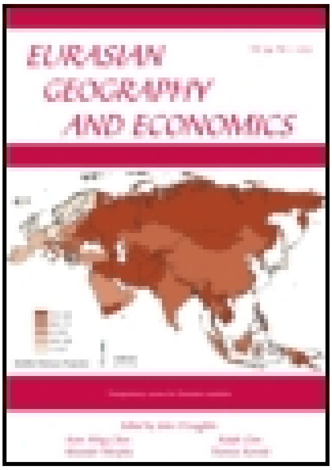


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# Geopolitics and revenue transparency in Turkmenistan and Azerbaijan

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# Geopolitics and revenue transparency in Turkmenistan and Azerbaijan

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Azerbaijan and Turkmenistan, both rich in hydrocarbons, diverge in their attitudes toward global initiatives that promote transparency in extractive industries. While Azerbaijan became a champion of the Extractive Industries Transparency Initiative in the region, Turkmenistan declined to embrace the norm of revenue transparency. This paper analyzes the reasons for this outcome by evaluating the impact of external influences on the management of extractive industries in Turkmenistan and Azerbaijan since 1992. In particular, it questions the role of geopolitical and economic factors in making oil and gas revenues more transparent. The paper argues that in comparison with the leadership in Azerbaijan, the Turkmen elite had few incentives to cooperate with international organizations that promote transparency due to Turkmenistan's dependency on Russian and Chinese pipelines and limited foreign investment from Western countries.

**Keywords:** transparency; Azerbaijan; Turkmenistan; geopolitics; energy; pipeline



Resource-abundant growth can be a challenge for the political institutions of countries in transition. In the last decade, international financial institutions (IFIs) promoted transparency in revenues as a remedy for all resource-rich countries in order to help them overcome mismanagement and corruption in the extractive sectors. Transparency in revenues became a global phenomenon where even countries with questionable human rights records began to display their willingness to comply. Yet, not all countries are keen on the initiative. The Caspian states Turkmenistan and Azerbaijan, both resource-rich and authoritarian, show an interesting variation in their willingness to embrace revenue transparency. While Azerbaijan became a champion of the Extractive Industries Transparency Initiative (EITI) in the region, the increasingly influential global discourse on transparency did not compel Turkmenistan to jump on the bandwagon. Ashgabat, which currently controls the fourth largest natural gas reserves in the world, refrained from participating in the EITI.

This paper analyzes the reasons for this policy divergence between the two Caspian neighbors by looking the impact of geopolitical factors on domestic elite preferences. I argue that pipelines routes and patterns of foreign investment had a major impact on existing transparency practices in Azerbaijan and Turkmenistan. In other words, the current divergence on revenue transparency policies reflects respective geopolitical and commercial affiliations of these two countries.[1] In particular, the Turkmen elite have

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few incentives to cooperate with global transparency advocates due to Turkmenistan's dependency on Russian and Chinese pipelines and limited foreign investment from Western countries. In contrast, the transparency reforms were rational reactions of the Azerbaijan elite to secure investor confidence, considering Azerbaijan's increasing dependency on Western energy markets and firms.

The paper proceeds as follows: I first survey the debates on natural resources and international energy relations to construct an analytical framework of leadership preferences toward transparency reforms in resource-rich authoritarian countries. I then apply this framework to the case of Turkmenistan and Azerbaijan to identify why their policies on revenue transparency diverge. The analysis shows how energy geopolitics, or global competition for scarce energy supplies, can shape and transform institutions in producer countries. It also highlights the ongoing relevance of pipeline politics and foreign investment in the Caspian region.



## *Resources, transparency, and the EITI*

Heavy dependency on resource revenues introduces major challenges to the economies of developing states (Auty 2001; Gylfason 2001; Karl 1997; Ross 1999). The original resource curse thesis claimed that abundance of hydrocarbons and certain minerals would slow down economic growth in the long term (Sachs and Warner 1995, 2001). Yet, the contemporary literature identifies poor governance of revenues as one of the main reasons why we observe a negative correlation between natural resource dependency and economic development (Ploeg 2011; Sala-i-Martin and Subramanian 2003). It is how the resource revenues are owned and managed, rather than their mere existence, that is likely to cause slow economic growth (Luong and Weinthal 2010). As remedies, it is argued that institutional qualities associated with good governance, including transparency, have a positive impact on economic growth in natural resource countries (Isham et al. 2005; Mehlum, Moene, and Torvik 2006; Robinson, Torvik, and Verdier 2006).

In the extractive industries, transparency refers to the accessibility of government revenues from the production and sale of hydrocarbons. More precisely, transparency of resource management includes the disclosure of contracts with international companies, transfers from the national oil funds to the state budget and other accounts, and clarity in how the funds are used (IMF 2007). In countries where institutional capacities are limited, the existence of easily collected rents from oil and gas revenues can encourage and facilitate corruption and mismanagement in each of these categories (Wantchekon 2002). These states show heavy signs of corruption, weak rule of law, and a dysfunctional bureaucracy, which leads to low levels of governance (Beblawi 1987; Larsen 2006; Mahdavy 1970). Transparency as a remedy can undermine corruption by making such acts more risky, by providing good incentives to public officials, and by initiating a fair selection process for public service. In contrast, a less-transparent business environment increases access to rents, thus removing incentives for reform.

The literature on transparency lacks a standard measure for the concept, and it is one of the reasons why it is very difficult to compare transparency levels across countries (Brunetti and Weder 2003; Islam 2006). In the absence of a practical measure of transparency, the EITI standard emerged as an important indicator of revenue transparency. The EITI is currently the leading institution on transparency promotion in resource-rich countries. It is a coalition of countries, companies, and civil society groups that aims to establish a global standard of transparency in extractive industries. In the EITI model, participating oil, gas, and mining companies are required to publish what they pay to the governments of their host countries, and the governments are required to publish what they receive. In this manner, the EITI aims to institutionalize regular publishing of resource revenues. Subsequently, the monitoring starts when an independent firm comparatively audits these published accounts. Local NGOs assess these reports and offer comments and suggestions for improvements. Overall, the multi-stakeholder group, which includes designated representatives from the government, companies, and civil society groups, supervises the process in each EITI country (Eigen 2006).

In time, the initiative expects the applicant countries to become fully compliant. Compliance to the EITI requires effective oversight by the multi-stakeholder group, timely publication of comprehensive and detailed reports on government revenues and payments to the private sector, easy public access to published reports, a credible assurance process, and a functioning feedback mechanism (EITI 2013). In this way, the initiative sets a definitive standard of revenue transparency, and the compliant members can be characterized as revenue transparent.



### *External influences on governance and transparency*

The literature on natural resources and good governance traditionally problematizes the domestic implications of resource abundance. Accordingly, in a *rentier* economy, as the leadership does not have any incentives to improve governance, one could observe a stagnation of political and economic reforms. While this country-level analysis is valuable, international factors, such as the distribution of economic and political power or the flow of ideas and norms, can also shape elite preferences on institutional reform toward better governance (Finnemore 1993; Finnemore and Sikkink 1998; Gourevitch 1978). In particular, over the last 30 years, scholars have documented that external pressures initiated important reforms in developing countries (Grugel 1999, 18). Energy-exporting developing states attract particular interest from the IFIs, as they are of crucial importance to the world economy. Here, I identify two main external influences relevant to the energy sector.

Firstly, the geopolitical standing of the country and the nature of its commercial relations with major international actors can play a major role in governance of extractive sectors. Since the turn of the century, in the face of rising demand for oil and the instability of supply from the Middle East, many consumer states, including the USA and China, have aspired to diversify their energy suppliers to include African and Asian states (Yergin 2006). These prominent powers exert influence to these hydrocarbon exporters through aid, investment, and even sanctions in order to sign long-term energy contracts. The leverage of consumer nations and international oil companies (IOCs) over producers is even more pronounced with the recent dramatic increase in global energy supplies, which drove down energy prices at the end of 2014. With lower prices, new investments in energy-rich countries would be scarcer and the competition to attract foreign investment will be much fiercer (Yergin 2014). Besides securing much-needed energy sources for future needs, Western countries and businesses often use this leverage to promote good governance (Bayulgen 2005). For example, more and more, the USA and European countries consider certain governance reforms as a prerequisite to doing business in developing countries. Furthermore, Western-based IOCs are encouraged by their home states to reveal the exact nature of their transactions with the hosts through measures such as the Foreign Corrupt Practices Act in the USA. Similarly, the European Union (EU) adopted an accounting directive in 2013, which obliges European multinationals to declare payments of more than €100,000 to foreign government officials in an attempt to eradicate corruption and improve transparency (Hall 2013).

However, not all international influences necessarily promote institutional quality. Unlike Western countries, Russia and China have strictly business-related agendas, and they are indifferent to good governance in their supplier states (Taylor 2006; Zweig and Jianhai 2005). These diverging perspectives often find international actors at odds with each other on high-profile cases of human rights abuse. For example, Organization for Economic Co-operation and Development (OECD) governments severely criticized national oil companies (NOCs) from China, India, and Malaysia during the 2000s for prioritizing their business interests despite the ongoing humanitarian crises in Burma and Sudan (Barnes and Jaffe 2006, 14). The competition of Western countries with Russia and China over the control of limited energy resources can have a direct impact on the quality of institutions in hydrocarbon-rich states. For instance, countries that have closer commercial interactions with NOCs from non-Western states will have fewer incentives to carry out transparency reforms (Chen and Jaffe 2007). In contrast, countries that are within the Western sphere of political and economic influence are more tempted to adopt this norm in order to appease their investors.

A second major influence is from IFIs, which may complement the political and economic relations described above. IFIs provide financial and technical support to host countries in exchange for carrying out good governance reforms. In particular, the World Bank and the IMF focus on good governance as a critical component of development assistance. They aim to inspire political and economic elites to be more open to liberalization and to empower domestic groups to promote their interests in the social and political arena. In particular, in energy-rich countries, IFIs prioritize the transparency of oil and gas revenues in order to combat corruption and mismanagement (Kolstad and Wiig 2009). First, they actively promote transparency through conditionality, where a country is expected to carry out expected reforms in order to secure international loans. Second, IFIs increasingly use technical assistance to help key actors internalize the norm of transparency. For example, the World Bank helps local civil society groups to improve their monitoring skills. Similarly, the IMF published its "Guide on Resource Revenue Transparency" in 2007, which provides references of good and best practices of resource revenue transparency as a guideline for both governments and civil society groups (IMF 2007).

Still, it is crucial to define, explain, and understand the actual mechanisms and precise effects of external influences on transparency in energy-rich countries. Despite their potential for stimulating reforms, external influences do not automatically translate to institutional change. For these efforts to succeed in non-democratic states, the leadership must have incentives to accommodate transparency promotion from abroad. The IFI influence is crucial in terms of dissemination of the norms and the implementation of reforms, yet this type of influence often succeeds an already-made political decision to initiate reforms. It is, in fact, geopolitical and economic relations that determine leadership incentives on governance reforms, while the IFIs provide the much-needed technical support in the following stages. The next section will provide the framework in which international influences can shape transparency reforms in resource-rich countries.

### *The analytical framework of transparency reforms*

Transparency in natural resource revenues is particularly promoted by global actors, including states, IFIs, and transnational networks, as a measure to prevent or minimize corruption and mismanagement of revenues (Gillies 2010). In hydrocarbon-rich countries, where the state enjoys financial autonomy from the societal forces, international transparency promoters such as the IMF and the World Bank focus their efforts primarily on the political elite, which have the sole power and the authority to initiate economic reform. Given the rentier state dynamics and the lack of democratic accountability in these countries, only direct material benefits from cooperation are likely to create incentives for the elite to reform institutions in line with the demands of international actors (March and Olsen 1984). Authoritarian rulers comply with the demands of external transparency promoters, when complying provides additional opportunities for the political elite to maintain their privileged status in an economy dominated by energy revenues.

Aware of the importance of revenues for their political survival, the political elite evaluate short-term benefits and costs of carrying out institutional reforms. In the case of revenue transparency, the costs of complying are public oversight over earnings from resource extraction, disclosure of secret contracts with international companies, and forgone personal income otherwise distributed to guarantee patronage. Making revenues transparent, hence, could raise awareness and mobilize public dissent, especially if the majority of the population lives in poverty. On the other hand, the benefits of transparent institutions are foreign direct investment (FDI) and political support from Western countries.

Thus, in authoritarian resource-rich countries, transparency reforms are more feasible when external influences that favor transparency have leverage over the domestic elite and can induce them to carry out reforms using material incentives. In that sense, international pressure in favor of more transparent institutions is more likely to be successful when the country is economically or politically in need of Western support. Otherwise, the costs of compliance would often be too high for authoritarian leaders. In addition, as studies on regime change show, leverage without linkage does not guarantee expected results (Levitsky and Way 2006). The density of ties and the intensity of cross-border flows with OECD countries would also improve the likelihood of governance reforms. For developing resource-rich countries, I expect that the presence of direct transport routes, such as pipelines, or substantial investment from countries that prioritize good governance would increase the incentives for the political leader to comply with transparency promoters.

## Geopolitical influences on revenue transparency in the Caspian

Table 1 shows that Azerbaijan and Turkmenistan, two former Soviet republics, have comparable economic and political indicators. While both countries struggled with problems of economic and political transition during the last decade of the twentieth century, in the last 15 years, they have experienced fast economic growth, due mostly to high oil and gas prices. During this period, per capita GDP increased more than tenfold in both Azerbaijan and Turkmenistan (World Bank 2014b). This process accelerated the dependency of these countries on their subsoil resources and consolidated their authoritarian governments. As a result, they have very low rankings in various indicators of democracy and accountability (Freedom House 2015; World Bank 2013).

At the moment of independence in 1991, both countries had to rely on Soviet-era pipelines for their energy exports. Particularly, Turkmenistan remained almost completely dependent on the Central Asia Center (CAC) Pipeline to Russia due to lack of alternative export routes (see Figure 1). This dependence continued until the

Table 1. Selected economic and political indicators for Azerbaijan and Turkmenistan.[a]

| | Azerbaijan | Turkmenistan |
|---|---|---|
| Population | 9,416,598 | 5,240,072 |
| GDP per capita (current US$) | 7811.80 | 7986.70 |
| Freedom Score 2014[b] | Not Free – 6 | Not Free – 7 |
| Corruption Perceptions Index Ranking 2014 | 126/175 | 169/175 |
| GDP composition: | Agriculture: 6.2 Percent<br>Industry: 63 Percent<br>Services: 30.8 Percent | Agriculture: 7.2 Percent<br>Industry: 24.4 Percent<br>Services: 68.4 Percent |
| Fuel exports Percent of merchandise exports | 93 Percent | 90 Percent |
| Extractive sector Percent of fiscal revenues | 74 Percent | 80 Percent |
| Extractive sector Percent of GDP | 47 Percent | 44 Percent |

Sources: CIA (2014), Freedom House (2015), Revenue Watch (2013), Transparency International (2014), World Bank (2014a, 2014b).
[a]All the figures are for 2013 unless otherwise stated.
[b]Freedom Score is an index of political rights and civil liberties with 1 representing the most free and 7 the least free.



Turkmenistan–China pipeline was inaugurated in 2009, which significantly amplified Chinese influence in the country. In contrast, since its independence, Azerbaijan has gradually oriented toward the West. At the moment, a substantial majority of Azerbaijan's energy exports are destined for European markets via the Baku–Tbilisi–Ceyhan (BTC) and Baku–Tbilisi–Erzurum (BTE) pipelines. The following


Figure 1. Major Caspian oil and natural gas export routes.
Source: EIA (2014a).

discussion evaluates the interaction of geopolitics and leadership incentives in Turkmenistan and Azerbaijan that, respectively, prevented and facilitated transparency reforms in the extractive industries.

## Turkmenistan

### *The extractive industry and transparency*

Turkmenistan's economy severely lacked transparency during the rule of Saparmurat Niyazov, the First Secretary of the Turkmen Communist Party, who quickly established his own control over the former Soviet state in 1991 (Anderson 1995, 509; Hancock 2006, 69). During Niyazov's rule, public finances remained hidden, and the state budget did not report total revenues from the sale of natural gas. In this period, Turkmenistan's revenues from the export of natural gas were concealed from the public by "deceptive accounting practices, non-transparent swap arrangements and under-the-table transactions" (Gleason 2010, 78). Similarly, transactions with a handful of IOCs that operate in Turkmenistan took place behind closed doors, and the production data and contract details remained unknown. For instance, by 2010, Turkmenistan had concluded Production Sharing Agreements (PSAs) with six foreign companies; however, the government did not disclose any information regarding shares of ownership or profits.

During his presidency, Niyazov directly controlled the flow of money through several funds intended for his personal discretion. For instance, the former Turkmen leader allegedly appropriated $1.5 billion from the sale of natural gas in 1992 and 1993 (Esanov, Raiser, and Buiter 2004, 7). Though these funds were not a part of the state budget, they amounted up to 60 Percent of the GDP during the peak years of gas production (Bohr 2003; Peyrouse 2012, 173). As is the case with many energy-exporting countries, Turkmenistan established the State Fund for the Development of the Oil and Gas Industry in 1996 in order to stabilize revenues and save funds for future generations. However, an undisclosed, larger savings fund existed at the *Deutsche Bank* – the Foreign Exchange Reserve Fund, controlled tightly by the former president (Kalyuzhnova and Bluth 2008, 45).

The secrecy of the regime concealed any information on how the funds were managed. Yet, it is evident that a considerable sum was channeled to the construction of palaces and golden statues, which helps support the personality cult of the president (Kalyuzhnova and Bluth 2008, 55). The revenues were also spent on subsidies and large public investment projects, such as the large artificial lake in the *Karakum* Desert despite its significant ecological and financial costs. Overall, the use of funds in this manner prevented diversification and investment in other sectors of the economy.

In December 2005, Niyazov passed a law on the oil and gas industry to further establish his personal authority over the rents. The new legislation eliminated the role of the Ministry of Oil, Gas, and Natural Resources as a supervisory body over foreign companies. In the aftermath, the president became the sole legal authority to approve exploration, permits and he began to control all aspects of natural gas production (Peyrouse 2012, 173).

After Niyazov's death in December 2006, Gurbanguly Berdymukhammedov, his former health minister, was elected to rule the country in February 2007. Initially, Berdymukhammedov's presidency signaled a changing trend from an absolutist way of governance to a more rational one. Under Berdymukhammedov, Turkmenistan began to carry out a series of market-friendly reforms (Šír 2010). The new president reformed the Central Bank of Turkmenistan and assembled a more stable system of fiscal and monetary policy in April 2008. He also created the National Bureau of Statistics in

Table 2. Resource governance index and its components.[a]

| Rank | Country | Composite Score | Institutional and legal setting | Reporting practices | Safeguards and quality controls | Enabling Environment |
|---|---|---|---|---|---|---|
| 28 | Azerbaijan | 48 | 57 | 54 | 51 | 24 |
| 57 | Turkmenistan | 5 | 13 | 4 | 0 | 3 |

[a]Resource Governance Index measures the quality of governance in 58 resource-rich countries. The scores are from 0 (worst) to 100 (best).
Source: Revenue Watch (2013).

place of the previous *Türkmenmillihesabat,* which was a Niyazov era institution for manipulation (Peyrouse 2012, 158). Finally, Berdymukhammedov established the State Agency for Management and Use of Hydrocarbon Resources to set the standard for all oil and gas operations in the country, to negotiate and conclude contracts, and to supervise the management of funds.

Despite some of the reforms described above, Berdymukhammedov sustained Niyazov's policy on maintaining a tight grip on the extractive industry. Promoting his own *Ahal Teke* clan in the energy bureaucracy, he handed the posts of Minister of Gas and Oil and the Deputy Prime Minister to his fellow clansmen (Peyrouse 2012, 112). Similarly, the president's new initiatives often suffered from the same kind of opaqueness as those of Niyazov. Berdymukhammedov established a new stabilization fund in October 2008 in response to the global economic downturn (Nichol 2009, 7). The fund was established to collect budget surpluses and to protect the country during the global financial crisis (Peyrouse 2012, 158). However, there is very little information on this fund, its board of directors, location, and management (Crude Accountability 2011, 11). Consequently, the Resource Governance Index ranks Turkmenistan 57th among 58 resource-rich countries as one of the worst in terms of governance of natural resources (Revenue Watch 2013), and considerably below Azerbaijan. As Table 2 shows, Turkmenistan is particularly weak in "reporting practices," which signify dissemination of information.

One of the main reasons for this divergence in revenue transparency between Azerbaijan and Turkmenistan is the latter's lack of any enthusiasm to join the EITI. Turkmenistan's unwillingness to embrace revenue transparency as a norm and join the EITI is heavily influenced by geopolitical factors such as its natural gas export routes and economic relations.

### *External influences*

The Turkmen leadership essentially feared external influences during the reign of former president Saparmurat Niyazov from 1991 to 2006 and prevented their access to the state institutions. However, Niyazov's visit to China in 2006, subsequent confirmation of substantial natural gas reserves, and Berdymukhammedov's rise to power encouraged various external actors to improve their relations with Turkmenistan. In particular, the EU and China aspire to import Turkmen natural gas in order to diversify their energy sources. Similarly, the USA and Russia aim to protect their strategic economic and political interests in the region.

*Foreign relations and pipeline diplomacy*

Russia is traditionally the most influential external actor in Turkmenistan due to deep cultural and historical ties between the two countries. However, Turkmenistan's relationship with Russia has been fairly contentious since 1991. Until very recently, Ashgabat was economically dependent on the CAC Pipeline, transferring Turkmen gas to Russia. This dependence triggered tensions between Turkmenistan and Russia throughout the 1990s and 2000s, as *Gazprom* controlled the export capacity of Turkmenistan and limited its access to international gas markets (Dzardanova 2010, 4). Given the importance of natural gas for the Turkmen economy, Niyazov and his successor constantly explored other export routes in order to diversify foreign markets. For example, in 1997, the *Korpoje–KordKuy* pipeline between Turkmenistan and Iran began to transport 212 Billion cubic feet of natural gas per year (Bcf/y). This was the first time a country in the region bypassed the CAC pipeline to export natural gas. Nevertheless, the capacity of the 120-mile pipeline is small in comparison with the overall export capacity of Turkmenistan, which is 3500 Bcf/y (EIA 2014b).

Turkmenistan's energy revenue prospects significantly improved in 2008, when Gaffney, Cline, and Associates, a global consultancy group, confirmed the existence of substantial natural gas deposits in South *Yolotan* and *Osman* fields (Kilner 2011). This discovery suddenly made Turkmenistan the fourth largest natural gas-rich country in the world (Peyrouse 2012, 170). Confirmation of these huge deposits and the prospects of reform opened up possibilities for external actors to be more active in the country, and for Turkmenistan to finally increase production and diversify its export routes.

The USA and the EU had already shown interest in the energy potential of Turkmenistan as an investment opportunity for their businesses. To this end, from late 1990s onwards, the USA and some West European countries eagerly began to support the *Nabucco* project, which would transfer Turkmen gas to Europe under the Caspian Sea and through Azerbaijan, Georgia, and Turkey (Hancock 2006, 76; Lubin 1999, 63). The *Nabucco* project was revitalized after the confirmation of natural gas deposits and various European leaders and companies began to lobby the president to lend his support behind the proposed pipeline project. Notably, the EU Energy Minister and the Commission President visited Turkmenistan in January 2011 to pressure Berdymukhammedov to guarantee the supply of natural gas to Europe (Crude Accountability 2011, 37). However, problems regarding the cost-effectiveness of the project and the lack of funding options delayed progress, and the European countries shelved the project in 2013. In addition to financial feasibility issues, one of the most important reasons for the negative outcome of *Nabucco* negotiations was the fierce opposition by Russia, which did not want to compete with Turkmen gas in Europe.

The rich natural gas reserves of Turkmenistan also attracted the attention of China. The construction of the Central Asia–China Pipeline, which was opened in December 2009 and became fully operational in July 2011, provides a much-needed alternative route for Turkmen gas. The pipeline transfers Turkmen gas to China via Uzbekistan and Kazakhstan over a 1140 mile route, which carries 1060 Bcf/y of gas. Under the provisions of the agreement, Turkmenistan, Uzbekistan, and Kazakhstan equally share the capacity of the pipeline (Peyrouse 2012, 182). Turkmenistan and China also agreed in principle to increase the Turkmen contribution to 2100 Bcf/y, which would be a huge boost for Ashgabat's revenues (Cutler 2011).

China had already become a key economic partner in Turkmenistan even before the conclusion of the pipeline (Šír and Horák 2008). In recent years, Turkmenistan and

China concluded several treaties on technical and economic cooperation. For example, China loaned $4 billion to Turkmenistan when the gas supply to Russia was cut off in 2009. In response, Turkmenistan singed a PSA contract with the Chinese state company China National Petroleum Corporation (CNPC) for the gas field *Baghtiyarlik* and allowed Chinese companies to participate in the South *Yolotan* project (Ahmedov 2010).

In 2010, Turkmenistan's natural gas exports to Iran doubled with the inauguration of the *Dauletabad–Sarakhs–Khangiran* pipeline, which helped Ashgabat to further diversify its export routes (BBC News 2010). Finally, another potential export route for Turkmenistan is toward South-East Asia. The proposed trans-Afghanistan pipeline would transfer Turkmen gas to India via Afghanistan and Pakistan. Yet, the security concerns and price negotiations between the parties have so far delayed any progress. If approved, the pipeline would transfer 1200 Bcf/y over 1000 miles (EIA 2014b).

Unlike many Western states, Russia, China, and Iran do not publicly criticize authoritarian practices and human rights abuses in countries they do business with. For example, Russia turns a blind eye to the ethnic discrimination faced by 200,000 Russians in Turkmenistan due to Gazprom's interests in Turkmen gas. Russia is likely to tolerate such behavior as long as Turkmenistan is willing to use Russian export routes to sell gas to western Europe (Overland and Torjesen 2010, 143). Similarly, the arrival of Chinese companies that disregard OECD business practices such as transparency and accountability can hinder economic reforms and urge Turkmenistan to further distance itself from the West (Goldman 2009, 85).

Even though China has now replaced Russia as the dominant business partner of Turkmenistan during the reign of Berdymukhammedov, the implications of this new geopolitical context are the same for governance and transparency. Chinese influence does not create incentives for the Turkmen elite to embrace far-reaching governance reforms.

### *Foreign investments*

The ability of the political elite to maintain the inflow of foreign exchange is an essential requirement for rentier states, without which clientelism would not work. As a consequence, a high density of foreign assets in the energy sector can potentially increase the influence of external actors over the leadership, which relies on revenues from the extractive industries to maintain political support. It can also provide the necessary linkage to establish long-term economic relations with foreign actors. However, in contrast to Azerbaijan and Kazakhstan, Turkmenistan did not receive substantial FDI after its independence. In fact, the level of FDI in Turkmenistan was only a fraction of the investments made in Azerbaijan and Kazakhstan. Between 1995 and 2005, Azerbaijan and Kazakhstan received $1,515,620,636 and $1,969,458,506, respectively, in net inflow of FDI, while Turkmenistan received merely $201,010,909 (World Bank 2014b).

Ashgabat was not in a hurry to attract foreign investment thanks to its relatively recently established gas industry and cotton production as an alternative source of revenue (Luong and Weinthal 2001). Another factor that affected the amount of foreign investment was the former president's absolute authority over decisions to award extraction contracts. The extremely autocratic nature of the government damaged Turkmenistan's credibility for many Western companies as the contracts were awarded not based on merit but on political patronage. With only limited international investment and possessing a relatively recently developed infrastructure, Turkmenistan pursued a passive approach to natural gas production and relied on existing gas fields and pipelines. As a consequence, Ashgabat fell from being the sixth largest producer of natural gas in 1993 to twelfth in 2003 (Pomfret 2001).

Limited international investment is also closely related to the lack of export options in the country, creating a vicious cycle for the Turkmen economy. As mentioned above, until recently, the country was almost completely dependent on Russian pipelines for its natural gas exports. The lack of alternative routes and Russia's control over the pipelines significantly restricted the extraction of natural gas (Ahmedov 2010). For example in April 2009, a pipeline explosion caused a 50-percent fall in natural gas production. Following the repair, Russia agreed to import only one-third of the pre-explosion quantity and negotiated a lower price, which reduced Russia's credibility as a reliable partner (EIA 2014b).

The quantity and the source of foreign investment had an important impact on elite preferences in Turkmenistan. Foreign companies of Western origin could not find the opportunity to operate in Turkmenistan during Niyazov's era, with Eni (Italy) being the most notable exception. Turkmenistan has seen a substantial increase in the net inflow of FDI in the last five years thanks to Berdymukhammedov's efforts to liberalize the economy (see Figure 2). However, majority of new foreign investments are from Russia, China, and Iran (Heritage 2014). In contrast, Turkmenistan so far has failed to secure FDI from American companies, mostly due to fact that foreign investment decisions in the country are politically driven. Accordingly, "companies from 'friendly' countries are often more successful in winning tenders and signing contracts" (US Department of State 2013b). At the moment, the main foreign energy companies are the CNPC, Dragon Oil (Dubai), Eni (Italy), and Petronas (Malaysia), which operate almost exclusively on offshore fields, with the exception of CNPC, which also participates in several onshore projects (EIA 2014b).

This trend continues in the distribution of the contracts for the newly discovered fields. Highlighting the rising importance of Asian demand for Turkmen gas, companies

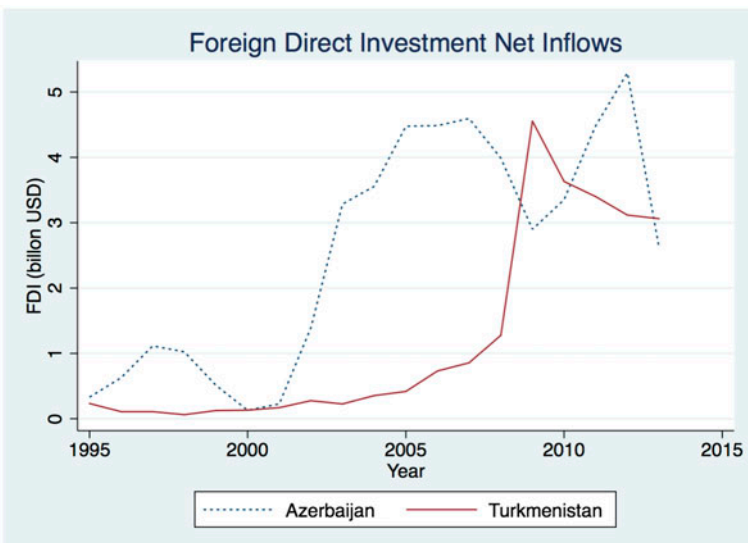


Figure 2. FDI net inflows.
Source: World Bank (2014b).

from China, South Korea, and the United Arab Emirates acquired the vital contracts from the South *Yolotan* field in 2010, while Western multinational energy companies such as Total, Exxon Mobil, British Petroleum, Chevron, and Royal Dutch Shell were largely disappointed (Dzardanova 2010, 13).

*Transparency advocates*

The absence of international leverage from Western countries and businesses removed the urgency of transparency reforms in Turkmenistan. In light of low leadership preferences favoring reforms, global transparency advocates failed to influence the Turkmen government and society. Unlike other countries in the region, such as Azerbaijan and Kazakhstan, the IFI influence in Turkmenistan is very limited. For example, Turkmenistan joined the IMF in 1992, but the Fund did not finance any projects and eventually withdrew in 2000 when Turkmenistan stopped sharing financial information (Anceschi 2008, 84; Pomfret 2006, 91). During the Niyazov period, the World Bank extended only three loans to Turkmenistan on public resource management, financial transparency, and a public transport system (World Bank 2012, 5). This limited cooperation suddenly halted in 1997 following a decision by the Turkmen government not to approve further projects (Peyrouse 2012, 195). The World Bank's relations with Turkmenistan slightly improved after Berdymukhammedov came to power, and the Bank now offers technical advice to the Turkmen government on revenue management and national wealth funds (World Bank 2012, 5).

Global networks that promote transparency and good governance also suffer from similar limitations. The Open Society Institute, Crude Accountability, and Revenue Watch, which have substantial experience in management of hydrocarbons and interaction with local NGOs, cannot access the Turkmen government and society. A handful of international correspondents that had operated in the country, such as the Radio Free Europe, left Turkmenistan in response to government's crackdown on NGOs and international observers in 2004 and 2005 (Crude Accountability 2009, 22).



## Azerbaijan

***The extractive industry and transparency***

Since its independence in 1991, Azerbaijan had taken on many governance reforms in the management of oil, such as strengthening banking governance, the tax code, accounting and executing system, and internal and external auditing capacity (Hopkings et al. 2007, 21). Yet by early 2000s, concerns about wasteful spending and corruption lingered in Azerbaijan. During this period, Azerbaijan decided to take part in the EITI under the direction of the former president Heydar Aliyev, and the country formally joined the initiative at its first summit in 2003. Initially, the Azerbaijani government showed skepticism toward NGO participation, despite the fact that civil society participation is a key component of the EITI (Asadov 2009, 97). Finally, three parties to the initiative, the government, the oil companies, and the NGOs, signed the EITI memorandum of understanding in 2004, and Azerbaijan became the first fully compliant country in 2009.

The most obvious contribution of the EITI toward transparency in Azerbaijan is the publication of reports on oil revenues. Thanks to the EITI process, the Azerbaijan government has published timely and regular reports on its extractive industries since 2003 in a systematic process of "disclosing, reconciling and publishing company payments and government receipts" (SOFAZ 2009). The annual reports are very comprehensive, with detailed information from companies and different revenue streams. For example, Azerbaijan's 2012 EITI report, which covers the hydrocarbon and the mining sectors, accounts for all the major revenue streams going to the government by 31 companies operating in the country. The EITI process allows these companies to clarify their payments to the government, reducing the likelihood of corruption (EITI 2012).

Unlike other EITI-affiliated countries such as Nigeria, which had problems carrying out the requirements of the initiative, Azerbaijan has consistently produced reports without delays (Guluzade 2009). Until recently, Azerbaijan was also ahead of Kazakhstan, another EITI member, in the timeliness of its reports as well as the disclosure of its PSAs.[2] For example, Kazakhstan keeps its contracts with foreign international firms secret; however, in Azerbaijan, British Petroleum, the largest foreign investor in the country published its PSAs on *Shah Deniz* and *Chirag* projects via the website of State Oil Fund of Azerbaijan (SOFAZ) (Bagirov, Ahmedov, and Tsalik 2003).

The EITI process had a significant impact on SOFAZ. The fund's current sources of income are net revenues from the sale of hydrocarbons and returns generated from its investments (SOFAZ 2011). The fund makes information about oil revenues freely available on its website, and this makes Azerbaijan a leading country in the region in terms of transparency. An independent firm, Ernst and Young, conducts an annual audit of its revenues, and SOFAZ publishes quarterly statements on its revenues and assets.[3]

Despite the increasing visibility of government revenues, serious problems of resource management remain in Azerbaijan, which are discouraging for the establishment of transparency as a norm in the country. Most importantly, issues of vital importance to revenue management, such as government expenditures and the accounts of the NOC, remain unmonitored and opaque (Öge 2014). Nevertheless, EITI reforms are major achievements, especially because before Azerbaijan began to comply with the EITI standards, the exact amount of oil revenues remained unknown. As a consequence, in response to its efforts to implement the EITI, SOFAZ received "The United Nations 2007 Public Service Award" (SOFAZ 2007). On the Resource Governance Index in Table 2, Azerbaijan ranks much higher than Turkmenistan, which is remarkable for a country that has significant problems in terms of political accountability and corruption (Revenue Watch 2013).

Why did Azerbaijan join the EITI? Unlike Turkmenistan, Azerbaijan had plenty of incentives to embrace transparency. Particularly, Baku's close political and economic ties with OECD countries as well as the establishment of the BTC pipeline motivated the Azerbaijani leadership to carry out these reforms with the help of global transparency advocates.

### *External influences*

The war with Armenia over Nagorno-Karabakh (1988–1994) shaped Azerbaijan's foreign policy in the 1990s. In response to Russia's tacit support of Armenia in the war, Azerbaijan began to pursue a more pro-Western foreign policy and concluded major contracts with major IOCs, led by British Petroleum (Nassibli 1999, 107). After the war, Azerbaijan further oriented itself toward the West via Turkey with which Azerbaijan shares a common culture and history. At the same time, Azerbaijan did not risk alienating Russia, which was a key arbitrator in the conflict with Armenia. In the end, in a key geopolitical region with substantial resources, Azerbaijan chose to pursue a balanced foreign policy, yet open to European and American influence.

*Foreign relations and pipeline diplomacy*

A major foreign policy implication of post-independence oil production was the pipeline diplomacy, which initiated the transfer of Azerbaijan's oil and gas to European markets. Two pipelines, BTC and BTE, run parallel to each other, and they connect the Caspian oil and gas to Europe. IOCs led by British Petroleum made direct investments in these pipeline projects, which made Azerbaijan relatively more independent from Russian pipelines and influence and further oriented toward Europe. The BTC and the BTE began operating in 2006 with a capacity of 1.2 million bbl/p of oil and 8 billion cubic meters of gas, respectively (Gojajev 2010, 5).

Azerbaijan's proximity to Europe allowed the EU and the Council of Europe to become important influences. The EU and Azerbaijan concluded a Partnership and Cooperation Agreement in 1999, which dealt not only with economic transactions, but also with political rights and freedoms. The EU also supports specialized programs, such as the TACIS (Technical Aid to the Commonwealth of Independent States) and its successor, European Neighborhood and Partnership Instrument, which urge cooperation in oil and gas industries, among others. Azerbaijan has also been a member of the Council of Europe since 2001. The Council was an essential actor behind the 2002 amendments to the constitution, which attempted to bring the Azerbaijani legislation in line with the Council of Europe standards in terms of political and human rights. Similarly, the Azerbaijan government applied the experience and insights from European countries in the creation of SOFAZ. Experts from Azerbaijan were especially inspired by the experience of the Government Pension Fund of Norway, a benchmark case of sovereign wealth fund management.[4]

*Foreign investments*

Oil extraction was the central activity of the economy in 1991, and this was vital for the country, which was in dire economic condition following the war with Armenia (Hoffman 2000, 56). However, Azerbaijan lacked the capital and the technology to extract oil without securing large investments from multinational oil companies. The second president of Azerbaijan, Haydar Aliyev, signed the "Contract of the Century" in 1995, which created a list of PSAs with mostly Western foreign oil companies (Nassibli 1999, 107) under the banner of the Azerbaijan International Operating Company.

Azerbaijan benefited significantly from foreign investments in its oil industry, high oil prices, and the BTC pipeline. As a consequence, the country sustained record-breaking growth levels during 2000s. Since 1995, Azerbaijan has had a very fast-growing economy with an average yearly GDP growth of 10.9 Percent (World Bank 2014b). However, this prosperity made Baku even more dependent on oil exports. Hydrocarbons comprise almost 93 Percent of total exports in Azerbaijan, larger than both Kazakhstan and Turkmenistan (World Bank 2014b). This is very problematic for Baku, as output projections already predict the peak of oil production between 2012 and 2015 (Raballand and Genté 2008, 9). Furthermore, this high level of dependence makes the country vulnerable to sudden fluctuations in the market, such as the steep decline of oil prices at the end of 2014. Given its dependency on oil revenues, Azerbaijan urgently requires the inflow of foreign investment and technological know-how in order to delay the decline of its oil production and offset the impact of lower prices.

In this context, the dominant position of Western IOCs in the country motivates the political leadership to be more inclined to cooperate with transparency advocates. In fact, the pressure from IOCs operating in the country was critical for Azerbaijan's decision to join the EITI (Akiner 2004, 378–379). The ailing Heydar Aliyev endorsed the EITI to maintain international prestige and to garner the support of the OECD countries for his successor, his son Ilham Aliyev, who assumed the presidency in 2003 (Makhmutova 2005).

*Transparency advocates*

In Azerbaijan, the construction of the pipelines to European markets and the influence of multinational oil companies motivated Baku to cooperate with IFIs. Since 1995, when the first major oil contracts were signed, Azerbaijan has attempted to take on many governance reforms to strengthen banking governance, the tax code, the accounting and executing system, and internal and external auditing capacity (Hopkings et al. 2007, 21). Most of these reforms were facilitated and monitored by the World Bank, the IMF, or the European Bank of Reconstruction and Development. Azerbaijan has also been working closely with the World Bank in particular in order to "improve the quality and transparency in public sector governance" (World Bank 2010).

The financial leverage of the World Bank eventually waned as Azerbaijan received substantial sums from oil windfalls during 2000s.[5] My interviewees from SOFAZ agree that the Bank is currently not capable of making a direct impact on national policies.[6] However, the government still pays attention to IFIs, "as it does not want to lose prestige."[7] Specifically, Baku still respects the World Bank for consulting, training, and capacity building purposes.[8]

Azerbaijan's relations with global advocacy groups, such as Revenue Watch, Transparency International, and Publish What You Pay follow a similar pattern. The government is generally tolerant of the operation of these groups in the country; however, their influence is often restricted by the absence of democratic institutions and political accountability.[9] The enthusiastic manner in which the Azerbaijani government carried out transparency reforms, despite the limited influence of transparency advocates, confirms the rational incentives model proposed in this paper. The leverage of transparency advocates gradually decreased as Azerbaijan acquired financial stability; however, the enduring importance of pipelines routes and FDI pressures Azerbaijan to comply with the EITI standard.

**Assessment and implication**

Despite the substantial external interest in the natural resources of Turkmenistan, Ashgabat did not embrace the norm of transparency. The Berdymukhammedov government does not disclose the revenues from the sale of natural gas to the public and international observers; meanwhile, the new stabilization fund and the state oil and gas companies operate in complete secrecy. Finally, the Turkmen leadership did not show any enthusiasm to join the EITI, while other countries in the region, such as Azerbaijan, Kazakhstan, Uzbekistan, Tajikistan, and Afghanistan became members. The lack of transparency lingers because the discovery of new resources did not fundamentally change leadership preferences on transparency. Two concrete factors explain the lack of reforms in Turkmenistan: the dominance of Russia, and later China, over export routes and insubstantial FDI from OECD countries. Currently, the three main export destinations of Turkmen natural gas are China (52 Percent), Russia (24 Percent), and Iran (22 Percent) (BP 2014). This reality undermined the leverage of OECD countries over the domestic leadership in Ashgabat and weakened transnational economic, political, social links in relation to transparency in extractive industries. Similarly, it removed the necessity for the current president to adopt transparency as a norm developed and promoted by Western institutions and companies. Hence, global transparency advocates had very limited access to Turkmen institutions and never established the connections they had done in other post-Soviet states.

In contrast, Azerbaijan became EITI compliant because the process paralleled Azerbaijan's increasing orientation toward the West. Azerbaijan is highly dependent on its peaking oil production for growth, and the oil industry requires foreign investment to prevent the decline of revenues. Hence, the EITI reforms were rational reactions of the Azerbaijan elite to secure investor confidence, considering that most influential IOCs in Azerbaijan are of Western origin (Nassibli 1999). The existence of a direct export pipeline to Turkey and the potential gas exports to South-East Europe further provided incentives for compliance to the EITI.

In addition, joining the EITI was a face-saving act by the Azerbaijani government, who is often criticized by the West for its harsh treatment of political dissenters (Guliyeva 2005, 42). By leading the EITI process, Baku aimed to restore its global prestige in the eyes of foreign investors and governments. Turkmenistan, under both presidents, did not have any pressing need to implement and show off reforms due to the relatively weak position of energy companies from the OECD countries. Table 3 summarizes the specific geopolitical and economic factors discussed in this paper that determine leadership preferences on transparency reforms.

The transparency of revenues is successfully implemented in Azerbaijan as seen by its successful completion of the EITI criteria. The rapidity with which Azerbaijan carried out the requirements of EITI membership is impressive, but its compliance in this sense does not signify a long-term willingness to improve governance. Despite the EITI membership, indicators of good governance such as rule of law, corruption, and voice and accountability did not improve in Azerbaijan (World Bank 2013). Eager to signal openness, Azerbaijan signed on to the EITI without necessarily changing its other policy practices on natural resource governance. In the governance literature, this phenomenon is explained by concepts such as decoupling (Meyer and Rowan 1977; Westphal and Zajac 2001), or mock compliance (Walter 2008), which both explain the gap between the formal rules and institutions and the actual policies. In the particular case of Azerbaijan, the successful adoption of revenue transparency did not prevent high-level corruption and wasteful government spending (Öge 2014). This outcome further

Table 3. External influences on transparency reforms.

| | Turkmenistan | Azerbaijan |
|---|---|---|
| Major Pipeline Routes | Russia, Iran, China | Turkey (80 Percent of exports), Russia, Georgia |
| Major Sources of FDI | China, Russia, Iran, Gulf States | The UK, the Netherlands, Turkey |
| Major Foreign Operators | China National Petroleum Corporation, Dragon Oil (Dubai), Eni (Italy), and Petronas (Malaysia), | Led by British Petroleum and includes Chevron, ExxonMobil and Hess (the USA), Inpex and ITOCHU (Japan), Statoil (Norway), and Türkiye Petrolleri (Turkey) |

Sources: EIA (2014a, 2014b); US Department of State (2013a, 2013b).

underlines the instrumental use of transparency reforms by the Azerbaijan regime, not in order to eventually be more democratic, but to maintain the inflow of FDI and Western support. In contrast to Turkmenistan where the influence of Russia and China removed the urgency of EITI membership, Azerbaijan's orientation toward the West was the decisive element in its relatively successful adoption of revenue transparency. Regardless of its real impact on good governance, the policy split between two shores of the Caspian Sea is still crucial since it underlines how global competition for hydrocarbons shape domestic institutions in energy producing states.

## Conclusion

Studies on energy geopolitics often ignore the impact of international energy relations on resource management. Furthermore, the literature on the governance of natural resources has yet to offer a compelling argument on the nature of international factors that affect transparency in authoritarian regimes. This paper fills this gap by demonstrating how geopolitical dynamics and international economic relations may in fact be the key to understanding certain aspects of institutional reforms. When an authoritarian state is economically dependent on a globally traded commodity that brings significant rents, leadership preferences toward good governance are inevitably tied to those of major consuming nations and their spheres of influence. In the Caspian, pipeline routes and geopolitical affiliations have been the main determinants of policies on revenue transparency.

In the case of Turkmenistan, restricted export routes and limited FDI from the OECD diminished the incentives of the ruling elite to cooperate with transparency advocates. As a result, transparency promoters, such as the World Bank and the IMF, could not compel Turkmenistan to improve its energy governance. Whereas in Azerbaijan, the abundance of Western businesses and the construction of export routes to Europe motivated the political elite to fully endorse the EITI and lead to a relatively successful implementation of revenue transparency.

In the future, the business-oriented nature of Berdymukhammedov can eventually make Turkmenistan more susceptible to external influences that promote transparency. The president is eager to exploit the huge natural gas reserves of Turkmenistan, and he has shown willingness to tolerate international organizations in order to fulfill the energy potential of the country. However, the increasing influence of China and the ongoing shunning of Western companies reduce the leverage of OECD countries and the likelihood of reform. Accomplishing revenue transparency would require Turkmenistan to increase its transactions with international oil and gas companies from the OECD countries and tolerate transnational advocacy networks that work on transparency. Given the existing pipeline routes, the level of authoritarianism and the enduring lack of incentives in the country, this outcome seems unlikely in the short term.

## Disclosure statement

No potential conflict of interest was reported by the author.

## Notes

1. In addition to descriptive and secondary resources, the paper draws upon in-depth interviews by the author with government officials, non-governmental organizations (NGOs), and IFI

representatives in Azerbaijan conducted in 2010. I would like to thank David Deese and Juliet Johnson for their valuable suggestions on earlier versions of this paper.
2. A PSA guarantees a share of the crude production to the foreign investor at the beginning of the production cycle, and the rest is divided between the foreign participants and the government according the details of particular PSA (Hoffman 2000, 58).
3. Interview with Farid Farzaliyev, Head of the EITI Secretariat, SOFAZ, 18 June, 2010, Baku.
4. Interview with Farid Farzaliyev, Head of the EITI Secretariat, SOFAZ, 18 June, 2010, Baku.
5. Interview with Sabit Bagirov, a member of the EITI Council, the director of the FAR Center, and the former president of SOCAR, June 18, 2010, Baku. Interview with Azer Mehdiyev (chairman) and Rovshen Agayev (expert in economics) of the Support for Economic Initiatives Public Union, 14 June 2010, Baku. Interview with Ingilab Ahmedov, Director, Public Finance Monitoring Center and member of the institutional board of EITI in Azerbaijan, 16 June 2010, Baku.
6. Interview with Farid Farzaliyev, Head of the EITI Secretariat, SOFAZ, 18 June 2010, Baku. Interview with Bahruz Bahramov, Portfolio Manager, SOFAZ, 10 June 2010, Baku.
7. Interview with Fidan Najafova, Program Director for Transparency of Oil Revenues and Public Finance, OSI-AZ, June 7, 2010, Baku.
8. Interview with Kenan Aslanli, expert, Public Finance Monitoring Center, 9 June 2010, Baku.
9. Interview with Fuad Suleymanov, Program Director, OSI-AZ, 7 June 2010, Baku. Interview with Rena Safaraliyeva, Executive Director, Transparency Azerbaijan, 9 June 2010, Baku.

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