Turkish port of Ceyhan for a refinery in Italy. This is strategically the most important pipeline in the region and, in many ways, the greatest success of the Multiple Pipeline Strategy since it achieves all the primary goals thereof: it helps Azerbaijan and Georgia maximize their economic opportunities independently from Russia; it facilitates the regional cooperation of Azerbaijan, Georgia and Turkey; and it establishes an alternative corridor that Caspian oil producers can use to supply European and Mediterranean markets.

Another successful pipeline project under the Multiple Pipeline Strategy is the *South Caucasus Gas Pipeline (SCGP)* also known as Baku-Tbilisi-Erzurum pipeline. The Pipeline became operational in 2007 and it connects the Caspian gas fields Shah-Deniz in Azerbaijan to the Turkish natural gas distribution network at Erzurum. The strategic significance of this project is that in addition to supporting and diversifying the energy security of Georgia and Turkey, this pipeline system allows natural gas to be shipped to Europe via the Interconnector project between Turkey and Greece.

In addition to the previously mentioned pipeline projects, the railroad and port systems have also supported significant transits of oil and oil products as well as dry cargos and containers through the region and beyond. By the summer of 2008, the South Caucasus transportation corridor was a functioning system capable of transiting numerous types of cargo in and out of Central Asia and the Caucasus by various means of transportation. The system has demonstrated the steady trend of attracting increasing volumes of cargos from the entire region, competing with the Russian and Iranian transportation systems.

Despite substantial success in the development of the Southern corridor, the chain is only as good as its weakest link and Georgia will remain an impediment to the success of the transit route due to its tense relationship with Russia and the tentative status of its frozen conflicts.