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ABSTRACT

This paper examines the energy partnership between Turkey and Azerbaijan in the context of the Southern Corridor. It argues that an interdependent relationship between Turkey and Azerbaijan has emerged, parallel to the rising importance of the Caspian basin in European energy security discussions. It maintains that Azerbaijan plays three distinct yet interrelated roles in Turkey's energy policies: supplier for domestic markets, contributor/enabler of transit projects, and investor. The paper investigates the development of Turkey-Azerbaijan relations chronologically. It shows how these three roles evolved in three successive phases: the 1990s; the first decade of the 2000s; and recent years. The paper then analyzes the implications of the recent TANAP+TAP project for Turkey-Azerbaijan relations as well as for the Southern Corridor in general.

Turkey | Azerbaijan | Oil | Natural gas | Pipelines | European Union



The Turkey-Azerbaijan Energy Partnership in the Context of the Southern Corridor

by Şaban Kardaş*

Introduction

The Southern Caucasus is a region of key strategic interest to Turkey. Considering Turkey's close bilateral ties to Azerbaijan and Georgia on the one hand, and its dispute with Armenia on the other, the Southern Caucasus occupies a prominent place on Turkey's foreign policy agenda. The South Caucasus is also a transit corridor that potentially connects Turkey to the other Turkish-speaking countries of Central Asia. Given the vast energy reserves in Central Asia and the Caspian basin, Turkey is also keenly interested in developing a proactive policy towards the broader region. The new prospects for the region's oil and gas deposits in the post-Cold War era have resonated well with Turkey's efforts to bolster its supply security and to assert its role as an energy hub or transit corridor. Ankara has sought to import larger volumes of resources from the region, while also promoting the pipeline projects running through its territory.

In such complex energy geopolitics, or the "new Great Game", a special interdependent relationship between Turkey and Azerbaijan has evolved. The drivers of this partnership have been manifold, but most significantly they have included Turkey's search for supply security and its ambitions for a hub role on the one hand, and Azerbaijan's quest to consolidate its independence through integration into trans-Atlantic structures on the other. Azerbaijan so far has played three distinct yet interrelated roles in Turkey's energy policies: supplier for domestic markets, contributor/enabler for transit projects, and investor. The energy partnership between the two countries has gone through several phases in which a combination of these roles has determined the nature of their ties.

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1. First phase: transit corridor for Azerbaijani oil

In the initial period of the early 1990s, the broader debate on competing alternatives for the development and transportation of Azerbaijani oil set the parameters of the energy partnership. As a newly independent country, Azerbaijan was seeking to leave Moscow's orbit and to consolidate its economic and political independence. It thus worked to develop a multi-vector foreign policy and to build strong ties with the West through Turkey by capitalizing on its energy resources. Turkey gained a stake, albeit limited, in the production-sharing agreement for Azerbaijani oil reserves, which was a major turning point not only for Azerbaijan's pro-Western orientation, but also for the internationalization of Turkey's energy companies. Turkey and Azerbaijan cooperated closely on the realization of the Baku-Tbilisi-Ceyhan (BTC) crude pipeline, which formed the backbone of the US project for an East-West energy corridor. As Russia was unwilling to forego its hold over the former Soviet republics and pressed for its own alternatives for the main export line for Azerbaijani oil, Turkey's efforts to develop pipelines circumventing Russia heightened the strategic rivalry between Ankara and Moscow.¹

The geopolitical significance of the BTC project, which became operational in 2006, was widely acknowledged, but its economic feasibility was often questioned.² As a result, although it has proved to be an essential component of Turkey's ambitions to turn Ceyhan into a major energy terminal, it is far from being utilized at its full potential. Having incurred some costs from the operation of BTC, Turkey only recently resolved the resulting disputes with Azerbaijan. Moreover, the true contribution of BTC to Turkey's hub role still remains conditional on the completion of other proposed projects carrying additional volumes of Middle Eastern and Caspian basin crude to Ceyhan, such as the Samsun-Ceyhan pipeline or additional pipelines from Iraq.

Moreover, Turkey deemed Azerbaijan a vital corridor for its access to other producers of oil and gas on the eastern shores of the Caspian Sea. The proposed Trans-Caspian Pipeline (TCP) was conceived to form the second leg of the East-West energy corridor, by tapping Caspian basin gas reserves, especially those of Turkmenistan. At the time solely dependent on gas imports from Russia, Turkey too signed a major supply agreement with Turkmenistan in search of supply diversification. However, the legal and political disputes revolving around the delineation of the Caspian Sea made it impossible to realize Turkey's plans to access Turkmen gas through Azerbaijan and the TCP. Similar problems also curtailed the prospects for exporting major volumes of Kazakh oil through the BTC pipeline, undercutting its commercial feasibility, as referred to above.

¹ Süha Bölükbaşı, "The Controversy over the Caspian Sea Mineral Resources: Conflicting Perceptions, Clashing Interests", in *Europe-Asia Studies*, Vol. 50, No. 3 (May 1998), p. 397-414.

² Tuncay Babalı, "Implications of the Baku-Tbilisi-Ceyhan Main Oil Pipeline Project", in *Perceptions*, Vol. 10, No. 3 (Winter 2005), p. 29-60, <http://sam.gov.tr/?p=1892>.

As a result, Turkey had to opt for the Blue Stream gas pipeline with Russia and the Tabriz-Erzurum pipeline with Iran, through deals which are mostly deemed commercially unattractive and geopolitically problematic.³ As Russia and Iran have emerged as major suppliers of gas, Ankara has become increasingly dependent on two of its rivals in the region. This situation has dealt a serious blow to Turkey's energy security, especially considering the fact that throughout the last decade the share of natural gas in Turkey's energy mix has expanded, and more often than not Ankara has experienced political tensions with Moscow and Tehran.

2. Second phase: Azerbaijan as natural gas supplier and enabler of transit corridor

Throughout the first decade of the 2000s, Azerbaijan was again central to Turkey's energy policies, in terms of both supply and transit-related considerations. In the field of oil transportation, with the realization of the BTC, operated by a consortium led by BP, Azerbaijan took major steps towards the consolidation of its independence, and became more self-confident in regional affairs.⁴ Nonetheless, aware of Russia's intentions towards the former Soviet republics under Vladimir Putin's rule, Azerbaijan treaded carefully in order not to anger Moscow. Overall, however, it preferred to integrate into Western institutions, and its choices in energy policies were clear indications of that strategy. The BTC project, along with security cooperation and policy coordination among Azerbaijan, Georgia and Turkey, was instrumental in Baku and Tbilisi's "physical connection" to the Western world through Turkey; hence their adoption of a pro-Western orientation. As a result of the weaknesses of Georgia, Ankara, and later Baku - drawing on the wealth which it had derived from energy revenues - invested in Tbilisi's political stability and territorial integrity, leading to a trilateral mechanism among the three countries.⁵

Turkey-Azerbaijan energy relations focused principally on natural gas projects.⁶ After it started to monetize oil reserves, Baku, backed by the Shah Deniz consortium, started to develop its underwater gas reserves, which are estimated to be substantial. Given its acute need for a market and an export route, Turkey was the natural partner for Azerbaijan. Here, again, Azerbaijan's desire to use its energy resources

³ Şaban Kardaş, "Turkey-Russia Energy Relations: The Limits of Forging Cooperation Through Economic Interdependence", in *International Journal*, Vol. 67, No. 1 (Winter 2011-2012), p. 81-100.

⁴ İbrahim Arınç and Süleyman Elik, "Turkmenistan and Azerbaijan in European Gas Supply Security", in *Insight Turkey*, Vol. 12, No. 3 (Summer 2010), p. 169-190, http://file.insightturkey.com/Files/Pdf/insight_turkey_vol_12_no_3_2010_arinc_elik.pdf.

⁵ Mehmet Dikkaya and Deniz Özyakışır, "Developing Regional Cooperation among Turkey, Georgia and Azerbaijan: Importance of Regional Projects", in *Perceptions*, Vol. 13, No. 1-2 (Spring-Summer 2008), p. 93-118, <http://sam.gov.tr/?p=1973>.

⁶ Şaban Kardaş, "Turkish-Azerbaijani Energy Cooperation and Nabucco: Testing the Limits of the New Turkish Foreign Policy Rhetoric", in *Turkish Studies*, Vol. 12, No. 1 (March 2011), p. 55-77, <http://dx.doi.org/10.1080/14683849.2011.563503>.

to consolidate its pro-Western orientation was a decisive factor. Throughout the 2000s, a competition unfolded between Russian and EU-backed projects that were intended to develop new pipelines as part of the natural gas leg of the East-West energy corridor. Moscow tried to force Baku, through a combination of carrots and sticks, to thwart the latter's ambitions for marketing its gas directly to European markets. Azerbaijan committed only 1 bcm of its gas to Gazprom, despite Russian pressure. Azerbaijan's resistance to Russian offers and its unequivocal preference for Turkey and the projects bound for European markets were clear indications of the extent to which it valued integration into the Western world.⁷

From Turkey's perspective, two interrelated factors facilitated its partnership with Azerbaijan in natural gas projects: the aggregation of Turkey's supply security considerations, and the EU's new-found interest in tapping the Caspian basin natural gas reserves. First, parallel to its rapid economic development, Turkey's energy consumption soared. This demand was met largely by gas conversion power plants. Natural gas topped Turkey's energy mix, as it accounted for around 50% of electricity generation. Consequently, diversification of supply became a key component of Turkey's energy policies. Second, natural gas also assumed a special place in the European discussions on energy security throughout the 2000s. While environmental considerations led to renewed interest in an increased use of natural gas, the decline of domestic reserves and growing concerns about Russia's dominant position gave way to a new understanding, whereby energy security was almost equated with bringing Caspian basin and Middle Eastern gas into European markets.

As this idea evolved over time into the so-called Southern Corridor, the interests of Turkey and the EU appeared to overlap perfectly.⁸ While both Turkey and European countries needed to access new volumes of gas for diversification purposes, the pipelines crossing Turkish territory were publicized as the most feasible options. Turkey, then, capitalized on this idea, and often presented itself as the "fourth artery" that would carry gas to European markets. Such a prospective energy partnership was intermingled with the Turkey-EU accession process. Moderate voices on both sides often argued that Turkey's prospective contribution to European energy security through the Southern Corridor constituted an additional reason to accelerate accession talks. Despite the failure to create such a positive synergy and the stalemate experienced in Turkey's membership bid, the parties have managed to work on specific projects. As a result, throughout the 2000s, attention was focused on the highly-publicized Nabucco project and those that replaced it.⁹

⁷ "Russia Ready to Buy Azerbaijani Gas at Record Price", in *RIA Novosti*, 30 June 2009, <http://en.ria.ru/business/20090630/155389576.html>.

⁸ Şaban Kardaş, "Geo-Strategic Position as Leverage in EU Accession: The Case of Turkish-EU Negotiations on the Nabucco Pipeline", in *Southeast European and Black Sea Studies*, Vol. 11, No. 1 (March 2011), p. 35-52.

⁹ John Roberts, "Turkey as a Regional Energy Hub", in *Insight Turkey*, Vol. 12, No. 3 (Summer 2010), p. 39-48, http://file.insightturkey.com/Files/Pdf/insight_turkey_vol_12_no_3_2010_roberts.pdf.

Leaving aside other thorny issues, such as the designation of a transit route or solving financing and marketing uncertainties, the key question was how to find the gas to fill the proposed pipelines, be it Nabucco or others. It was on this point that Turkey's interest in Azerbaijani natural gas emerged as the lynchpin not only of bilateral Turkish-Azerbaijani relations, but also of Turkey-EU energy cooperation. Though Azerbaijan initially was considered only as a transit country for gas produced in other Caspian-basin countries, with the discovery of major offshore reserves in its own sectors in the Caspian, Azerbaijan's role as a supplier in its own right came to the forefront over time.¹⁰

First, as a gas supplier, Azerbaijan became essential to Turkey's efforts to diversify its imports away from Russia and Iran. When the Baku-Tbilisi-Erzurum (BTE) pipeline became operational in 2007, it not only allowed Turkey to have access to cheaper gas, but also equipped Ankara with a hedge against Moscow and Tehran. The BTE pipeline was constructed parallel to the BTC pipeline, and under the terms of the supply agreement, Turkey was to import gas produced from Shah Deniz I under preferential terms for an initial period. The talks for the revision of price, which were mired by the row caused by Turkey's efforts to normalize diplomatic relations with Armenia in 2009, lingered for a long time. Eventually, that issue was also settled as part of a package deal covering several energy issues after 2011, including the development of Shah Deniz II and TANAP.

Second, as a contributor to transit projects, Azerbaijan occupied an increasingly central place in the Southern corridor; hence became critical to Turkey's ambitions for an energy hub role. Since the supply contract with Azerbaijan granted Turkey the right to re-export Azerbaijani gas, Turkey developed the Turkey-Greece Interconnector (TGI), which would be extended from the BTE pipeline. Although the quantity was limited (1 bcm) when the gas started to flow in 2007, it demonstrated that Caspian gas was now being consumed in a European market.

On the issue of finding suppliers for the game-changing Southern Corridor projects, Azerbaijan, with its ongoing investment in the development of Shah Deniz II, emerged as the number one option. Among the possible sources for Southern Corridor projects, the Middle Eastern options, such as Iran and Iraq, were hindered by political uncertainty. Short of a solution to the TCP, which would have enabled access to Turkmen gas, the development of Shah Deniz II became by definition the *enabler* of the Southern Corridor projects. By most projections, whatever Southern Corridor project was chosen would be scaleable in the sense that it would start with Azerbaijani gas and then reach full capacity with the inclusion of other Caspian-basin or Middle Eastern suppliers.

The project with sufficiently substantial volumes to realize the Southern Corridor idea was Nabucco, but its supporters failed to overcome the many uncertainties

¹⁰ John Roberts, "The Role of Azerbaijan in European Gas Supply and Greek Interest", in *ICBSS Policy Briefs*, No. 15 (May 2009), http://icbss.org/media/128_original.pdf.

which surrounded it. They struggled hard in the face of Russia's efforts to undercut Nabucco by *inter alia* introducing the South Stream project. They even managed to get a "historic" intergovernmental agreement signed in 2009, and carried out feasibility studies. Nonetheless, the project failed to materialize as planned. Although there is tendency to attribute the failure of Nabucco to Russia's countermoves, it is in fact related to a myriad of factors. The changing environment of natural gas markets in the wake of the shale gas revolution, the declining energy consumption due to the global economic crisis, and the difficulty in solving financing issues were only a few factors that increased the uncertainty about the project. The lack of clarity about possible suppliers beyond Azerbaijan and the inability to secure purchase commitments dealt further blows to the project. At the same time, the problems pertaining to the Nabucco consortium itself, such as management issues or the fact that it was composed of minor players, were further undermining its feasibility.¹¹

With Nabucco's dimming chances over the years, other subsequent proposals such as Nabucco-West, ITGI or the Trans-Adriatic Pipeline (TAP) competed to realize the Southern corridor. At the center of that competition was the effort to transport Azerbaijani gas through a pipeline crossing Turkish territory.

3. Third phase: emergence of multi-faceted energy partnership

Since Turkey and Azerbaijan reached an understanding on various energy issues in 2011, they have entered a new critical phase in their energy cooperation. This new phase involves deeper partnership in the gas sector and increased foreign direct investment by Azerbaijan in Turkey's downstream markets.

When the Nabucco project hit apparent deadlock due to the factors mentioned earlier, the breakthrough came with Turkey and Azerbaijan's announcement of the Trans-Anatolian Pipeline Project (TANAP) in 2011. Like Nabucco, TANAP aims at transporting gas from the Caspian basin to European markets through a dedicated pipeline, rather than by using Turkey's existing pipeline network. While the throughput of BTE alone will not be able to accommodate additional volumes from Shah Deniz II, TANAP is not developed solely for Shah Deniz II and is designed to carry gas from other suppliers in the future. Therefore, TANAP will not be extended from BTE, but will start from the Georgia-Turkey border and operate as a stand-alone pipeline.

In December 2013, the final investment decision for Shah Deniz II was signed, after the Shah Deniz consortium selected TAP to carry Azerbaijani gas to European markets from Turkey onwards. Meanwhile, sales agreements were also concluded with European buyers for Shah Deniz II gas. As things stand, Azerbaijan's SOCAR will

¹¹ Katinka Barysch, "Should the Nabucco Pipeline Project be Shelved?", in *CER Policy Briefs*, May 2010, <http://www.cer.org.uk/node/102>.

control about 58% of the shares in TANAP, which has an approximate value of USD 12 billion, with BP having 12% and Turkey 30%. As it allocates 6 bcm to the Turkish domestic market and transports the rest to European markets, TANAP could make a major contribution to Turkey's energy policies. First, Turkey will benefit from TANAP by receiving larger volumes of Azerbaijani gas at prices more favorable than those which it currently pays on average. Likewise, such a diversification strategy and new hedge could enable Turkey to gain leverage with Russia and Iran when negotiating the terms of its future imports. Second, TANAP might open the way for the realization of Turkey's ambitions to become a major corridor or hub for the trade in natural gas.¹² Overall, Turkey appears to be satisfied with the terms of the transit agreement, so that it would also be commercially profitable to Turkey. By holding 30% of the shares in TANAP, Turkey will move beyond consumer and transit roles and start to be influential in upstream and midstream. Moreover, the selection of TAP as the follow-on route and the plans to branch out TAP into South-Eastern Europe could put Turkey in an advantageous position in European energy security discussions.

TANAP+TAP, along with the ongoing development of Shah Deniz II, was a major game-changer in many senses. First, rather than waiting for the resolution of the myriad problems bedeviling mega projects such as Nabucco, it constituted a more feasible project which gave a second life to the Southern Corridor idea. Second, Azerbaijan's decision to finance a major portion of the project also underscored its growing confidence in energy geopolitics. Such downstream investment by SOCAR is a clear indication of how far Azerbaijan has progressed in bolstering its economic and political independence. As the co-financer of the project, Turkey too signaled its willingness to play an autonomous role, unlike in the case of the Nabucco project, which appeared predominantly European.

Furthermore, with its scaleable nature, TANAP keeps open the possibility of an expansion of capacity, which bodes well for the other projects pursued by Turkey. In the future, additional volumes of gas from Turkmenistan, Iran or Northern Iraq could be transported through the same grid, with the extension of TANAP's capacity by means of additional compressor stations. There has also been speculation about the possibility of connecting East Mediterranean gas to the same system. Azerbaijani officials have also left open the possibility of carrying third parties' gas through TANAP. For instance, during a recent trip to Baghdad, Azerbaijani Foreign Minister Elmar Mammadyarov offered his Iraqi counterparts the possibility of delivering their gas to Europe.¹³ Currently these are only wild ideas, and the realization of any one of them will first and foremost depend on the resolution of intricate political disputes, not to mention the issues of technical and commercial

¹² See the conclusions of a roundtable attended by officials from energy sector and public agencies, entitled "TANAP Project's Role in Turkey's Quest to Become an Energy Hub" and held on 14 February 2014, http://www.hazar.org/eventdetail/events/turkey_will_be_an_energy_hub_with_the_tanap_project__614.aspx?currentCulture=en-US.

¹³ "Baku offered Iraq to help to deliver Iraqi gas to Europe", in *Contact Online News*, 11 February 2014, <http://www.contact.az/docs/2014/Economics&Finance/021000068621en.htm>.

feasibility. Moreover, it still remains to be seen to what extent Azerbaijan will be willing to allow competition from other suppliers, especially Turkmen gas. Turkey, for its part, has been working hard to bring about these alternatives, including the TCP. However, the settlement of the political disputes that are stalling these proposals is beyond Turkey's sole control, and their joint initiatives towards third parties, such as the Turkey-Azerbaijan-Turkmenistan trilateral dialogue, will need to be bolstered in the future.

The rivalry between Turkey and Russia over alternative pipelines has to an extent eased over this period. Previously, in response to Nabucco, Russia had proposed South Stream, which led to an almost zero-sum competition between the two projects. After the Southern Corridor was revived in the form of TANAP+TAP, it has for now averted a direct confrontation with Russia. While the Nabucco-classic and Nabucco-West projects targeted the same markets as South Stream in Eastern Europe, TANAP+TAP would mainly deliver gas to Southern Europe. The elimination of the challenge from Nabucco might have increased the chances of realizing South Stream at this stage, but it is far from certain that it will be realized in the short term. Major problems pertaining to South Stream, such as its enormous costs, questions about its technical feasibility and uncertainty over the future of European and international gas markets, will continue to bedevil it.

In any case, TANAP's market diversification approach has apparently reduced Russian concerns, allowing Turkey and Azerbaijan to proceed with their energy partnership without antagonizing Russia. With this new understanding, Azerbaijan has managed to export its gas, as well as its oil, into Western markets on its own terms. Nonetheless, the competitive dynamics with Russia might resurface if Turkey or the European actors press for the inclusion of Turkmen gas by refocusing on TCP or other projects. In such a scenario, closer strategic dialogue and policy coordination between the Western actors and the Turkey-Azerbaijan duo will be an urgent necessity.

In this new phase, the energy partnership between Turkey and Azerbaijan has gained a new dimension with the increase of Azerbaijani foreign direct investment in the Turkish economy, most notably the energy sector.¹⁴ In the first two periods, the tendency was for Turkish foreign direct investment to flow into Azerbaijan, an example being TPAO's investments there. Azerbaijan is the number one destination for Turkish foreign direct investment. In recent years, SOCAR's acquisition of a majority stake in Turkey's petrochemicals company PETKİM was a major turning-point. Together with the projected investments for TANAP, Azerbaijan is poised to be the top source of foreign direct investment in Turkey, at an amount of USD 21 billion. This development underscores how Azerbaijan is using its energy

¹⁴ "SOCAR Türkiye Başkanı Kenan Yavuz: Yatırımlarımız 20 milyar dolara doğru gidiyor", in *Star Gazete*, 1 August 2013. See also SOCAR, *İlham Aliyev: I Want to See SOCAR as the Biggest Industrial Company of Turkey in 2023*, 6 June 2013, <http://www.socar.com.tr/en/content/ilham-aliyev-president-republic-azerbaijan>.

revenues to consolidate its position in downstream markets, hence bolstering the prospects for Shah Deniz II exports. Turkey's decision to open its critical energy infrastructure to Azerbaijani investment is yet another indication of the value it places on its strategic partnership with that country.

Conclusion

Today, the future of the European idea of the Southern Corridor relies heavily on the constructive partnership between Turkey and Azerbaijan. Moreover, the evolution of the two countries' strategic environment since the end of the Cold War has rendered them indispensable to one another in terms of energy policies. Consequently, an interdependent relationship between Turkey and Azerbaijan has emerged, parallel to the rising importance of the Caspian basin in European energy security discussions.

On the one hand, without its partnership with Turkey, it would not have been possible for Azerbaijan even to consider such an ambitious role in contemporary energy geopolitics. For instance, without Turkey's import commitment, the development of Shah Deniz I would have been hard to imagine. Again, a significant portion of Shah Deniz II gas will be imported by Turkey. Similarly, alternatives to Turkey-bound pipeline projects, such as selling to Russia or exporting to Europe through White Stream or compressed natural gas (CNG), are either too costly or have in the past been geopolitically high-risk gambles for Azerbaijan. BTC, BTE and TANAP will continue to be essential ingredients in Baku's pro-Western foreign policy orientation.

On the other hand, Azerbaijan is critical to Turkey's energy security and potential role as a transit hub. The current and projected imports from Shah Deniz have provided Turkey with a major hedge, and helped alleviate its unhealthy dependence on Russia and Iran. Similarly, both BTC and TANAP+TAP are major enablers of Ankara's ambitions to assert its role as a major hub in the region. More significantly, in view of the current ownership structure of TANAP and the final investment decision for Shah Deniz II, Turkey will be no longer a mere consumer or transit country, but also a shareholder, and hence joint owner, of this gigantic project, which is the cornerstone of the Southern Corridor. This new role is likely to give Ankara greater leverage in regional energy politics and the Southern Corridor in general.

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