

# **A STABILITY PACT FOR THE CAUCASUS**

*A Consultative Document of the  
CEPS Task Force on the Caucasus*

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## PREFACE

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CEPS formed a Task Force on the Caucasus on 28 January 2000 in concluding a conference in Brussels, convened by CEPS at the proposal of the OSCE High Commissioner for National Minorities, Max Van der Stoep. With the present document the Task Force puts into circulation the preliminary text of a comprehensive plan for the region. Consultations are now being undertaken with interested parties, official and non-governmental, in the region and outside, in order to improve the present proposals operationally, and to create momentum in public debate.

A word on the title “A Stability Pact for the Caucasus” is called for. The Task Force has hesitated over this. Of course the substance rather than the name is the main point. But still, the chosen title serves to bring into the open some vital issues. Is the intention to copy the Balkan Stability Pact of 1999, or the Balladur Stability Pact of 1995? Neither, since the circumstances in each case are different and so must also be the mechanisms – despite some obvious similarities between the Balkans and the Caucasus (multi-ethnic “Balkanisation”, conflicts, frontiers of former empires and ancient civilisations).

Still there are three features in common:

- 1) Multilateral diplomatic initiatives concerning territories that border or overlap the former Soviet Union and the enlarging European Union;
- 2) Normative foundations consisting of common values codified by the pan-European organisations (Council of Europe and OSCE); and
- 3) Complex actions that have to be based on the interests of regional actors, but that also depend on the economic incentives and peacekeeping capacities that only the major powers can deploy.

The proposed Stability Pact for the Caucasus is perhaps closer to the Balkan Stability Pact, being about ethnic conflict resolution or post-conflict situations, rather than preventive diplomacy as with the Balladur Stability Pact. It is categorically different, however, in that there has been no significant Western military involvement, the region is entirely post-Soviet Union space, and the geographical proximity of the European Union is less. Still, the Task Force has attempted to draft a Stability Pact for the Caucasus with the same three common features identified above. But the combination of measures has to be different: more importance attached to regional

integration (of the South Caucasus), direct responsibilities assigned to Russia (Northern Caucasus), long-term perspective on integration with the EU (for the Southern Caucasus), agreement of the essential need for a Pact to establish a predominantly cooperative regime for the whole region. The latter would be underwritten by all the regional actors and the major external powers, progressively supplanting the regime of local hostilities backed by opposing geo-political alliances.

There may be some fatigue with stability pacts in European diplomatic circles. However the following perspective is suggested. An historic task for the post-communist period is to stabilise the borderlands of Russia and the enlarging European Union. The first Stability Pact was rather successful in Central Europe. The second Stability Pact is work-in-progress in the Balkans. A third is now needed for the Caucasus, and with that, we would have a real chance of winning the ultimate prize of achieving stability in the entire European space.

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## ***A CONSULTATIVE DOCUMENT OF THE CEPS TASK FORCE ON THE CAUCASUS***

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### **1. Appeals of leaders of the region**

President Demirel of Turkey proposed on 16 January 2000, that there should be a Stability Pact for the Caucasus.

President Shevardnadze of Georgia has for several years been arguing in favour of a Peaceful Caucasus initiative. On 17 November 1999 at Istanbul, he proposed enhanced Black Sea Economic Cooperation, to give a balanced attention to economic, political and security issues and to creation of a BSEC-EU Cooperation Platform.

President Aliiev of Azerbaijan advocated recently that “the countries of the South Caucasus must enter the 21<sup>st</sup> century free from all conflicts and confrontations, and accept their own Pact for Security and Peace ...”.

President Kocharian of Armenia addressed the Georgian parliament on 29 March 2000, arguing that:

- a security pact for the Caucasus can only be effective if all states of the region are involved,
- not only security and conflict resolution issues should be addressed, but it also should provide the basis for economic cooperation and democratic reforms;
- the pact should be based on a 3+3+2 agreement: i.e. Armenia, Azerbaijan, Georgia + Russia, Iran and Turkey + US and EU.

Georgian foreign minister Menagharishvili spoke in reply that Tbilisi supports all initiatives aimed at stabilising the situation in the Caucasus.

President Aushev of Ingushetia on 30 March 2000 called upon President Putin to seek a political solution in dialogue with all the Caucasus leaders, the entire region being destabilised by the Chechnya war, in addition to the conflicts involving Armenia, Azerbaijan and Georgia.

In the past two years, statements favouring a renewed effort for a comprehensive approach to political stability and economic development through regional cooperation in the Caucasus were also made by the US Secretary of State Albright and the Russian Foreign Minister Ivanov.

## **2. EU-Russia-US to respond**

The powers are thus invited to assist in producing a durable solution to overcome the region's instability. They have now a window of opportunity and duty to use it. It requires engineering – politically and diplomatically – a shift of paradigm from one reminiscent of the 19<sup>th</sup> century to one worthy of the 21<sup>st</sup> century; from one of rivalries, realpolitik, violent nationalism and conflict, to one of cooperation and integration based on the norms developed in Western Europe during the second half of the 20<sup>th</sup> century.

The status quo has many features of a 19<sup>th</sup> century paradigm. There are many conflicts and tense oppositions in the region, from the clan to the geo-political. The pivotal case, both in terms of local geography and geo-politics, is that of Nagorno-Karabakh. Behind the trenches and land-mines of no man's land lies a wide set of virtual alliances, notwithstanding the efforts of the Minsk Group of the OSCE (co-chairs: France, Russia, US). The virtual alliances on the Armenian side sees support from Russia with arms and military bases. Iran cooperates closely with Armenia. On the Azerbaijan side there is political support from Turkey, which blockades Armenia. The US supports a line of virtual alliance from Turkey through Georgia to Azerbaijan, as seen in oil pipeline diplomacy. The US sanctions Iran. Armenia blockades the Azeri province of Nakhichevan. Russia argues that Georgia has not been helping stop infiltration of terrorists in and out of Chechnya. Abkhazia adds further frictions to the set of regional relationships. Both Georgia and Russia blockade Abkhazia for its attempted secession. Russia has at times lifted its part of the blockade, when it felt Georgia was not being helpful over Chechnya, whereas the illegal Chechnyan business in and through Abkhazia has also been widely reported. Both Georgia and Azerbaijan feel insecure in relation to Russia, and so discuss developing a stronger relationship with NATO, which further aggravates the atmosphere between Russia and the US. Meanwhile the economy of the whole region suffers. Political stalemate clearly favours the rise of extremist elements throughout the region. Nationalist polemics and demands for vengeance are intensified.

According to a 21<sup>st</sup> century paradigm a set of agreements over the several conflicts could set in motion a virtuous circle of economic, political and societal developments. The South Caucasus could start on the process of long-run convergence on the European integration model, both for intra-regional integration and later with the EU. Political agreements would allow the immediate removal of blockades, triggering a restart of commercial exchange and more normal relations between the communities. Political security, if really credible, would be the signal for big investments in the oil and gas sector, both in production and trans-Caucasian pipelines, some of which should cross presently blockaded frontiers. Both in the Northern Caucasus and the three South Caucasus countries there are outstanding

natural assets and an amazingly rich cultural heritage, which are presently greatly under-exploited. Resources would be released from military budgets, to benefit social expenditures and civil infrastructure investments. Western aid would be undoubtedly expanded, to help in financing repair of war damage, and providing funds for renewal more generally. Projects to advance economic integration in the region are waiting for peaceful removal of blockades, such as railway lines presently cut: the north-south line from Russia through Abkhazia into the rest of Georgia, cross-border links between Azerbaijan, Armenia and Turkey, and east-west line along the southern Azerbaijan and Armenian frontiers with Iran. In the Russian Northern Caucasus, especially in Chechnya, the growth of religious extremism and political terrorism has been fostered by the miserable economic conditions since the first Chechnyan war of 1994-95. Economic recovery in the Northern Caucasus is indispensable for durable peace, and this would be aided by progress in the Southern Caucasus.

Reality is of course not black and white. Elements of both paradigms co-exist, but the question is which one is to dominate. The desirable strategy has to engineer the shift in paradigm, from domination by 19<sup>th</sup> century norms to the ascendancy of 21<sup>st</sup> century values. The war-weariness of the region may now at last permit this, but nothing can happen without engagement of the big powers.

Indeed, the proposed Stability Pact for the Caucasus brings into focus the very substance of the future relationships between the Russian Federation, the European Union and the United States. All three are in a position to claim that they have legitimate (historical or recently acquired) interests in the area - political, economic or strategic. Those interests, though different, are not necessarily divergent. Unlike the Balkan situation, the geopolitical stakes in the Caucasus are more clearly identifiable. The Caucasus will probably be the next big test for transatlantic solidarity. It is also the terrain where a new chapter of, hopefully, constructive cooperation can be opened between Russia and the West. The potential for positive action is enormous. Conversely, the absence of an accepted common purpose and strategic vision - and the failure to act accordingly - carries the danger of serious confrontation. In either case the consequences, good or bad, for the peoples of the region and the future of international relations will be considerable.

A comprehensive approach, based on a rational balance of trade-offs and pay-offs, can provide viable answers to the complex issues of the region. Some of those problems are really difficult, some are endogenous and some are compounded by extraneous elements, some are pressing and some can wait, some have to be tackled one at a time and some have to be dealt with in a package, some are old and some are new. None of them is intractable. The ultimate beneficiaries of the proposed multilateral negotiation process will

have to be the peoples in that long-suffering area and their neighbours in the wider Black Sea–Caucasus–Caspian region.

### **3. A Stability Pact for the Caucasus**

The first Balladur Stability Pact of 1994-5 was EU preventative diplomacy to clear up frontier and minority problems among accession candidate countries, using this as a precondition for accession and therefore a strong incentive mechanism to settle.

The second Balkan Stability Pact of 1999 is a soft conference mechanism. Its creation depended entirely on the prior NATO intervention, which led to the Dayton and UNSC Res.1244 peace settlements imposed on Bosnia and Kosovo, with the incentive of EU integration, however distant, also a factor.

Neither of the two pacts are therefore a model for the Caucasus, where the conflicts are not yet settled, and where part of the region is Russian territory.

For conflict resolution in the South Caucasus, since all three countries aspire to a future in modern Europe, it is suggested that one particularly valuable precept from European experience be observed. This would be to play down notions of absolute independence and sovereignty, given that Western Europe's own difficult ethnic conflicts and tensions are only being resolved through complex systems of distribution of competences, interdependence and shared sovereignty. This would indeed mean a shift of paradigm for the Caucasus, to jump from the 19<sup>th</sup> century to the 21<sup>st</sup>.

Concrete examples may be drawn from, amongst others, the 1998 Northern Ireland agreement and Belgian federalism, both in the EU setting. The Northern Irish agreement is characterised by multi-tier relationships between state entities (Ireland, UK), nations which are autonomous but non-state entities (Scotland, Wales), and a self-governing province (Northern Ireland). These relationships are in part horizontal and asymmetric (i.e. sub-state entities share power with states for certain powers). The words federation, confederation and independence do not appear. The point about Belgium is that it is a federation, but one in which the federal level is rather thin in power now as a result of devolution of powers to the EU, to the territorial entities and also to the separate cultural/language communities. The conflicts of the South Caucasus seem to be calling for solutions which could draw on some of these features (see 4.1 below).

The EU and Russia can also draw on their experience in deepening the “Northern Dimension” to their border relations, which builds on the Baltic and Barents Sea cooperation (analogue of the Black Sea), and also seeks to develop cooperation on major economic (energy, transport) projects as well as highly sensitive border issues (Kaliningrad). Therefore a “Southern

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Dimension” concept is suggested, building on existing Black Sea cooperation, but going further, also with the US as full partner.

Still the overarching shift of paradigm has to be engineered and set into motion, and this requires a powerful impulse. Therefore an operational mechanism is proposed, with a variable geometry designed to provide the initial impetus for action, to ensure adequate coordination and monitoring of progress, and to lock in potentially diverging interests in a comprehensive cooperative enterprise at a regional level:

A Trilateral understanding, comprising Russia, the EU and the US, consisting of a willingness to participate in a Stability Pact for the Caucasus, perhaps with 6 chapters:

For the Southern Caucasus Community:

A/ Conflict resolution and prevention

B/ South Caucasus Community;

C/ An OSCE regional security system.

For the wider Southern Dimension

D/ Russia/EU/US Southern Dimension cooperation

E/ Broader Black Sea – Caucasus – Caspian cooperation

F/ Oil and gas investment and related infrastructure.

The Trilateral would then propose this agenda to a Caucasus Contact Group. This would of course include Armenia, Azerbaijan and Georgia, who in turn might wish to invite their direct neighbours, Turkey (acknowledging President’s Demirel’s initiative), and Iran (supposing a will to join a broadly cooperative scheme), making perhaps a Group of 8.

It would be clear from the beginning that the wider agenda of six chapters could only proceed with assurance of political settlements of the conflicts. The prospect of the wider agenda would increase the incentives to settle, but the substance would not be pre-negotiated. On the contrary the wider agenda would follow, otherwise the negotiations to settle the conflicts would risk getting bogged down deeper and deeper.

According to the topic additional players would of course be involved: the OSCE/ UN for conflict resolution and regional security arrangements; the Council of Europe for human and minority rights, the international financial institutions (IMF, IBRD, EBRD) as required, and autonomous entities such as Abkhazia and Nagorno Karabakh where their vital interests are directly concerned. However this extended participation would be organised on an ad hoc basis, rather than by creating a very large, formal, plenary structure, such as the Balkan Stability Pact.



The broader Black Sea – Caucasus – Caspian dimension, bringing in all countries of the Black Sea and Caspian Sea, would be based on the existing mechanism of the Organisation for the Black Sea Economic Cooperation (BSEC) of which the countries of the Caucasus are members. The BSEC organisation itself would be upgraded in operationality, with full membership now appropriate for the EU in view of the status of Bulgaria, Romania and Turkey as accession candidates, and possible association links with the South Caucasus. There would be a Black Sea-Caucasus-Caspian Political Forum (BCC) for actions and consultations which by their nature should include all countries of the region as well as the EU and US.

The Trilateral would also develop a specific understanding on how the EU and US might make “best efforts” contributions to ease the very difficult problems of the Russian Northern Caucasus.

#### **4. South Caucasus Community**

##### **4.1 South Caucasus conflict resolution and prevention**

Hachapuri recipes<sup>1</sup>. The vocabulary of independence, sovereignty, federation and confederation sometimes bedevils the search for solutions in the Caucasus. It is proposed to make only limited use of such contested terms, and to focus instead on the mechanisms of governance and constitutions appropriate for complex multi-ethnic communities such as the Caucasus, the Balkans and indeed much of Western Europe. The European model, which the South Caucasus may at some stage join, is about shared sovereignty, coordination, cooperation, equality between national communities and cultures, interdependence, and multi-tier (sometimes asymmetric<sup>2</sup>) structures of governance. Precise recipes for the Caucasus will be indigenous (Hachapuri) and specific for each case, but should have common features, and also could be enriched by a judicious use of some current ingredients from Northern Irish, Belgian, South Tyrol, Aland Islands etc. Concretely a schema of how competences may be shared by level of government is suggested in Box 1. This is a reference, or a tool-kit, or basis on which individual cases may be discussed - not a universal recommendation. The general idea is to work for solutions that avoid violent or unagreed changes in state frontiers. Obviously enough, the Caucasus region has demonstrated already its potential for escalating violence (see Annex B). Its potential for further escalation of ethnic violence and cleansing as seen in the Balkans

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<sup>1</sup> *Hachapuri* is a fine Caucasian cheese-cake, primarily Georgian, much appreciated in Abkhazia, with Armenian recipe variants, also appreciated in Baku.

<sup>2</sup> “Asymmetric” in this context means that entities of different constitutional status (states, federated states, regions) may share certain policy competences in a non-hierarchical manner.

surely exists too. This is why the search for other solutions, even if complicated, is imperative.

*Box 1. Tool-kit on the distribution of competences among self-governing entities.*

Constitution. Federated states and republics would write their own constitutions, subject to not contradicting state competence. There would be no provision for secession without agreement of the state and the entity. The distribution of competences and coordination between the different levels of governance would be regulated so as to minimise conflicts and tensions (e.g. in the Belgian federal system it has been found easier to regulate a multi-ethnic system with exclusive rather than shared competences).

South Caucasus Community (SCC) dimension (see 4.2 below). This would introduce a new tier of economic powers and political integration, diluting traditional conflicts, leading also to the perspective of European integration.

Horizontal and asymmetric relations between entities. Black and white ideas of independence versus subordination would be diluted in a more complex set of relationships between entities, including some horizontal relations between the different levels of governance, including the possibility for self-governing political units to establish relations with foreign states in their fields of competence (see below). This possibility may include in certain cases treaty-making powers.

Citizenship. Passports would carry designation “South Caucasus Community”, then a state identity “Armenia/Azerbaijan/Georgia”, then in exceptional cases, when provided in the peace agreement, the indication of a specific citizenship of political entities such as Abkhazia or Nagorno Karabakh. Dual nationality (“state identity”) would be possible. Residents of entities with important communities of another state (e.g. Armenians in Nagorno-Karabakh) would be free to choose either or both state identity.

Defense, security and police. Entities warranting a high degree of autonomy may have territorial armed forces, of multi-ethnic/non-discriminatory composition. Entities recently at war would be subject to specific security agreements and guarantees of the OSCE, and this would condition the prerogatives of territorial commanders (e.g. to safeguard the rights of refugees and displaced persons). The armed forces of these entities would also be included in the activities of international security organisations, such as the OSCE. Police would be an entity competence, subject to security guarantees for all ethnic communities.

External relations. Membership of UN and international organisations and international diplomatic recognition an exclusive prerogative of the state, which does not exclude a certain access to these organisations of other entities. In matters of entity competence, direct relations with third countries and international organisations. Representations in third countries of such entities as

Abkhazia, South Ossetia, Adjara or Nagorno Karabakh possible, for instance as identified members of state diplomatic missions. Frameworks for cooperation and joint projects between entities and with states possible in such fields as education, culture, language, sport and youth if these are within the scope of the entity's competences. This should be possible within the SCC, as with related communities in Russia, Turkey and Iran.

Currency and monetary policy. Competence of state, until and unless international currency adopted (e.g.euro). Purely symbolic differences in banknotes possible, but an expensive luxury (as in Belgium-Luxembourg).

Trade policy. Tariffs and/or free trade regimes, competence of the state, until and unless becomes a South Caucasus Community policy, possibly with special agreements with EU customs union (i.e. including Turkey) and Russia.

Taxation and public expenditure. Degree of decentralisation to entity level depends on size of entity. Public infrastructure for inter-regional and international transport, telecommunications and pipelines requires concertation at all levels: South Caucasus Community/bilateral/state/entity.

Nagorno Karabakh (NK). Proposals made within the context of the OSCE Minsk Group negotiations have included concepts of common statehood, horizontal ties between NK and Azerbaijan, a recognition de jure of NK's status as part of Azerbaijan while allowing NK self-government and a significant number of competences. An eventual solution to the conflict will have to find some combination of these Minsk Group proposals together with other elements in order to be accepted by political leaders in the two countries and to stand a reasonable chance of being ratified by their respective legislative branches of government.

Most independent analysts agree that the current situation (technically, a state of war) cannot endure indefinitely and that, sooner or later, it may lead to another armed confrontation. In fact, the resolution of the NK conflict, the only one in the region which directly opposes two sovereign entities, is the key to any meaningful progress toward a regional security and co-operation arrangement. The stalemate has so far favoured the ascent of more radical elements in both Armenia and Azerbaijan. It has fueled a propaganda war and an escalating regional arms race. The adverse impact on the democratic process, socio-economic development and much needed foreign investment in the two countries has been serious. In addition, the conflict continues to affect perversely Armenia's and Azerbaijan's relations with the neighbouring countries and the rest of the world.

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To break the deadlock a renewed effort is required of the Minsk Group, together with the parties concerned, to resolve the NK conflict in a single package, with the following elements:

- Territorial questions, including withdrawal from occupied territories, coupled with appropriate constitutional dispositions regarding the legal status of NK and assured access to both NK and the enclave of Nakhichevan;
- Replacing the cease-fire with a permanent legally binding agreement, either bilateral or trilateral (including also Georgia), with adequate international guarantees; transitional arrangements including the mandate and composition of an international peace keeping mission;
- Return or relocation of displaced persons and refugees with proper safeguards and generous international funding;
- Special dispositions concerning post-war rehabilitation and reconstruction, economic and human development in a regional format;
- A clear commitment to the values of pluralistic democracy, good governance, human and minority rights, rule of law, and market-driven prosperity.

The multi-level type of integration to be achieved in the SCC would give increased possibilities for Nagorno Karabakh to cooperate with Armenia in the fields of their competences, without threatening the territorial integrity of Azerbaijan.

Abkhazia. Georgia proposed a new federal constitution in July 1999, hoping to accommodate demands for increased Abkhazian autonomy. Abkhazia replied in October 1999 with a declaration of independence. Earlier proposals for a common state represent an intermediate position and are a basis for our further comment. The term “common state” is used to identify an equal rank for Abkhazia in a state which it shares with Georgia. There would be only one state represented in the UN and recognised internationally as such. There would be a “federal” budget and taxes etc. of the common state. There would also be far-reaching decentralisation and needs for coordination of policy in various domains.

There have also been proposals for Pan-Caucasian institutions, drawing on European models, both of the EU institutions and the “Europe of the regions” idea. This has much in common with the SCC proposal. We would however suggest keeping the SCC to the South Caucasus. Whereas a Pan-Caucasus entity with the North Caucasus entities of Russia has been advocated implausibly (in our view), we could envisage special cooperation between the SCC and the Russian Northern Caucasus.

In the case of Abkhazia, the return of internally displaced persons (IDPs), reconstruction and de-blockading are all inextricably linked. From a pre-war population of 537,000 the two-year war led to more than 200,000 displaced persons, and extensive destruction. Comparative analysis with Bosnia and Kosovo suggest that up to \$ ½ billion would be needed to cover reconstruction expenses. The Russian and Georgian economic blockades have prevented Abkhazia from economic recovery. It has a number of important economic assets, such as its previously prosperous tourism industry, its export of subtropical goods such as wine and hazelnuts, and its commerce through the port of Sukhumi.

Although the absence of refugee repatriation is partly the result of the Abkhaz perception of threat by a massive inflow of ethnic Georgian displaced persons, it is also critically linked to the absence of reconstruction in turn connected to the persisting economic blockades on the region. Without serious reconstruction efforts in rebuilding homes and reconstructing roads, hospitals and schools, Abkhazia could not function with its pre-war population, i.e. double its population of today. Reconstruction would allow the repatriation of refugees mainly of Georgian origin to Abkhazia. Refugee repatriation in turn would reduce Georgia's economic strain allowing Tbilisi, together with authorities in Abkhazia, to join with international agencies in financing of reconstruction efforts.

South Ossetia. Conflict in South Ossetia has in recent years been defused through confidence-building measures, the reopening of communication links with Georgia and the agreement between conflicting parties on the non-use of force, refugee repatriation and demilitarisation. However, the constitutional delimitation of powers remains the major issue of disagreement, which could in future trigger renewed armed conflict. Recent Georgian proposals suggest constitutional amendments recognising South Ossetian representative executive and legal bodies. On the other hand, South Ossetia calls for a union with North Ossetia under the Russian Federation, with competence in foreign, economic, trade and cultural affairs. In between these opposed positions, Russia has made proposals which could be useful in working out a settlement. Some of these ideas, together with the present document's proposal for a South Caucasus Community, are reflected in the following:

- South Ossetian self-government within a Georgia federation could be exercised in the following areas: culture, education and tourism, as well as in local transport, environmental affairs, local taxation, social policy, health and urban/rural development. Some degree of competence in economic policy could also be envisaged. Democratic accountability would call for a local parliament with decision-making powers in the above legislative areas. South Ossetia would also be represented as a distinct federated state within a SCC Assembly.

- North-South Ossetian relations. North-South Ossetian relations could be articulated within the forum of pan-Caucasian cooperation between the SCC and Russia thus not threatening Georgia's territorial integrity. North-South Ossetian relations could cover both issues such as refugee return and transport links, and other matters such as education, language and cultural affairs.

Adjara. Tensions between the Republic of Adjara and Tbilisi have been reflected in power struggles, which however have avoided explicit conflict. Yet a smoother and less uncertain future of the region requires a constitutional settlement along federal principles. The very recent agreement between Presidents Shevardnadze and Abashidze suggests that such a settlement could be now in sight. The Georgian parliament has recently passed a special decree reconfirming Adjara's autonomy. The constitutional amendment to give this effect is still unknown. However one could envisage some degree of Adjarian autonomy, and more constructive economic cooperation between Tbilisi and Batumi. Adjara's political autonomy could be exercised in linguistic and religious affairs in the light of the widespread Islamisation and use of the Türki language in the region. In these matters of competence, Adjara would be represented as a federated state within a South Caucasian Political Assembly, with cultural links with related Turkish communities. Adjara could also be granted some economic autonomy with respects to the port of Batumi, and would be called to ensure the payment of federal taxes to Tbilisi. Georgia, remaining in control of other areas of economic policy-making, would assure a due place for Adjara in infrastructure projects integrated within the framework of South Caucasus initiatives.

Javakheti. Although Javakheti never erupted as a violent conflict, important issues of contention need to be addressed. The Armenians of Javakheti call for a constitutional settlement in which Javakheti would manage its own cultural affairs, while Tbilisi is keen to retain Javakheti within the same administrative unit as Meskheti. In this case competences could be distributed between two local governments, one dealing with competences having clearly territorial dimensions (economy, transport, infrastructure, ecology), and the second with competences linked to cultural identities (education and culture). The first government (and assembly) would be constituted on a multi-ethnic basis; for the second however the Armenian community would be able to manage their "cultural" affairs within the Meskheti-Javakheti unit. (Such a system has a precedent in Belgium, where the small German language community has exclusive jurisdiction over "cultural" matters, whereas territorial competence are exercised by the Walloon region). Furthermore, representation within a SCC parliament would enable the Armenian Javakhetis to articulate their relations with Armenia in a comprehensive way within an all-encompassing regional

structure. The Georgian state, remaining in charge of the economic policy, would be called to prioritise the development of Javakheti, in the light of the latter's disproportionately poor economic performance.

The Lezghins. Since 1993/94, the potential conflict between the Lezghin population and Azerbaijan appears to have been capped. Nonetheless the possibility of future trouble remains. Hence, the need to address constitutionally the rights of the Lezghin people. As in the case of Adjara, Ossetia and Javakheti in Georgia, the Constitution of Azerbaijan should allow some degree of autonomy in cultural, linguistic and educational spheres to its Lezghin population in the north-east. The latter should also be allowed representation within an SCC Parliamentary Assembly. Pan-Caucasian cooperation should provide the forum within which Lezghins across international borders articulate their relations in social, cultural and educational spheres.

Nakhichevan. Azerbaijan's constitutional provisions on the status Nakhichevan as an autonomous republic appear to have satisfied local political demands. Hence, retaining the existing constitutional model, Nakhichevan could be represented separately both within a SCC Parliamentary Assembly and in other SCC forums of policy cooperation dealing with the republic's fields of competence.

#### **4.2 South Caucasus regional integration**

Once there are clear signs of progress towards resolving the most serious regional conflicts, especially Nagorno-Karabakh, the South Caucasus could take up the obvious opportunities for beneficial regional economic integration, and later increasing integration with the EU. Assuming that the three countries wanted to strengthen their aspirations for a European vocation, there would be every reason to have in mind some well-established integration models. The EU for its part could see intra-regional integration as a stage on the way towards the region's European vocation (as the joint EU-South Caucasus summit declaration of June 1999 already hints).

South Caucasus Community. The comparable size and economic geography of the three states, and a presumed will to establish a constructive post-war order, makes an ultimately ambitious plan for regional integration conceivable. The three states could take an initiative, called perhaps the "South Caucasus Community" (SCC), which would start with obviously useful initiatives, but aim at continuously deepening integration. The process could be sponsored and assisted by the EU in view of its unique experience of multi-national integration, and the possibility of linkage of the SCC later to the EU.

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Assuming that the conflicts were resolved, there could be a fresh approach to the region's integration, especially within the Southern Caucasus, but not neglecting both pan-Caucasus and EU aspects.

There is moreover an extensive world-wide experience of regional integration initiatives, which are summarised in Inset B. This shows that the EU model, although by far the most developed, is certainly not the only one to bear in mind. These different models highlight a number of questions of strategic design.

First is the question of priority as between economic, political and security objectives. Second there is the related but different question of sequencing of initiatives and the logic of the process.

The EEC/EU is only one example. Here the objective is political integration and security through making war unthinkable, while economic integration was the first step in the process, aiming to achieve political objectives by creating material interdependence. On the other hand ASEAN began as an association to pursue common security objectives, and only later turned to trade integration. EFTA has been a purely economic action, but its lack of political integration structures provoked a subsequent preference by most members to switch to the EEC/EU. APEC aims at bringing an enormous and highly divergent group of countries – from China to the US – closer together through trade liberalisation. The first Stability Pact (Balladur) aimed essentially at preventive diplomacy with respect to ethnic/frontier questions, whereas the second Stability Pact (Balkan) is a loose framework for cooperation over economic, political and security issues, following the Bosnia and Kosovo wars and peace agreements, with an interim period ahead of unknown duration before the ultimate objective of EU integration. These examples suffice to suggest that one needs to work out very deliberately what the objectives, mechanisms and strategy should be, rather than copy some supposedly standard package.

### Inset B: Tool-kit for regional integration

EEC - Monnet method to start. From the early days of European integration, when memories of war were still very fresh, the idea was to start with some vivid and concrete action in selected sectors, to begin to learn by doing. The European Coal and Steel Community was the action, with member states relinquishing powers to common institutions initially just in this field.

EU model. Highly developed model, uniquely so. Objective: comprehensive, supranational integration, open-ended destination. Sequential accumulation of competences: trade, single market, monetary, foreign policy, justice/home affairs, and defense. Full institutional structure: Council, Commission, Parliament, Court of Justice, Economic and Social Committee, Committee of



Regions. Full legislative capacities. Evolutionary institutional system: voting system moves progressively from unanimity to majority.

EFTA. Purely free trade agreement. Small secretariat. Minimalist conception of economic integration, initially competing with political integration model of EEC. Most members left for EEC/EU.

CEFTA. Central and South East European candidates for EU accession make free trade area between themselves as transitional step before accession.

Baltic/Barents/Black Sea cooperation. Highly heterogeneous groupings, united by geography. Extensive soft cooperation/contacts/confidence building. Attempts to deepen cooperation on energy, environment. Not competent for main trade or security policy issues.

ASEAN (South East Asian states). Began in 1967 as foreign ministers' club. Primary security concern (China). Common diplomacy in multilateral security debate. Relations with US, EU. ASEAN Free Trade Area only in the 1990s. Little legal base, not even treaty.

APEC Asian and Pacific states, including China, Japan and US. Aims at free trade by 2010/2020.

Mercosur (4: Argentina, Brazil, Paraguay, Uruguay). Free trade area, with partial customs union (common external tariff with holes). Purely economic, no political/security content. Small secretariat; wholly inter-governmental. No monetary integration (Argentina prefers dollarisation).

NAFTA (3: US, Canada, Mexico). Free trade, also aiming at liberalising foreign investment and services. No custom union or monetary integration. No institutions. Labour and environmental standards, with mechanism of judicial appeal. N.B. involves two highly developed and one developing country.

CIS. Formed to limit disintegration of former Soviet Union. Economic, political and security aspects. Many political decisions lacking implementation. Institutions loosely modeled as shadow of EU, but little legal order or clear core functions. EU model does not fit because of size of Russia relative to others, and weakness of legal order. Tariff free trade and customs union sub-grouping.

Stability Pact # 1 (Balladur). Facilitated settlement of ethnic minority and related frontier issues in sub-regions, with incentive of EU membership if successful.

Stability Pact # 2 (Balkan). Framework for cooperation in economics, democracy and security. Regional integration potential limited by Yugoslavia heritage. Perspectives for EU integration for all, but distant for some.

For the SCC one might for example think in terms of the following priorities:

- Short-run priority # 1: Security – support political settlements of conflicts, even on an interim basis, with a credible system of security guarantees, with external peace-keeping presence for some time, and some security cooperation with regional neighbours.
- Short-term priority # 2: Economic - re-establish the normal workings of the economy of the region, removing blockades, giving effect to free trade, establishing sound transport infrastructures and correct cross-border administrative procedures.
- Long-term objective: Join modern European political standards – this will come about only with a long process of economic, societal and institutional development. However a path would best be sketched out from the beginning, and the prospect of future anchorage into the EU system may be important for the design and support of the process.

The short-term priorities 1 and 2 would go together, each positive step in dealing with the political/security matters being accompanied by practical measures for improving the economic situation.

The SCC could at an early stage be mandated to prepare the ground for cooperation on matters of security policies, both for making regional contributions to the peace-keeping task (see 4.3 below), and for combating cross-border crime.

However the SCC would surely move immediately on the most urgent tasks of re-opening frontiers for normal trade, both internally and externally, and upgrading the regional transport infrastructures and frontier/customs facilities. Fortunately, the TRACECA and INOGATE networks of projects supported by the EU (through the Tacis programme) are an ideal basis on which to proceed, with many plans available for early execution. In fact, those two programmes could be leading vehicles for the EU to promote

common mechanisms and standards for regional integration. The obvious material advantages for all the parties concerned would provide additional incentives for developing regional organisational structures, which have already begun with a TRACECA office in Baku, and a Regional Environment Centre in Tbilisi. The EU could welcome the outbreak of peace and inception of the SCC by switching on availability of large-scale investment financing from the European Investment Bank to complement existing grant-funded technical assistance, and the IBRD and EBRD would naturally be able to rise to the occasion also with expanded programmes.

The SCC would then examine its policy options and objectives for trade policy. In theory the region shares tariff free trade through the CIS, both with Russia and between the three South Caucasus states. However in practice this does not mean much in a region divided by blockades, both within the Southern Caucasus (between Armenia and Azerbaijan), within Georgia (Abkhazia), between Russia and Abkhazia, and because of the Chechnyan war.

Inset C: Tool-kit of regional trading arrangements

Normal trading relationships: among WTO members states tariff levels are bound at most favoured nation rates (MFN). Other conditions of trade obey WTO rules. WTO accession: Armenia, expected to conclude negotiations in 2000; Azerbaijan, envisaged for 2002; Georgia, negotiations concluded, to ratify soon in 2000. In the meantime the Partnership and Cooperation Agreements (PCAs) between the EU and the three states provide for MFN tariff regime in advance of WTO accession.

Transit and logistical arrangements within region. This is what TRACECA has been doing. Example: TIR system for permitting containers to be transported through countries without customs duties or opening of sealed containers (EU provides assistance to prepare this).

Partial preferential regimes. This would be for limited agreements for exchanging tariff concessions. Problem: not allowed under WTO.

Preferential arrangements for border regions. WTO allows special arrangements that facilitate localised trade across borders. "Export Processing Zones", usually on sea-coasts, may allow for a limited zone to import, process and re-export goods free of customs duties and other taxes. However the zone is not fully integrated into the inland economy.

Free trade within region. Allowed under WTO as long as it covers substantially all sectors (see next on CIS). Armenian-Azerbaijan trade blockaded by war.

Free trade within CIS. The South Caucasus states are part of CIS free trade arrangements, but these are subject to numerous exceptions and may not be WTO compatible.

Free trade – without cumulation of rules of origin. The countries of the region might at some stage make a free trade agreement with the EU. However under a first variant each would be treated bilaterally for the purpose of rules of origin (see next).

Free trade – with cumulation of rules of origin. Rules of origin require that goods are substantially transformed in the free trade partner country, not just imported from another country outside the free trade agreement, and re-exported. "Cumulation of value-added" allows for a production process that cascades between countries of the free trade area, thus "cumulating" a sufficient transformation of the product to meet the "rule of origin" in the region as a whole, not just in a single country. This second multilateral variant can become important for the economic integration of a region, even if intra-regional trade may remain relatively small for the SCC.

Free trade with EU. The PCAs make no provision for opening of negotiations for free trade with the EU, unlike the PCAs with Russia and Ukraine (but these provisions are not yet activated). However a multilateral free trade agreement between the EU and the South Caucasus is an obvious policy option at some stage.

Customs union. This requires adopting a common external tariff. Turkey now shares a customs union with the EU. The three South Caucasus states have not joined the customs union of Russia, Belarus, Kazakhstan, Khyrgyzia and Tadjikistan.

Single market. This requires a comprehensive harmonisation of product and safety standards and regulatory requirements for service sectors such as banking. This is needed for complete freedom from internal barriers, such as achieved in the EU with the 1992 programme, and between the EU and some non-members states such as Norway in the European Economic Area (EEA).

The three SCC states would surely seek to conclude their WTO accessions as rapidly as possible. However there then opens up a wide menu of further trade policy options, as summarised in Inset C. A possible sequence of actions could be: 1/ make a SCC free trade area, compatible with WTO; 2/ bring SCC trade policies with CIS countries into a state of WTO compatibility, with either WTO-compatible free trade, or if not reversion to standard WTO most-favoured nation regime; 3/ examine the scenario of SCC free trade with the EU/Turkey customs union.

The SCC may wish set up an Economic Policy Committee or Council. Matters such as cooperation over excise taxation (smuggling/evasion) would be likely early topics. Monetary policy would initially be subject to exchange of information and analysis, including matters of mutual currency convertibility. Monetary integration, in the sense of moving to a common SCC currency, should not be on the agenda. In the long-run the use of the euro in the region could become important. Initially the euro will become a second parallel currency alongside the dollar for private transactions. The SCC monetary authorities would follow closely the developing interest world-wide in either dollarisation or euro-isation as currency regime (i.e. total replacement of the national currency with a world class money).

The SCC would have a Council or governmental structure, perhaps following EU lines: Councils of Ministers for “pillars 1,2,3” - economic, foreign policy and police/justice/immigration policies, and a Summit level; a Court of Justice (with linkage to the EU Court) later, as and when the Council began to legislate.

## A STABILITY PACT FOR THE CAUCASUS

The institutional structure should be consistent with the constitutional content of the peace agreement over Nagorno-Karabakh and the special arrangements for Abkhazia and other sub-state entities. To this end some inspiration could be drawn from two models – the Northern Ireland Agreement (see Annex G) and Belgian federalism within the EU setting. These two models allow for multi-tier structures, in which for certain fields of competence sub-state and state entities cooperate horizontally together, and in other instances there are competences devolved to cultural/language communities that overlap regional and state frontiers. In these ways there is much sharing of sovereignty and much interdependence, and notions of independence are diluted with multiple affiliations (including passports which can combine supra-national, nation-state and national but sub-state identities).

There would also be a South Caucasus Assembly, with two parts:

- Parliamentary Assembly about 170 members (1 per 100 000 inhabitants), elected by a list system or transferable vote for sub-national constituencies of up to ten members, so as to assure representation of minority communities. The advantage of going straight away to direct elections would be to overcome or bypass the sensitive issue of representation of members designated by national and sub-national entities.
- Civil Assembly, for NGO interest groups and professional elites. Analogous to EU Economic and Social Committee or Northern Irish Civic Forum. Representatives could include professional and business associations, leaders of educational establishments, non-government organisations working for development of civil society, religious leaders, and leaders of regions and peoples.

The key objective here would be to begin building institutions capable to developing a trans-national view of the interests and priorities of the South Caucasus region as a whole. Their role would be consultative in the first instance. The methods of election or designation should avoid issues of hierarchy between levels of state and sub-state government, or unresolved constitutional issues within or between states.

Cooperation over the broad area of justice and home affairs, and including policies on the movement of persons, immigration and freedoms to reside and work, as well as for combating crime and corruption, would be a natural priority for the SCC.

EU integration perspectives. The new model of Stabilisation and Association Agreements, as developed for the Western Balkans could be offered, with proper adaptations, as a perspective for the Southern Caucasus, which would be conditional on progress in intra-regional integration. Once the conflicts are resolved politically, the prospects for these three countries to work together should be relatively favourable: economic geography and the comparable size of the three states suggest this. Institutional links would be organised between the SCC bodies and their EU counterparts.

Comparable programmes in the all three SCC could be developed for the promotion of good governance, with support from the EU, OSCE, Council of Europe and other relevant organisations. Once the operational practices and procedures are perceived to be similar, it will be much easier for those institutions to work together in a regional mode. Such an approach would also facilitate the gradual capacity building for the implementation of regional projects and for the eventual absorption of selected portions of the *acquis communautaire*. The three countries of the SCC could be encouraged to prepare National Strategies for Sustainable Development according to a single methodology, combining economic policy targets and environmental concerns in a congruent manner, which would gradually ensure compliance with their own international commitments and accepted European standards.

Pan-Caucasus relations. The SCC would of course develop cooperative relations with Russia and its Northern Caucasus entities in a mutually agreed manner. Specific cooperative arrangements would be fostered between culturally linked entities that straddle the North and South Caucasus (Abkhazia-Adygeya, North and South Ossetia, and the Lezghin communities on both sides of the Dagestan-Azeri frontier).

#### 4.3 South Caucasus regional security system

The present situation is a hybrid and contradictory regime. All states of the region are full members of the United Nations. They are also OSCE members, share its codes and obligations, participate on a basis of consensus in its policy decisions and contribute to various operational tasks. All states of the region also are participants in the NATO sponsored Euro-Atlantic Partnership Council and the Partnership for Peace programme of activities, involving joint exercises, seminars etc. On the other hand Armenia, but not Azerbaijan and Georgia, participates in CIS military cooperation together

with Russia, Kazakhstan, Khyrgyzia and Tadjikistan. For their part Azerbaijan and Georgia, but not Armenia, talk in political speeches about stronger relationships with NATO (possibly membership, bases). And, of course, as the hinge of this binary opposition of virtual alliance systems, there is the confrontation of Armenian and Azeri front-line trenches in and around Nagorno-Karabakh.

Both the common OSCE and the binary alliance systems are live realities. The overarching question for the security system of the region is whether one of these two contradictory systems will grow and become the dominant system with the other fading away into lesser significance, or whether a tense confusion of interests and institutions carries on indefinitely.

The cost of the present confusion of systems is that the parties to the conflicts of the region are themselves not receiving clear incentives and pressures to settle. Each has, more or less, its big protector. Apart from Nagorno-Karabakh, also in the case of Abkhazia there would seem also to be confused implicit signals to the region's leadership. The costs of non-settlement of the conflicts are enormous. They consist of:

- (a) for much of the population of the region this spells impoverishment, falling living standards, and dim prospects for strong economic recovery;
- (b) for the big powers there remains a zone of instability with potential for escalation of tensions and conflicts, reducing or endangering the value of the oil and gas sector in the region;
- (c) for the neighbouring states or regions of the Black and Caspian Seas, Southern Russia and Central Asia there is damage to the economic development prospects of the whole wider area, in particular by inhibiting or delaying the implementation of major inter-regional infrastructure programmes.

These are also the reasons why all parties in the region and the big powers alike might be able to discern a convergence of interests in engineering a comprehensive regional political settlement. This would mean, concretely, that a common security order for the Southern Caucasus should become the dominant feature of further joint action.

OSCE regime. Therefore, as the peace settlements for Nagorno-Karabakh, Abkhazia and other conflict areas are being worked out, a comprehensive regional security system should be defined. There is the issue of choice of



organisation to sponsor the system, with several candidates in theory: UN, OSCE, NATO, CIS, EU.

The lead organisation, or sponsoring organisation, should probably be OSCE. The UN is invaluable in providing the mandate and international legitimacy for specific peace-keeping operations. But OSCE has the role of security organisation and system for a common European house. The two can work together, in the sense that specific operations have legal bases, which can contain a consistent cascade of references to general principles and specific terms of reference relating to both UN and OSCE. The standard OSCE principles would apply, in particular with regard to the inviolability of state frontiers, with changes to be made only by agreement of all parties, reinforced by a set of confidence and stability building measures and by appropriate international guarantees.

UN peace-keeping functions in Abkhazia could be transferred or mandated to OSCE in the interest of a more coherent institutional organisation in the region.

The enhanced OSCE regime would reverse recent tendencies towards a stand-off between CIS and NATO activities or implicit alliances. Neither CIS nor NATO would be generally acceptable lead organisations. Both NATO and CIS sponsor military cooperation. NATO's Partnership for Peace includes all states of the region, including Russia, but this is limited to modest cooperative activities at present. As regards the aspirations voiced in Azerbaijan and Georgia for future NATO membership, there is no sign whatsoever that NATO wishes to extend itself into the South Caucasus region as regards enlargement for full membership with its entailed formal collective defense guarantees. On the contrary NATO appears to discourage such aspirations. This is in itself a helpful factor, with a view to working towards an OSCE sponsored regional system. The EU's security and defense policies are far too embryonic to think of it as a security organisation in the present context.

Inset D: Tool-kit for security mechanisms

Security guarantees.

NATO. Article 5 makes an attack on one member an attack on all. (No application for the Caucasus envisaged).

CIS. Tashkent Agreement of 1992 says that aggression against one member is an aggression against all. Armenia was founder member of Tashkent Agreement. Azerbaijan and Georgia joined some of its elements in 1993. Russia did not allow Azerbaijan to activate the collective defence provision in 1993 over Nagorno-Karabakh on grounds that it only applied to external challenges to the CIS area.

Turkey and Nakhichevan. The Treaty of 1921 signed by Lenin and Ataturk governed the status of Nakhichevan as an autonomous protectorate of Azerbaijan. During the Karabakh war, Armenia began attacking the Nakhichevani village of Sadarak. In response some prominent personalities in Turkish politics urged Turkey to intervene on the grounds that the 1921 Treaty gave the right to do so, but the text does not make this clear. Ultimately the use of force was ruled out, but the threat of Turkish invasion warned off the Armenian offensive.

Neutrality guarantees. European history has several examples of territories lying between or near the great powers being subject to neutrality guaranteed by allied or competing powers: Switzerland in 1815; Belgium 1830/31; Sweden and Norway in 1855; Black Sea in 1856, Austria in 1955.

#### Peace-keeping

UN. May provide the mandate for peace-keeping operations and either operate them or mandate others to do so.

OSCE. Used to observer missions, e.g. on very large scale in Kosovo in early 1999, or on small scale now on Russia/Chechnya/Georgia frontier. OSCE observer and monitoring mission in Nagorno Karabakh. Istanbul summit of November 1999 allows for possible peace-keeping role, or to provide mandate for peace-keeping by others (member states or other organisations to provide resources and expertise). An OSCE High Level Planning Group (HLPG) exists to prepare the execution of OSCE peacekeeping missions.

NATO. Operates heavy peace-keeping missions in Bosnia (SFOR) and Kosovo (KFOR), in both cases with UN mandates, coordinates large assembly of NATO and non-NATO PFP contingents, including Russia under autonomous command arrangement.

CIS. Operates current peace-keeping/blockade of Abkhazia with UN auspices, with UN observers.

EU. Rapid Reaction Force in the making for 2003. Political/military command and control system being established. Eurocorps already takes on headquarters duties for KFOR in Kosovo.

Nature of security guarantees. The states of the region are calling for security guarantees as a matter of priority. What could this mean concretely? While both CIS and NATO have formal collective defense mechanisms in their statutes, for reasons mentioned neither are offering the desired security service for the Southern Caucasus. Both organisations would be doing “too

much”, either in terms of political acceptability and/or of being over-extended, if they were to undertake such formal security guarantees.

A more specific security agreement or treaty, or set of agreements or treaties would seem however more appropriate. When the conflicts of the region yield to specific solutions (as discussed in the preceding sections), these would define the security aspects, including questions of territories, guarantees of the rights of ethnic communities, constitutional arrangements and matters of civilian and military security cooperation. Such agreements and/or treaties could receive appropriate degrees of endorsement and support (political, material, security mechanisms) from the international community. Such endorsement and sponsorship could involve resolutions of the UN Security Council, definition of the role of the OSCE, and specific sponsorship by the major powers: Russia, EU, US. The texts could specifically include also references to the other neighbouring states, Turkey and Iran, of course endorsed by them.

It would be a matter for negotiation how far the sponsoring parties would go in the extent of their commitment to action in the event that states of the region breached the agreements or treaties. While automatic collective defense mechanisms of the NATO article 5 type seems excluded, there are all possible graduations in language, including such well-known phases of the type: “ ... if a party [seriously and persistently] breaches a provision of this agreement/treaty, the sponsoring parties shall take appropriate action.” In addition there would various mechanisms built into the agreements or treaties, for example for peace-keeping and regional security cooperation, which would increase the credibility and solidity of the peace. It may be useful to have in mind the kind of multi-power sponsorship of some earlier treaties establishing the neutrality of certain states or regions (see Inset D).

Organisation of peace-keeping. At the time of entry into force of political agreements over such cases as Nagorno-Karabakh and Abkhazia, where there will be difficult matters of troop withdrawals, of inter-community relations and refugee return, international peace-keeping forces will surely be needed. With present operations in the Balkans there is now a serious shortage of well trained and equipped forces available, especially when constraints of political balance are added.

Peace-keeping operations come in all graduations, from a few symbolic observers to massive enforcement as in Bosnia and Kosovo. The South

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Caucasus conflicts now to be resolved would seem to be placed high, but not at the highest extreme on this spectrum. It is to be hoped, perhaps expected, that when the political deals are struck, they will be respected in a relatively disciplined way by the parties involved. In other words, it should not be a state of anarchic ethnic violence of the kind observed in Bosnia and Kosovo.

Participation in peace-keeping could be the subject of an ad hoc coalition of participants, especially since there would be a preference for avoiding that the operation be mandated as a whole to either the CIS or NATO. The EU and its member states could in principle take a more leading role politically, but its Rapid Reaction Force is not ready yet, and the member states are heavily committed in the Balkans. An ad hoc coalition of forces under OSCE auspices would seem therefore the most plausible formula. Such states as Poland and Ukraine both have substantial armies and soldiers with relevant language competence (but the Ukrainian forces in the Balkans are evidently lacking in material resources). A Polish Ambassador currently heads the OSCE monitoring mission in Nagorno Karabakh.

Regional security cooperation. As mentioned above, the South Caucasus Community (SCC) could make an early start over cooperation between both civilian and military forces. The SCC would thus be following a quite different ordering of its development compared to the EEC, which long remained exclusively economic. Here it is possible that the Partnership for Peace activities could be most useful, since the three countries are already working alongside each other in this NATO framework, which also includes Russia. Such activities presently concern reform and modernisation of the armed forces in relation to internal political structures.

Security for the increasingly important oil and gas pipeline systems in the Caucasus is an obvious task for cooperation, and this is apparently already being prepared within the framework of the GUUAM group (Georgia, Ukraine, Uzbekistan, Azerbaijan, Moldova).

Guaranteed transnational corridors. The agreement or treaties would surely cover explicitly the needs for secure land transport specifically between Nagorno-Karabakh and Armenia, and between Nakhichevan and the rest of Azerbaijan. It is understood that land swaps have been discussed for these cases. However other solutions, for a region intending to cooperate and embrace modern European norms, would seem preferable to operations requiring the displacement of substantial populations. Specific transport

routes could be given international legal status, or subject to international guarantees, supported as long as necessary by a peace-keeping presence. In due course such notions will evaporate, as borders become open and integration advances.

Guarding frontiers against infiltration. OSCE observers are already posted on the Chechnya-Georgian frontier. Given the extreme importance of stopping criminal and terrorist infiltrations all along the Russian-South Caucasus frontiers in a politically sound and credible manner, OSCE would support a thorough border control system as substantially as necessary.

Arms limitation and demilitarisation. OSCE would preside over negotiations to arrive at mutually agreed arms reductions in the South Caucasus, possibly to include also demilitarisation of selected territories. Already the CFE Treaty, as adapted at the OSCE Istanbul summit in November 2000 and now awaiting ratification, provides a key set of quantified and verifiable limits (see Annex E). In particular quantified limits apply for the main conventional weapons for each of the three South Caucasus states and Russia (as well for other OSCE states).

The quantified limits have both “territorial” and “national” ceilings, any difference referring in effect to the weapons of foreign states. However these limits are the same for the four countries mentioned. In other words, if a state wishes to use fully its ceiling for national weapons there would be no room for foreign weapons on its territory, subject to agreement over temporary arrangements.

For Russia there is special provision for quantified limits in so-called “flanking regions”, which include both the Northern Caucasus and some Southern Russian oblasts as well as Northern regions such as Leningrad and Pskov. This means a significant link between Northern and Southern “Dimensions”, because the limits apply only to the total for both flanks. Thus, if Russia wished to redeploy weapons from North to South flanks, for example to handle the Chechnya problem, this could be done in principle within compliance of the CFE Treaty. Recently the Russian authorities, since renewal of the Presidency, have confirmed their intention to bring weapon deployments into compliance with the Istanbul agreed limits, whereas at the present time they are in excess.

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In general terms the CFE Treaty provides a well-developed structure for negotiation, binding agreement and mutual monitoring of compliance, including coverage of the specificities of the North and South Caucasus situation. It provides an invaluable basis for confidence building and considering further positive developments. For example there is also the important question for the South Caucasus of controlling and reducing stocks of small weapons such as rifles, which presents an obvious agenda for future attention.

Redeployment of Russian troops and bases. Moreover, at the OSCE Istanbul summit in November 1999, Russia and Georgia also adopted a joint statement on implementation CFE Treaty for Russian force reductions on Georgian territory, with details on the timing and modalities of its withdrawal from the bases of Gudauta and Vaziani, and conditions of its use of bases at Bakull and Akhalkalaki. The agreement also refers to the readiness of OSCE countries to support financially these reductions and withdrawals. In the framework of a comprehensive OSCE security system for the region, the process of dismantling unwanted foreign military bases would be completed, possibly accompanied by financial measures.(see Annex F).

## 5. A wider Southern Dimension

### 5.1 Russia/EU/US Southern Dimension cooperation

The stability of Europe in the 21st century will depend greatly on the relationship between the enlarging EU and Russia. In the North (Baltic-Barents) area there is already a functioning system for good neighbourly relations and deepening cooperation under the “Northern Dimension” policy, even over highly sensitive matters like Kaliningrad.

The overall objectives could be the same for a “Southern Dimension” policy, but with specific mechanisms for the Black Sea-Caucasus region. Apart from obvious differences between these Northern and Southern regions, there is a difference in the natural roles of the EU and US. In the Northern parts, and the Baltic and Barents Seas, the EU and Russia are already direct neighbours or close enough for real proximity effects (environmental etc.). In the Southern parts this is not so, whereas the US has been so far been a more weighty diplomatic actor. On the other hand the EU, Russia and US have begun to experiment with some trilateral high-level diplomatic encounters. It is therefore a question whether cooperation over the Caucasus region might become an important domain for more developed trilateral cooperation.

Bilateral or trilateral, there could be a fresh initiative, of possible interest to the new Presidency of Russia. From a European standpoint the commonality with the Northern Dimension is a very simple but basic idea: the enlarging EU and Russia will be coming closer and closer together territorially over the next years and decades. The common border in the North is going to lengthen. In the South, the EU’s Black Sea enlargement means that the EU and Russia will become virtual neighbours there also on a large scale. If the South Caucasus states pursue seriously their “European vocations”, the virtual EU-Russian frontier extends again.

In the North there is a quality of trust and cooperation. In the South it should become the same. In that way Russia’s perception of the EU will be that of its large neighbour, which seeks solid cooperative relations wherever they

meet. Russia's strategy towards the EU contains no more superficial fantasies about EU accession, such as President Yeltsin and Prime Minister Chernomyrdin used to speak of (see text from now President Putin to the EU Helsinki Summit Council in December 1999). This becomes therefore a more healthy relationship politically.

The content of the Southern Dimension policy would have obvious differences but still some similarities compared to the Northern Dimension. It would have bilateral and regional components, then wider aspects involving all Black Sea as well as Caucasus countries (analogue with Baltic and Barents Sea cooperation), and important oil/gas-related economic developments (analogue with the Barents Sea and Yamal projects in the North).

It would be even better if it proved politically feasible for the US to join the Russian Federation and the European Union in a trilateral "Southern Dimension" cooperation. This would of course facilitate access to greater resources, and linkage with the diplomatic effort to establish a durable security system for the Southern Caucasus. It could become a matter for the two new presidencies of Russia and the US to consider, as an important test case for their future relationship. Such a programme would also enhance transatlantic cooperation and solidarity, identifying an additional area of EU-US cooperation.

EU-Russian bilateral cooperation. However the EU should explore the scope for a "Southern Dimension" policy with Russia bilaterally in any case, within the framework of their existing Partnership and Cooperation Agreement and recently exchanged strategy documents. A dialogue would be opened on the possible extent of cooperation in both the Northern Caucasus and its neighbouring South Russian regions (Rostov, Krasnodar and Stavropol).

In general in the Northern Caucasus, and not just in Chechnya, Russia has the extremely difficult task of working out a strategy for assuring basic law and order and then economic and social recovery. Neither the EU nor OSCE nor Council of Europe have an official view on how to revise or reform the workings of Russian federalism specifically in such regions as the Northern Caucasus. However the EU may be able to take a lead in helping in pragmatic ways.



The most urgent needs are for emergency supplies resulting from the Chechnya conflict (medicines, shelter, food), especially in Chechnya, Ingushetia and Dagestan.

Most of the North Caucasus entities are heavily aid dependent, in some cases up to 80 % of their total expenditures (civil service costs, social security and pension funds, even basic supplies) have to be covered from the federal budget. The prevailing precarious economic and social conditions have caused permanent aid-addiction and the emergence of subsistence economies, which are often dangerously linked to organised crime and extensive corruption. It is therefore a matter of priority for the Russian Federation to work out – and the EU could help with technical assistance and, as the case may be, financial support - a realistic short and medium term strategy to make those entities economically viable, by encouraging legitimate local entrepreneurship in a properly regulated market environment.

Subsequent actions could aim at the long-term recovery and development of the region. Concretely the EU could propose a preliminary agenda of cooperative actions, for example including the following six point programme:

- 1/ “Georgian military highway”: the only highway crossing the middle of the Caucasus, from Northern Ossetia down to Tbilisi. This route is strategic for any economic recovery of the Northern Caucasus. It needs upgrading and also modernisation and equipment of the frontier/customs/security facilities. The World Bank and EBRD could finance it later, but first a feasibility study is needed in cooperation with the Georgian side. Ossetian business interests already proposed this.
- 2/ Pan-European Corridors/Networks: for integration with South Russian transport networks and links to TRACECA and INOGATE projects. This would add coastal Caspian and Black Sea north-south connections to the existing east-west routes of the Southern Caucasus. Availability of European Investment Bank funding could be considered, if the political climate became promising.
- 3/ Alpine tourism: the Western Caucasus has outstanding tourist potential. Today it is underdeveloped and poorly equipped by modern standards, and most business has been driven away by security risks. But with peace and order in the region there could be a new take-off. Mt. Elbrus is equivalent of Mt. Blanc of the Alps (actually somewhat higher). The regional authorities of Alpine regions should be invited to join with Caucasus partners to advise on a comprehensive new development plan, with special

reference to the skills of organising cross-frontier cooperation (e.g. France-Italy, or Austria-Italy models from the Alps; or France-Spain from the Pyrennees. Twinning arrangements could be most helpful to open the eyes of Caucasus regional leaders to their natural opportunities.

- 4/ Combating crime: the EU understands the priority need to re-establish law and order throughout the region, especially to stop the horrendous kidnapping business that prevails throughout the region, not just Chechnya, and also the trans-Caucasus money laundering and drug/arms trafficking which is operating on a large scale. The EU for its part develops its Justice and Home Affairs competences. The scope for cooperation may be limited in the early stages but should be examined as a longer term proposition. International trafficking of drugs, weapons and money laundering are common concerns.
- 5/ Joint EU-Turkish-Russian business development programme, given the demonstrated aptitude of Turkish entrepreneurs to establish business ventures in parts of the North Caucasus (e.g. in Kabardino-Balkaria), and also the new status of Turkey as an accepted candidate for EU accession.
- 6/ EU-Russian sponsorship and EU financial support for a special Council of Europe programme for civil society and human rights in the North Caucasus (e.g. helping NGO structures develop, supporting the Convention for Human Rights, and facilitating recourse to the European Court of Human Rights, which now has jurisdiction in Russia).

Chechnya. The above are examples of conceivable cooperation under relatively normal North Caucasus conditions. Of course the case of Chechnya is different. Here the immediate priorities are to find a way of achieving peace, and then to work out a political regime for the region that has a chance for a return to normality.

Early in the post-Soviet period a Tatarstan type constitution for Chechnya might have been viable. But the two wars make this much more difficult. Direct rule from Moscow seems the only formula for the time being. Russian constitutional formulae are basically of three categories: 1/ direct rule, 2/ ordinary oblast status (region of the federation) and 3/ autonomous republic status, which however includes a wide range of variants, with Tatarstan the closest to independence. The conventional approach now in prospect might be to rely on direct rule for a period sufficient for law and order to be re-established, then to revert to autonomous republic status.

However the conventional approach may or may not work. There may come a time when more imaginative proposals including more substantial international contribution to solving the Chechnya problem is sought by Russia, for example if there seems to be in prospect an indefinite prolongation of guerrilla warfare and continued deterioration of relations between the Caucasus diaspora in Russia as a whole and the Russian ethnic population throughout the Russian federation.

A constructive and open-minded analysis of the options for conflict resolution has been recently offered by Dmitri Trenin of the Carnegie Moscow Center<sup>3</sup>. Trenin's argument has important messages for both Russia and the European Union. "The ways to solve the Chechen problem range from an agreement of association between Chechnya and the Russian Federation to formal independence. .... Perhaps at some point it will be decided that instead of a semi-independent subject it would be more beneficial to have a semi-dependent neighbour. ... The advantages of separate existence can reveal themselves only under a stable regime in Chechnya. Just as Israel finally agreed with the principle of an independent Palestine – provided that the PLO authorities refuse to practice terrorism and offer real guarantees of security to Israel – Russia might well want to exchange a piece of its territory for real guarantees of its security.

If such an approach were to be endorsed, Trenin adds that .. "at some point, and certainly at Moscow's invitation, observation of the implementation of commitments assumed by both parties could be maintained by international organisations, such as the OSCE. Of course, this requires an evolution of thinking on both sides, especially among the Chechens." (The OSCE role in Chechnya at present consists of an Assistance Group with offices in Grozny and Moscow, with a very limited mandate).

"Europe's problem is how to harmonise its moral indignation and its long-term interests. Russia at present may be neither a threat .. nor an opportunity .. for the countries of the European Union, but it is certainly not a country which can be safely ignored. At some point, when the European Union is confident enough about its Common Foreign and Security Policy, a Caucasus stability pact will need to be implemented – in close cooperation with the countries of the region and obviously with Russia. Together with the

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<sup>3</sup> "Land for Peace – A policy Option for Chechnya? On the Realities of War and Prospects for Peace", Bulletin of the Berlin Information-center for Transatlantic Security, February 2000.

Balkans, the Caucasus is a challenge to Europe's international identity. The way it deals with it will define its future role and heavily impact on its relations with Russia".

"The West, above all the European Union, must go beyond criticising Moscow for the conduct of the war in Chechnya and engage Russia in a constructive dialogue about ways of post-conflict rehabilitation of the region, including the creation of economic incentives for a lasting peace."

In the meantime the international community will of course react to evidence of abuse of the "rules of war", as well as breaches of the European Convention for Human Rights. This now has full jurisdiction in Russia, including the possibility of cases to be brought to the European Court of Human Rights in Strasbourg, which now also has a Russian judge. Proper investigation and judicial procedures have to be the norm. In fact an independent human rights commission was established by President Putin in the spring of 2000, but it is too early to assess its work.

At present open dialogue between Russia and representative Chechnyans hardly exists. It may be that some dialogue could be usefully initiated through the good offices of non-government organisations.

Bilateral US-Russian cooperation. If it were decided to proceed with "Southern Dimension" cooperation on a trilateral basis, there would doubtless be a rich agenda of topics and projects coming from the US side, with some of the same topics as those just listed (but we make no attempt here to sketch this). For their part the EU and US have acquired considerable experience of working together with Russian partners in the last decade, especially in Moscow.

## 5.2 Enhancing Black Sea-Caucasus-Caspian cooperation.

The Black Sea Economic Cooperation (BSEC) was established in 1992 and upgraded in 1998 into a full-fledged regional organisation. Its members include all Black Sea littoral states, but also all three South Caucasus states, as well as Greece and Albania. It has a full political structure, with a Summit level, a Council of foreign ministers, a Troika presidency mechanism, a

Committee of senior officials, a comprehensive set of sectoral Working Groups, a parliamentary assembly, a development bank, a policy research institute etc. This ambitious structure is young, BSEC has yet to become really effective, and it suffers from weak EU involvement. However its membership and structure are most promising. The focus could be on building up BSEC (and not duplicating it with a new initiative).

Ways of progressing might include, first, that the EU should enhance its involvement in the organisation, and put its political and financial resources behind it. The EU would rationalise its different mechanisms for financial intervention in the region, which are different for PHARE, TACIS countries and Turkey (however these seemingly bureaucratic questions belie political issues). Concretely BSEC should be well placed to facilitate the advance of major transport networks (including the eastern extension and connections of Pan-European Corridors), trans-border energy (including pipelines and high voltage transmission lines) and communication (optic fibre and wireless) infrastructure, and regional environmental programmes.

Presently there exists no adequate forum for multilateral consultations on the complex issues of regional coordination of oil and gas development issues. While negotiations of specific investments and contracts will of course be the preserve of the directly interested party, there could be value in a regular Black Sea-Caucasus-Caspian Energy Forum, under the auspices of BSEC. With rapid and major developments in both oil and gas sectors, the idea would be for a forum to keep constantly under review the evolution of common interest questions, such as management of the common environmental concern over Black Sea energy transportation. Another possible task would be to prepare for a regional application of the forthcoming "transit protocol" of the Energy Charter Treaty. This would be concerned with the conditions of access, ratification and dispute settlement in relation to multinational pipeline networks, and would build on the work already initiated by the EU-financed INOGATE project.

President Shevardnadze has recently proposed that BSEC give balanced attention to economic, political and security issues (see Annex G). If this were agreed the organisation might be renamed "Black Sea-Caucasus Cooperation" (BSC). To serve broader political needs there should be a wider Black Sea-Caucasus-Caspian Political Forum (BSCC), meeting under the auspices of the BSC, which the remaining Caspian states (Kazakhstan, Turkmenistan and Iran, possibly also Uzbekistan) would be invited to join as

well as the US (somewhat analogous to the Euro-Atlantic Partnership Council in relation to NATO).

### 5.3 Oil and gas development

The whole package of political, security and economic measures proposed would transform the business climate for the region as a whole, enormously reducing perceived political risk for major long term investors, notably in the oil and gas sector.

The hydrocarbon sector would be set to achieve its full economic potential. There has in recent years been a re-assessment of the earlier exaggerated claims for the size of the Caspian's economically viable hydrocarbon potential (see Annex C). Industry experts now assess the Caspian basin to be roughly of North Sea proportions, and certainly not the Persian Gulf. Moreover the cost of extraction and delivery to European markets is comparatively high but currently competitive with the North Sea.

For oil, by 2020 conventional predictions place total Caspian (North and South) production at between 3 to 5.5 million b/d (Annex C). Pipeline projects capable of transporting 4.5 to 5.5 million b/d are already identified. These figures also tie in with projected market demands within the Mediterranean, the Black Sea and within the Caspian region itself. If demand is lower, or production increases more slowly than predicted, then export capacity would adapt to the lower pace. The increased pipeline capacity would be built, and additional horsepower (i.e. increased operating pressure) would be added as capacity demand increased. Pipeline systems are highly flexible once the initial investment has been made.

For gas, the key driver will be the Turkish gas demand. Turkey today consumes some 20 bcm/y. This is projected to rise sharply by 2007 to 50 bcm/y. Demand is then planned to increase on a steady incremental basis, to 85 bcm/y by 2020 (Annex D). Two thirds of the expansion depends on the continuous development of the gas-fired energy sector. These growth projections are based on a series of inherently risky assumptions, and may well be on the overoptimistic side, at least as regards the speed with which such large demands build up. Nonetheless these developments will in any case be of strategic interest to the European gas supply situation, since they

will be the basis for major new investments, and the Turkish gas network connects with that of South-east Europe. Moreover the EU is going to need fresh gas supplies, given the decline of North Sea production and rising demand for gas favoured by environmental concerns. In this respect the plethora of suppliers from the region is attractive for competitive reasons, especially since these can converge in some options on shared pipeline infrastructures.

These factors imply that with a more secure investment climate and commercially effective transport routes, the energy sector, with its multiplier effect on the rest of the economy, could make an enormous contribution to the region's economic welfare. It would still not be a matter of global importance for the geo-politics of world energy markets. Nevertheless South Caspian oil, with its natural markets firmly positioned in the Black Sea and Mediterranean area, would be of strategic importance for the long-term energy requirements of Southern and South-Eastern Europe.

The policy interests shaping the framework conditions for oil and gas investments in the Caspian-Caucasus-Black Sea region are naturally those of the suppliers and the buyers: on the one hand the producers and exporters, which happen to be all the littoral Caspian states (Russia, Azerbaijan, Kazakhstan, Turkmenistan, Iran), and on the other hand the importers and consumers, which in terms of proximity are first of all Georgia, Armenia and Turkey, but then also the enlarging European Union, in particular South-central and South-east Europe. In addition, both the EU and US are represented by the major international oil companies' production and marketing interests. Supply and demand have natural divergencies of interest, but in the final analysis they have to meet.

Suppliers of energy are naturally interested in achieving dominant market positions, either through monopoly or oligopolistic cartels such as OPEC, if they have a chance to do so. Russia is the only supplier that may contemplate aiming at a monopolistic positions on a large scale, but for the enormous European market this is impossible for either oil or gas, given the alternatives sources. If such ambitions are seen to be unrealistic, then the objective must be to secure full access to international supply networks, under safe and fair conditions, and to achieve long-term supply relationships that will make major investments feasible.

Consumers of energy on the other hand, especially very large ones such as the European Union, have several natural interests:

- competitive conditions among a sufficient number of suppliers to get favourable terms of trade. To develop more ample supply capacities in the Caspian region would be useful, but not the main point in a world market where the OPEC cartel can have a major influence prices at least episodically,
- favourable business climate conditions in the supplying areas, so as to attract ample long-term investment to ensure supply capacities, including the whole range of legal security, taxation and governance issues (including the legal security of Caspian under-sea property rights, which is not yet settled),
- economic security of supply for such vital products as oil and gas, which is best served by multiple sourcing, and can be supported by international legal agreements concerning pipeline transit (the Energy Charter Treaty can help here),
- environmental security, for example to avoid oil pollution of the Black Sea through limiting traffic by large oil tankers through the Bosphorus,
- geo-political security, which means that sound long-term relationships with important neighbours, based on agreed rules and mutual advantage, need to be built up. The Russia-EU relationship is the most important one for Europe as a whole, and in fact the Brezhnev-Schmidt gas supply and pipeline agreement of the 1960s, leading to the trunk gas pipelines from Western Siberia to Germany, became a major geo-political-economic stabiliser for Europe. However the same clarity of strategic cooperation does not yet exist around the Caspian-Caucasus-Black Sea region.

Pipelines. The oil industry favors multiple options for commercially driven export pipelines, built in a timely manner in response to confirmed capacity demand. Consumer interests, whether Turkey or the EU, look for diversified sourcing, for both economic and geo-political security as argued above. In practice these objectives can be met to a high degree. Notably, there will surely be expansion of Northern pipeline routes through Russia, trans-Caucasus routes from Caspian to Black Sea, some Turkey–Iran connections as well as increased tanker transport of oil across the Black Sea.

The major new projects awaiting definitive decisions and full-scale implementation are the Baku-Ceyhan oil pipeline, the trans-Black Sea gas pipeline ('Blue Stream') directly from Russia to Turkey and the trans-Caspian gas pipeline from Turkmenistan to Baku. The economics of these projects are in fact interrelated. Moreover a new factor is the discovery of a



large new gas field in offshore Azerbaijan (Shah Deniz), increasing maybe decisively the case for a major new trans-Caucasus gas pipeline, whether connected to a trans-Caspian pipeline or not.

If this new gas pipeline were placed alongside the proposed Baku-Ceyhan oil pipeline, at least part of the way into Turkey, it would reduce the costs of the Baku-Ceyhan oil pipeline, which until now have appeared to be very high. Baku-Ceyhan has the advantage of completely avoiding the Bosphoros bottleneck, and the Turkish authorities might in any case resort to increasingly costly ways of securing environmental protection of the Bosphoros, such as double-hulled tankers and tighter regulations.

The Blue Stream and trans-Caspian pipelines are in direct competition and both could not succeed. However the Turkmen gas can be routed via Russia overland, with expansion of existing connections. Russian gas can also be routed to Turkey overland, as already round the Western coast of the Black Sea, and possibly through augmented supplies via the Georgian gas network to the East, which itself could connect with a new trans-Caucasus gas pipeline from Baku.

Legal security. Four steps could improve the investment climate:

-Russia's ratification of the Energy Charter Treaty (ECT). Russia has signed but not yet ratified the Energy Charter Treaty, which is important for the legal security and non-discriminatory treatment of investment and pipeline contracts. A formal ratification by the Duma would signal Russia's commitment to the principles of the treaty – namely non-obstruction of transit, non-discrimination, respect for property and contracts and a favourable investment regime. Russia's ratification of the ECT would serve as a valuable step towards its closer economic integration with the EU. The EU should engage Russia at high-level in a political and commercial dialogue to encourage Duma ratification.

-Transit Protocol Agreement. Negotiations are proceeding on the inclusion of an additional transit protocol agreement to the ECT. Serious obstacles include the unfavourable positions of several key Russian players: the main pipeline network corporation Transneft is reported to favour the Transit Protocol, but Gazprom to have reservations over this extension of the international legal framework. The EU should support these negotiations and engage in dialogue with Russia on the mutual benefits of the agreement.

-EU-Russia economic collaboration in the Caucasus beyond oil & gas. The South Caucasian states currently lack experience and expertise in the management of inter-state economic relations. Hence, the tendency to revert to atavistic attitudes based on self-assertion, which block the gains that flow from an institutional framework promoting trade, investment and financial collaboration. Such collaboration could be promoted by a regional trade & investment agreement - based on the ECT, but without the ECT's limitation to energy. The agreement could be proposed by the EU and elaborated with EU technical assistance.

-Attribution of Caspian seabed and offshore territorial rights. The clear attribution of Caspian sea-bed and offshore territorial rights is not yet assured. The current legal insecurity in the Caspian discourages risk averse companies and increases the political and financial risk of all operations in disputed areas - including exploration and laying of pipelines. On the other hand a proven model for handling such issues is the drawing of median lines as in the North Sea. For the Caspian this seems increasingly the most plausible outcome. Russia and Kazakhstan have made a preliminary median-line agreement, which awaits ratification. However it would be politically and economically prudent if short to medium term alternative options were developed, such as joint development zones, prior to a long term global solution for the subdivision of the Caspian being agreed. Joint petroleum development agreements have proved a useful transitory method to provide the legal security required for oil and gas investment prior to a permanent border delineation.

The EU could prepare a study incorporating the current claims and negotiations and suggesting a draft agreement prepared by technical and neutral experts. Such a study could include proposals for national subsoil areas, based on equi-distance and current agreements, together with a joint petroleum development zone for the most intensely disputed areas are recommended. The Thailand-Malaysia, Korea-Japan and UK-Norway joint petroleum agreements provide useful precedents. A draft agreement should also deal with regulatory issues and could propose joint, rather than separate regulation on fisheries, navigation, pipeline-laying and environmental regulation. Once a draft agreement is available the EU could initiate a process of conciliation between the different parties. The Caucasus states would thus become increasingly accustomed to peaceful and non-confrontational methods of settling seemingly intractable disputes.

Local economic benefits. The oil and gas development is most likely to produce, as it did in other regions, a significant across-the-board expansion of the local consumers goods and services markets, manufacturing industries, farming and food production, construction, banking and financial services, tourism and leisure, etc. Increased government revenues would also permit higher outlays for education, culture, health and social services. The resulting feed-back would provide additional incentives for enhanced regional cooperation and integration.

## 6. Financing

The Caucasus is a remote area for the EU and the US. Big grant money cannot be assured. The region does not have the proximity to Western Europe of the Balkans, nor the priority of EU accession candidates. The countries of the region would have therefore to make a huge effort in terms of their own political will for large-scale resources to be made available. However a credible cooperative strategy by all countries of the region, in agreement with the external powers, could switch on resources from private sector, as well as from international financial organisations. To have chance of gaining major grant support from the EU and US it would have to be clear that a real “new deal” was being secured: i.e. a lasting transformation of the political, security and economic context of the region as a whole, something that the Western political leaders could justify to their parliaments as a decisive investment. This is why leaders of the region have every reason to aim at comprehensive and radical action, not just an incremental step-by-step approach.

Up until 1999 the EU supplied 826 million euro of grant assistance to the three South Caucasus states. There are signs that the recent level of assistance will not be sustained unless political settlements of the conflicts, since the conflicts make it impossible to get good returns from such resources. For the EU to make an important, expanded contribution of grant finance it would be necessary for the European Council to request a revision of the medium-term financial perspectives of the EU Budget. Similarly, it would require a top-level political decision for EU finance ministers to give a mandate to the European Investment Bank to undertake operations in the region.

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For the US, there would have to be a request to Congress for authority to extend significant new financial commitments for the Caucasus.

The IBRD and EBRD could certainly amplify their lending and investment programmes in the context of a New Deal for the Caucasus (estimates should now be prepared by their staff economists).

The Council of Europe Development Bank has begun to undertake projects in South-East Europe for reconstructing housing, health-care and educational facilities for returning refugees communities, and could extend such activities into the North and South Caucasus<sup>4</sup>.

The oil and gas sector will be largely self-financing, and just need a politically secure business environment to proceed with maximum commercially justified investments. The Azerbaijan government's borrowing capacity will be increased if oil sector prospects improve.

The Armenian Diaspora shows considerable capacity and will to invest in the region, and this would surely be greatly amplified as trade blockades are lifted and the region would get set on a sound path of regional integration.

Similarly, the potential for expanded Turkish direct investment in the region is considerable.

In the absence of hard data on reconstruction costs for the war-hit parts of the Caucasus, certain data from the Balkans are of interest as some kind of yardstick.

1. For Bosnia the World Bank compiled in 1996 a five-year priority reconstruction programme, which donors endorsed. The total cost was \$5.1

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<sup>4</sup> Examples of operations in Bosnia and Croatia are in circumstances quite similar to war-hit areas of the Northern and Southern Caucasus. The Bank's total financing operations amount to over 2 billion euro per year, with only relatively small amounts so far for refugee return projects. However the member states of the Council of Europe could request that these operations in both the Balkans and Caucasus be given higher priority.

billion, for a state with 4.5 million population, at least half of whom had been displaced, and 250 000 killed (see Annex J).

2. For Kosovo the World Bank and EU Commission estimated in 1999 that the external financing requirement for a four-year period was \$2.3 billion. This is for a region whose population was about 2 million, of whom most were displaced (see Annex I).

Taken together, these assessments are beginning to suggest an empirical regularity of \$ 1 billion urgent and basic reconstruction needs per 1 million of population, for regions hit by Balkan-type (and Caucasus-type ?) wars. For comparison, Nagorno-Karabakh and the neighbouring Azeri territories presently occupied by Armenian forces had a population of about 800,000 before the war. Abkhazia had a pre-war population of about 540,000. If there was the same scale of damage as in Bosnia and Kosovo, and the same standards of need assessment, one would arrive at figures approaching \$1 billion for Nagorno-Karabakh and about \$0.5 billion for Abkhazia. Such benchmarks may be compared in due course with the findings of future World Bank missions to the Caucasus, hopefully sent in view of the imminent peace. In the meantime they may be retained as the most likely figures, pending replacement by directly collected data.

## Annex A: Background on the economies of the Caucasus

	Population, million	GDP p.c., \$	GDP, \$ million
Armenia	3.7	510	1,887
Azerbaijan	7.6	540	4,107
Georgia	5.4	967	5,221
Southern Caucasus	16.7	671	11,215
Northern Caucasus	11.6		

Armenia. Since independence Armenia's economy has undergone serious disruptions partly as a result of liberalisation and partly as a consequence of the Karabakh war and the 1998 earthquake. In the early 1990s Armenia underwent virtual industrial collapse with a drop of GDP of approximately 60% in 1991-93. Inflation spiraled into hyperinflation by 1994 and unemployment and poverty became widespread. The government's reform programme was slowed due the country's political and natural problems, which dramatically reduced trade, increased transport costs and multiplied investment risks.

Since the end of the war with Azerbaijan in 1994, the Government has implemented a stabilisation and structural reform programme, backed by several international donors besides the Armenian Diaspora<sup>5</sup>. Total IBRD/IDA commitments to Armenia as of July 1999 have been of \$607m for over 20 operations covering infrastructure rehabilitation, earthquake reconstruction, irrigation, agricultural development, health and education. Since 1994 the economy has been growing at an annual average of 6%<sup>6</sup>, inflation has fallen to an annual rate of approximately 9% and the budget deficit has fallen to approximately 3% GDP<sup>7</sup>. Growth has been triggered primarily by increased capacity utilisation facilitated by increased trade with FSU and Middle-East economies.

<sup>5</sup> Transfers from the Armenian Diaspora may amount to approximately half a billion dollars per year.

<sup>6</sup> European Commission, Economic Trends, Armenia, Oct-Dec 1998.

<sup>7</sup> Ibid.

Nonetheless, Armenia's economy remains seriously flawed. Investment is notoriously poor. The EBRD calculated that for 1997, total investment amounted to 8.8% GDP and FDI reached a mere \$52m, i.e. amongst the lowest levels throughout the FSU. Armenia's external trade performance is also weak with stagnating export levels and rising imports which have caused a rising current account deficit which reached 25.2% GDP in 1998. Poor trade performance is clearly linked to the Azeri and Turkish embargoes. Armenia is landlocked and far from European, North American and East Asian markets. Hence, the importance of its immediate neighbourhood. However, the Azeri and Turkish embargoes prevent Armenia's direct trade with Azerbaijan and Turkey. They also harm trade with Georgia and Iran. Georgia has exploited the embargoes by further increasing transport costs on Armenian goods<sup>8</sup>. Macro-economic trends in 1999 suffered further as a consequence of the 1998 Russian crisis, which caused a renewed industrial decline, a further deterioration of external balances and accelerating inflation.

Azerbaijan. Transition from the Soviet system and the war with Armenia over Nagorno-Karabakh, which led to the loss of approximately 15% of Azeri territory and to nearly one million Azeri refugees, caused significant economic disruptions. By 1994 GDP stood at 37% of its 1988 levels. Agricultural and industrial output fell by 43% and 60% respectively in 1988-94 and particularly harshly hit were the oil and gas sectors where production declined by 4.2m metric tons.

Since 1995, with a gradually stabilising political climate, the government began implementing the IBRD/IMF reform programme with considerable results. Inflation declined from 1,664% in 1994 to 1% in 1997 and has been negative since then, and budget deficits fell to 2% GDP in 1998 as a result of tight fiscal and monetary policies. However tight macro policies did not prevent annual GDP growth from reaching a 10% peak in 1998. External balances have also improved. The \$1.5billion (33% GDP) current account deficit of 1998 was successfully financed through FDI flows principally related to the expanding oil sector, which amounted to approximately \$1billion. Azerbaijan has also received substantial financial support by IFIs. Between 1992 and 1999 for example, international aid reached \$369million in projects principally providing technical assistance to strengthen the government's institutional capacity to manage and develop its oil industry.

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<sup>8</sup> Costs of transporting containers from Poti to Yerevan are around \$2,000, i.e. approximately the same amount for transportation from New York to Seattle, which is almost ten times the distance.

The country has thus made considerable economic progress in the latter half of the 1990s. However, the sustainability of its success and the full exploitation of its economic potential continue to hinge crucially upon political stability and most importantly the resolution of the Nagorno-Karabakh conflict. Political factors as well as external economic developments are particularly important in the light of Azerbaijan's lack of industrial diversification and exclusive concentration on the oil sector. The country's potential economic vulnerability was clearly evidenced during the 1997/98 collapse in oil prices and the 1998 Russian rouble crisis. That accentuated the current account deficit and caused a 7% depreciation of the manat against the dollar, which imported inflation in 1999.

Georgia. The economic disruption of Georgia caused by transition to a free market system was compounded by the civil conflicts in Abkhazia and South Ossetia, and potential instability in Adjara and Javakheti. As a result Georgia underwent serious economic decline with output falling by over 70% between 1990 and 1995, capacity utilisation declining to 20% of its 1980s levels. Annual inflation reached 8,400% in 1993 and internal and external imbalances were accumulating at an alarming pace.

With the cessation of heavy fighting and cease-fire agreements in 1992 for South Ossetia and 1994 for Abkhazia, the government was able to embark upon constructive structural reform and sound macro-economic management. The government was also considerably aided by IFI assistance. By 1999 \$510m has been committed by the IBRD in projects aimed at promoting private sector development, improving infrastructure, developing institutional capacity and strengthening social security. The EU has also been active in the country particularly via TRACECA projects focusing on the upgrading of Black Sea ports.

By 1996/1997 GDP growth reached 10%, and inflation fell to 1% in early 1998. As other countries of the FSU, Georgia suffered in 1998/1999 from the Russian financial crisis. Growth declined to 1.7% in the first half of 1999, inflation rose to 11% and the positive trends in internal and external accounts were reversed. Nonetheless the government has persisted in its policy of fiscal and structural reforms. The government in Tbilisi has aimed to increase tax revenues through an expansion of the tax base and improved tax administration, while directing public expenditure to priority policy areas such as health and education. The government has also aimed to diversify the country's production base by focusing on privatisation, infrastructure



development and the creation of a sound regulatory framework. Progress however remains slow partly due to the volatile political situation and lack of a formalised constitutional settlement of the conflicts.

The North Caucasus<sup>9</sup>. The North Caucasus comprises seven republics, including Dagestan, Chechnya, Ingushetia, North Ossetia, Kabardino-Balkaria, Karachai-Cherkessia and Adygeya. The total population of the republics is 11.5 million<sup>10</sup>.

The economies of the North Caucasus have been characterised by two interrelated phenomena. First, they have been relying upon financial transfers from Moscow. In the light of the region's depressed tourist sector and poorly developed industrial sectors, the republics are net recipients of budgetary transfers. The most heavily subsidised republic is the ethnically fragmented Dagestan, the poorest republic of the North Caucasus<sup>11</sup> with over 80% of its revenues coming from the centre. Transfers are primarily intended to provide minimum social protection including income support and free provision of electricity and gas. Few resources have been available for investment and development programmes.

Second, responding to necessity, the republics have effectively resorted to a variety of "survival strategies". In Ingushetia, President Aushev effectively bargained with Moscow the Republic's status of Free Economic Zone, allowing the Republic to earn income as if an off-shore area. North Ossetia has capitalised on its strategic position linking the Russian Federation to Georgia via two access routes, on its huge Russian military presence and on its role as link to transport tax-free alcohol from Europe to Russia. Chechnya has relied upon more explicit criminal activities including kidnappings and racketeering, in the light of the climate of political violence in this war-devastated region. Kabardino-Balkaria has been relatively successful in developing its manufacturing industry and has benefited especially from Turkish investments since the mid-1990s. Finally, both Karachai-Cherkessia and Adygeya have focused on the development of agriculture through small and medium-sized farms. In all of the above cases, politics continue to play a

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<sup>9</sup> For a more detailed account of North Caucasian economic trends, see Liono, A. "Economic Survival Strategies in the North Caucasus", CEPS Conference paper, January 2000.

<sup>10</sup> Nicholson, M. "Towards a Russia of the Regions", IISS Adelphi Paper 330, 1999.

<sup>11</sup> Per capita gross regional product of \$1,250 in 1998, UNDP, Human Development Report 1998.

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crucial role in the legal and semi-legal distribution of resources organised by local political elites.

Table 1: Population of the Northern Caucasus<sup>12</sup>

Adygeia	541 000
Chechnya (numbers unknown)	862 200 (early 1990s estimate, current numbers unknown)
Dagestan	2 150 000
Ingushetia (refugee inflows since)	303 500 (early 1990s estimate, large inflows since)
Karachaevo Cherkassia	436 000
Kabardino-Balkaria	790 000
Northern Ossetia	663 000
Total, 7 entities, approx.	5 500 000

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<sup>12</sup> Note: these figures come from a variety of sources and should only be regarded as approximate, and in any case take no account of recent displacements as a result of conflicts.

Annex B: Background on areas of conflict and tension

Nagorno-Karabakh. An autonomous region of the Azerbaijan SSR between 1923 and 1991/2, NK had a pre-war population of 200,000. The conflict over NK emerged in the late 1980s, as a result of the loss of legitimacy of the Soviet hierarchical framework which included Union republics (such as Azerbaijan), Autonomous republics (such as Abkhazia) and Autonomous regions (such as Nagorno-Karabakh). Autonomous regions were both dependent from Moscow and from their Union republic. Armenians in general and from NK in particular heavily questioned the legitimacy of the Azeri rule over the NKAO. At the time of the outbreak of the war the Armenian ethnic share of NK's population was 75%.

In the final years of the Soviet Union, unrest grew. Demonstrations soon acquired a distinctive ethno-political nature and tensions escalated, culminating in the first formal demand in 1988 by the Armenians in NK to transfer the region from Azeri to Armenian rule. Moscow rejected the demand and the Armenian SSR responded in 1989 by calling for the reunification of the Armenian SSR to NK. Following a brief interlude of direct rule from Moscow, NK voted in favour of full independence in January 1992. In reaction to this unilateral declaration, Azerbaijan abrogated the autonomous status of the oblast. These final events triggered a full-scale war between the Azeri army and well-organised forces of NK, which were directly supported by Armenia. By 1992-3 Nagorno-Karabakh had not only gained control of the NKAO territory but also of seven additional districts in Azerbaijan, which together represent around 10% of the Azerbaijan's total territory. The occupied districts include Lachin and Kel'badzhar, allowing the direct connection between NK and Armenia. Since the cease fire agreed in 1994 NK has functioned as a non-recognised state and NK Armenian troops remain stationed in all of the occupied districts.

The war led to extensive refugee flows and extreme economic distress. Ethnic riots took place in some of the cities of Azerbaijan where a significant Armenian population lived. Approximately 200,000 Armenians fled Azerbaijan to Armenia and NK, while 45,000 emigrated to Russia. On the other hand, 185,000 Azeris and 11,000 Kurds fled from Armenia and 47,000 Azeris left NK. Between 500,000 and 600,000 Azeris migrated from the occupied districts to Azerbaijan making a total of around 800,000 Azeri refugees and displaced persons (10% of the country's population).

Since the cease-fire of 1994 the situation in and around NK has been characterised by military stand-off (with just a few relatively minor flare-ups) and political stand-still. The OSCE-appointed Minsk Group (Russian Federation, United States, France) have produced several proposals for a possible comprehensive settlement, but none has proved acceptable to the parties to the conflict so far.

Abkhazia. An Autonomous Republic in the framework of the Georgian Union republic, in the hierarchical Soviet framework, Abkhazia was both dependent on the Moscow party leadership and the Tbilisi authorities. These relations were complicated by the fact that the Abkhaz community was holding a large number of leading posts in the republic of Abkhazia, but constituted only a minority of 18 per cent of its population. These privileges had been granted according to the Soviet view of the right to peoples to self-determination, which included the possibility for so-called "titular nations" to control administratively a certain part of the Soviet territory. The privileged position of the Abkhaz community in Abkhazia was challenged by the far larger Georgian community, which constituted in 1989 about 45 per cent of the population. From the Georgian perspective, the cultural and political hegemony of the Georgian nation over the Georgian Union republic had to be extended to its autonomous units.

In the last decade, the Abkhazian national movement had made repeated attempts to withdraw from Georgia and to be included in the Russian Federation. Since 1989, the conflict between the ethnic communities in Abkhazia escalated, leading to the intervention of Georgian troops in August 1992. In response, the Abkhaz, led by V. Ardzinba launched an offensive, supported by the so-called Confederation of the Peoples of the Caucasus. They also received support from Russian military stationed in Abkhazia. The Georgian troops were defeated and the Georgian population of Abkhazia fled.

In 1993 the UN deployed an observer Mission to Georgia (UNOMIG). A cease-fire was agreed upon, with the introduction of a Russian (formally CIS) peacekeeping force monitored by UNOMIG. Much of the peacekeeping activity takes place in the Gali region, whose pre-war demographic composition had been 90% Georgian. Peace negotiations have been carried out under the auspices of the UN. Through Russian mediation, Shevardnadze and Ardzinba signed in 1997 an agreement on the non-use of force. Nonetheless, Georgian refugees, resentful of the lack of perspectives to

return, have formed paramilitary groups, particularly in the Gali region. The situation in the security zone remains highly volatile.

In the negotiations, the Abkhaz authorities have been proposing a confederal framework, where Georgia and Abkhazia would be both equal in rights as sovereign entities. They would delegate a number of competences to the government of a Common State. The Georgian authorities are, to the contrary, convinced that Abkhazia has to be seen as a part of Georgia. They are ready to federalise Georgia in order to accommodate the Abkhaz claims. None of these proposals was providing sufficient security guarantees to the other side. In 1999, Abkhazia declared its independence, based on a referendum where only a part of the pre-war population was able to participate.

War damage from the Abkhaz war has not been tackled by serious reconstruction due to the Georgian and Russian blockades on the region. Food and other basic needs are scarce, factories operate at an extremely low capacity and the provision of gas and electricity is sporadic. The conflict has clearly also seriously damaged Georgia by cutting off the best transport routes to Russia and discouraging the rebirth of tourism throughout the country.

South Ossetia. There are approximately 600,000 Ossetes living in the Caucasus. Prior to the war a majority of 440,000 Ossetes lived in the Autonomous republic of North Ossetia in the Russian Northern Caucasus, while the rest were concentrated in Georgia, with around 65,000 in the Autonomous region of South Ossetia and the remaining 95,000 in the rest of Georgia. The conflict in South Ossetia emerged in the late 1980s when the South Ossetes began publicly to claim greater autonomy. In 1989 South Ossetia had requested its upgrading to the status of an Autonomous republic. Georgian nationalist movements mobilised to "defend the Georgian population" by force. They regarded the Ossetes as relative latecomers in the region, which had no right to a specific political status in Georgia. Both parties tried to use force to impose their views. South Ossetia was virtually depopulated of its ethnic Georgian population and approximately 100,000 Ossetes living in Georgia fled either to North or South Ossetia, while many South Ossetes joined their northern neighbours. In 1992 a South Ossetian referendum voted in favour of unification with North Ossetia within the Russian Federation, under dubious legal and political conditions. A number of leading Russian leaders supported South Ossetia openly. Russia was in 1992 at the brink of war with Georgia because of South Ossetia. In June

1992, Yeltsin and Shevardnadze met in Dagomys, and a cease-fire was signed between the warring parties. A Russian, Georgian and Ossetian peace-keeping force was established under a joint control commission. An OSCE Mission in Georgia promoting settlement negotiations was later incorporated in peacekeeping efforts. By late 1997, confidence building measures reopened communication links between Georgia and South Ossetia and thereafter the conflicting parties agreed to a memorandum establishing the non-use of force and a commitment to refugee repatriation and demilitarisation. However, there has remained disagreement over the ultimate political status of South Ossetia.

Adjaria. This coastal region in south west Georgia bordering Turkey, Adjaria has a population of just over 400,000, of whom a vast majority (392,000 in 1989) are Muslim and some are bilingual in Georgian and Türki, a variant of the Turkish language. Since the break-up of the Soviet Union and Georgian independence there have been tensions, but not violent conflict, over economic issues and struggles for political power between the region's president Abashidze and Shevardnadze's party. While Abashidze aims to strengthen the region's economic potential and encourages the presence of the Russian military bases in Batumi, Tbilisi has weakened the Adjarian economy by excluding Batumi from its major transport projects.

Meskhet-Javakheti. An in-land region of south west Georgia bordering Armenia, over 90% of a population of approximately 235,000 are ethnic Armenian. During the period of perestroika, the Armenians in Javakheti under the national popular movement 'Javakh' called for the preservation of their Armenian cultural heritage and protested against Tbilisi's neglect of their economic situation. The movement radicalised in subsequent years, calling for the autonomy of Javakheti or its incorporation in Armenia. Tensions escalated again in 1994 when Javakheti and Meskheti were merged in a single administrative unit, and an ethnic Georgian was appointed as State Representative of the region. There are 6 administrative districts that are ruled by independent consuls, who are directly linked to the central authorities in Tbilisi. There is no common administrative body for the region. Conflict in Javakheti has not erupted as in Nagorno-Karabakh and Armenia has a strong interest in caution (risks of another war, complete blockade). Russia has a military base in Alkahalki.

The Lezghins. According to a 1989 census, the Lezghins represent an ethnic group of 400,000, who like the Ossetes straddle a border area with Russia, in this case along the Samur River dividing the Republic of Azerbaijan and the

Republic of Dagestan. Approximately 252,000 Lezghins live in southern Dagestan, while the rest in the north east of Azerbaijan. The Lezghins have protested against their division following the break-up of the Soviet Union and the independence of Azerbaijan. They also perceived themselves to be discriminated against by Baku. The political organisation 'Sadval' was formed standing for Lezghin rights and for the possible formation of an independent Lezghin state. In 1993 Lezghin demonstrations erupted into violent clashes with the Azeri police. Baku however, keen not to involve itself in another war, has sought to cooperate with Dagestan officials on issues of Lezghin concern. An agreement between Dagestani, Russian and Azeri officials has been signed in Baku agreeing on a 'transparent' border between the two states.

Nakhichevan. An autonomous republic within the state of Azerbaijan bordering Armenia, Turkey and Iran, Nakhichevan has a population of 310,000 of whom the vast majority is ethnic Azeri. Political tensions in Nakhichevan in the late 1980s and early 1990s was more the result of an attempted assertion of independent political power, rather than a product of ethnic politics, given that by 1989, virtually all of the Armenian population of Nakhichevan had left the Azeri enclave. Following Azerbaijan's independence in 1991 the region remained an autonomous republic within Azerbaijan with its own constitution, government, parliament and judiciary. The authorities there had competence for policy areas such as local taxation, tourism, economic development, social security, environmental affairs, health and culture. During Elchibey's presidency of Azerbaijan, Nakhichevan, led by Heydar Aliyev, attempted to establish a greater degree of independence, before he took power in Baku itself. In this respect it is notable that Azerbaijan's last two presidents, Abulfaz Elchibey and Heydar Aliyev both originate from the region.

Annex C: South Caspian oil - realities and issues

Resource Potential. There has been continued speculation in the media on the size of South Caspian oil reserves. Since its inception in 1875, Baku's oil development has enjoyed a varied history. At the turn of the 20th Century, Baku was the leading oil producer in the world. During subsequent Soviet rule it became the economic mainstay of Lenin's Bolshevik Revolution, and later the critical energy supplier for the Russian Eastern Front in World War II. In 1949, Baku was the World's first truly offshore oil producer. However by the late 1970s, Moscow had redirected oil investment priorities to West Siberia, with long-term plans to return to the Caspian in the opening decades of the 21st Century. Oil production in Baku peaked at around 250 000 b/d in the mid-1980s, but then declined to some 140 000 b/d. By 1990 the oil industry of the South Caspian was already in a state of dilapidation and decline. With the ensuing collapse of the Soviet Union in 1991, the process rapidly accelerated.

During the Soviet Period, Caspian oil investment was closed to the West. But with the formation of the newly independent states in 1991, direct access by western investors into prime Caspian exploration and development acreage was encouraged. The attraction for the Oil Majors lay in the untested potential for new giant oil fields in the deeper waters of the South Caspian. There were already many clearly defined large untested structural traps, lying on trend with existing oil discoveries. Soviet technology constraints, coupled with delayed Soviet capital investment in the Caspian oil sector, had thus created a unique opportunity for low risk oil exploration by the West. A proven recoverable oil reserve of 17.5 billion barrels had already been discovered in the South Caspian (Azerbaijan and West Turkmenistan); and an extensive database was used for technical due diligence, to underpin a revised geological projection for the discovery of a further 20 billion barrels. Moreover South Caspian oil quality is particularly attractive (30 API with no contaminants), and these new reserves can all be accessed by conventional technology.

Already since the return of foreign oil investment in 1994 into South Caspian oil development, Azerbaijan production has risen to 240 000 to 260 000 b/d, and West Turkmenistan 120 000 to 130 000 b/d. But this is just a beginning. In the absence of significant impediments to investment, by 2010 South Caspian oil production should reach some 1.2 to 1.5 million b/d. This makes South Caspian oil resource comparable to a new North Sea equivalent; but not the new Kuwait that has been frequently promoted in the media.



But offshore exploration and development in the South Caspian is expensive. Failure costs are high (in excess of \$200 million per contract area). Conversely in the event of success giant (multi-billion barrel) oil fields will be found, and finding costs are low. These currently translate into about \$0.5 to \$0.75/bl., which in global terms is commercially very attractive. It also puts South Caspian oil potential to the forefront of opportunities for international exploration. But clearly this is a game for the Oil Majors, which have the financial means and breadth of global risk portfolios to tolerate the possible costs of failure. The full cost of producing Caspian crude is currently about \$12.50/bl. By coincidence this is the cost equivalent of a North Sea barrel. But two cost elements dominate the Caspian barrel; transportation (\$6.50/bl.) and drilling (\$3.0/bl.). Both are likely to fall within the foreseeable future. Therefore if the world price of oil were sustained at levels above \$13 to \$15/bl. (currently it is \$27/bl.), Caspian oil investment is highly profitable, and certainly globally competitive.

Since 1994 the South Caspian has attracted a substantial number of foreign oil investors. By applying a politically and commercially expedient oil policy, Azerbaijan created an environment conducive for investor confidence. Its low risk petroleum geology had already been confirmed. Commercial confidence was successfully achieved through the award of sophisticated Production Sharing Contracts (PSAs), which enjoy particular benefits and security under Azerbaijan parliamentary law. Some 19 such contracts have been signed to date, involving 27 foreign upstream investors. One (the so-called "Contract of the Century") is for the development of an existing giant oil field, with firm commitments for an ongoing investment of some \$10 billion. Eighteen Contracts were signed for renewed exploration, with short-term (3 to 5 years) expenditure commitments of some \$4 billion. If a third of these exploration contracts are successful and convert to Development PSAs, then a further \$30 billion investment is involved.

These major oil investments are clearly providing a fundamental driving force for economic renewal, whilst at the same time creating a series of remarkable set of international geopolitical alliances within the region and with the West. These oil contracts have become the central plank of Azerbaijan foreign policy. But the impressive processes of change achieved by 1998 have now slowed almost to a stop. Major offshore oil investments have been suspended, pending resolution of new regional export systems in a process that regrettably has become politicised. The symbiosis of economic growth and political stability in the Caucasus has

been demonstrated by events to date. But all must be underpinned by continuous investment from the private sector, to reinforce the realities of sustainable development long term. Also this investment activity must not be confined to the energy sector alone, but must be expanded into the power, manufacturing and agricultural sectors as well. The diversity of options for future economic growth within the Caucasus are truly legion, if positive regional political will is present.

Legal uncertainties over Caspian status. Legal uncertainties over national ownership of the waters of the Caspian Sea remain unresolved. This not only creates major conflicts of national interest between the littoral states; but also inhibits regional development of material offshore natural resources, and delays investment in much needed industrial infrastructure. In particular uncertainty over offshore title presents serious challenges for conventional project financing in the private sector. World Bank, IFC and EBRD financing, with political risk cover, is proscribed where national title is in dispute, and where the common agreement of all member states involved is required.

The land-locked Caspian, although connected to the Black and Baltic Seas by a series of canals, a priori does not meet the criteria set for a "closed" or "semi-closed" sea, as set by the Convention of the United Nations on the Law of the Sea (1982). Furthermore the newly emergent states of the Caspian have not yet themselves ratified this 1982 Convention. The issue of whether or not the Caspian is a Sea or a Lake remains ambiguous. The challenge at the heart of the debate is whether or not the sovereignty or jurisdiction over the Caspian sea-bed will be based on the principle of "Common Ownership" or "Separate Ownership".

Until 1991 the Caspian had two littoral states, Iran and the USSR. With the collapse of the USSR, Caspian jurisdiction is now claimed by five border states: the Russian Federation, Kazakhstan, Azerbaijan, Turkmenistan and Iran. Existing Caspian Treaties (1921, 1928, 1940) which established an agreed regime between Iran and the USSR, are now subject to renewed legal challenge. Although these treaties addressed the issues of a common border and rights of navigation, they made no reference to the exploitation of natural resources beneath the sea-bed and the legalities involved.

By 1994 the Russian Federation had concluded that they alone retained the rights and obligations under existing treaties, and warned the newly

independent states against unilateral action. However the latter soon recognised perhaps with some reluctance, the need for dialog and mutual cooperation, if long-term stability and sustainable economic development of Caspian resources was to be achieved.

In 1995 the littoral states agreed to establish a permanent mechanism for negotiations on the legal status of the Caspian, in the form of Joint Working Groups. These were to be led by the respective legal Directors of their Ministries of Foreign Affairs. The first meeting took place in Tehran (June 1995), followed by Almaty (September 1995); at which time the participants (excluding Russia) confirmed their commitment to the United Nations Charter as it applied to the Caspian. This was done with particular reference to the principles of territorial integrity, demilitarisation, protection of the environment, and free navigation for the littoral states.

In March 1996, Azerbaijan signed a formal Intergovernmental Agreement with Russia, in which the latter provided guarantees for the safe transit of Azerbaijan oil through its sovereign territory, which de facto recognised Azerbaijan's right to produce and develop the sub-surface resources of its offshore oil fields. In particular it confirmed the titular rights of the new Azerbaijan International Oil Consortium (AIOC), to produce oil from the Chirag Oil Field. A year earlier NIOC (State Oil Company of Iran) had applied for membership of the AIOC consortium, which de facto also provided recognition of Azerbaijan's rights to develop its Caspian oil resource.

However, by 1997 there was a renewed polarisation of views between the littoral states on the status of the Caspian. Both Iran and Russia advocated that division of the Caspian should be on the basis of a Condominium of equal interests, but with the creation of a 12 mile coastal zone under national jurisdiction. Azerbaijan and Kazakhstan proposed an opposing solution based on a sectorial split of the Caspian using existing norms of international practice. This position obtained the progressive support also of Azerbaijan and Turkmenistan, which embarked on negotiations for a determination of a common median line over a disputed area in which already proven undeveloped oil fields were located.

In July 1998 Russia and Kazakhstan unexpectedly signed a bilateral Caspian Delimitation Agreement, over the sea -bed of the North Caspian. This was done for the specific purpose of exercising their sovereign rights to develop

their own offshore mineral resources. For the first time a new Caspian successor state to the USSR established its exclusive right to develop and manage its own subsurface resource; whilst clearly separating the issue of sea-bed delimitation from the issue of the legal status of the Caspian. Consequently the Agreement recognised that freedom of navigation (and aviation), placement of underwater pipelines and cables and all other uses of the Caspian Sea, would be regulated by future bilateral/unilateral agreements between the littoral states, within a broader convention that would only then address the legal status of the Caspian as a whole.

Iran and Turkmenistan immediately protested over this independent bilateral agreement between Russia and Kazakhstan, emphasising "the irreversible principle of unanimity by the five littoral states on all decisions regarding the legal status of the Caspian Sea", to ensure equal shares of Caspian resources by all five states. However, this mutual support between Iran and Turkmenistan was short lived. By February 1999 Turkmenistan was already committed to the construction of a Trans-Caspian gas pipeline to Baku. This culminated in November 1999 in the signature of a framework Agreement between Turkmenistan, Azerbaijan, Georgia and Turkey, for a gas pipeline that would bypass both Iran and Russia. This is subject to continuing protest by Russia, on grounds of disputed legal status and ecological risk in the Caspian sector. Equally Iran itself was taking independent action. In December 1998 it signed an Exploration Study Contract with Lasmo and Shell to assess the hydrocarbon potential of the Iran sector of the Caspian Sea. This agreement included certain rights for the award of subsequent contract areas to the participants, on already agreed terms. However in May 1999 Iran formally claimed territorial rights over a substantially extended sector in the South Caspian, that impinged on areas that both Azerbaijan and Turkmenistan claimed as their territorial waters. In addition it included contract areas already awarded to foreign investors by the Azerbaijan. At the same time Iran continued to claim an equal share of all Caspian mineral resources under the proposed Condominium for the Caspian to provide them with 20% of the regional economic benefits from existing and future development. Clearly Iran has most to gain and least to lose from procrastination over Caspian title. A settlement through the International Court could be obtained, although the track record for reaching such international resolutions extend to decades.

Conclusion. The legal status of the Caspian remains unresolved; and presents serious political potential for ongoing conflicts of interest between all littoral states. Currently there is clearly a lack of general political will by the parties

to face the challenge of regional cooperation, essential for long term economic development of their offshore resources.

Although Western investment in the Caspian has seen the beginnings of one major offshore oil development in Azerbaijan (AIOC), this proceeded on the basis of own financing by the participants, without recourse to external project financing from the private sector. However for new development projects in the future, conventional financing will be required. Projects will need undisputed title or full regional concurrence. For such a high business risk area as the Caspian, private sector financiers will look to the World Bank and its subsidiaries for leadership.

Therefore it is a matter of priority that the littoral Caspian states are encouraged to re-engage in positive negotiations on Caspian status, to achieve not only a legal framework for the benefit of sovereign states themselves, but for continuity for long-term investment as well. Progressive legal solutions based on common and binding agreements must be considered, leading to a final resolution of full Caspian status only in the longer term. In the meantime the participants should be encouraged to revert to proposals submitted by Azerbaijan (1997), based on the Convention of Montego Bay (1982); which allows for the postponement of negotiations on specific median line resolutions. This would enable the parties to focus on the creation of exclusive areas with national undisputed development rights, following the divisions already described in Soviet oil regulations (1970). This would then create the ability to negotiate Joint Development Zones within Disputed Areas.

External funding and independent expert counsel on these highly specialised legal aspects of international maritime law and petroleum development practice, should be made available to Caspian sovereign states, to facilitate a balanced regional outcome.

Lastly under all ongoing scenarios for the final resolution of Caspian status, the parties must recognise requirements imposed by the findings of the International Court of Justice on the International law of the Environment whereby: "It is the general obligation of the States to ensure that activities executed within their jurisdiction and control respect the environment of other states or of areas beyond national control, is now part of the corpus of international law relating to the environment [and] this need is aptly expressed in the concept of sustainable development to reconcile economic

development with the protection of the environment" [ICJ 1996, 1997]. The creation of a common ecological baseline for the Caspian is clearly a matter of regional priority, to be addressed with some urgency.

Caspian pipeline strategies. The risk of not being able to transport Caspian Oil to market was, and still is, perceived to be the most significant business challenge for oil investment in the region. The extended delays experienced by Chevron in the evacuation of oil from Kazakhstan through Russia to the Black Sea, is a prime example. The creation of an effective regional pipeline by the Caspian Pipeline Company from Tengiz to Novorossisk, was pending since 1992. It is now under construction, and should become operational in 2001. The new CPC line to Novorossisk when fully commissioned will have an eventual export capacity of 1.3 million b/d. This should then capture the bulk of North Caspian oil exports, and serve Russian long-term commercial and political interests in a material way. The primary challenge that remains for the North Caspian is future shipment of substantial Russian and Kazakh oil volumes from the Black Sea, through the congested Bosphorous Straits.

In the South Caspian AIOC, the first foreign oil consortium, made export capacity to the Black Sea the strategic priority for its investors, before any offshore investments were made. Dual export routes were targeted, for operational expediency and commercial security. Consequently in early 1996 pipeline transportation agreements and inter-governmental treaties were signed by Azerbaijan, firstly with Russia, and subsequently with Georgia. These allowed for the transportation of some 120 000 b/d of Azerbaijan oil through the existing Russian infrastructure northwards to Novorossisk, and westwards through Georgia to Supsa. Azerbaijan oil was first transported to international markets through Russia in late 1997.

For the last three years some East Caspian crude has been successfully transported across the Caspian and transshipped through the Caucasus by rail from Baku to Batumi. Likewise Turkmen oil has been successfully transferred to the Tehran Refinery via the Iranian Neka Pipeline, for onward equivalent oil swaps in the Gulf. Additional export capacity for South Caspian crude is also available through the Volga Don Canal system (for summer operations); and by rail from Makhachkala to Novorossisk. Currently there is sufficient export capacity available to third parties, for all South Caspian exportable oil to be shipped to international markets.

For the longer term, there are emerging plans for major regional export pipelines, which are the subject of heated political debate. These are to the North (Baku-Novorossisk via a Chechen by-pass) with a capacity of up to 0.5 million b/d; to the West (Baku Supsa-Baku Ceyhan) with an initial capacity of 1 million b/d; and to the Tehran refinery in the South with a capacity of 350 000 b/d. It is no longer a matter of if, but when these pipelines will be built. Once new oil is found and capacity is needed, the market will respond, and new pipelines will follow. But without new oil, pipeline investments will be delayed

For existing Caspian export pipeline systems, market competition to capture export crude has already resulted in reducing transportation costs. In 1998, the Iranian swap option gave the best inclusive tariff (\$4.9/bl.). In 1999 in response to market competition, rail transportation costs were materially reduced from Dubendi to Batumi and tariffs fell (from \$8.3/bl. to \$6.50/bl.). Tariffs for Volga Don summer operations were also set at competitive levels (\$5.9/bl.). But all existing tariffs are still set levels which could accommodate price reductions. In summary, the current average transportation cost for exporting crude from the South Caspian to a Mediterranean refinery is around \$6.00 - \$6.50/bl., but will continue to reduce with time.

Swaps of crude oil with Iran are still the cheapest Caspian transportation option. Also there is significant potential for Iran to reduce their swap fees further, and still maintain competitive advantage. However the volume of such swaps is limited by Iran for strategic reasons, and the international tender for a new pipeline from Neka to Tehran confined pipeline design capacity to 350000b/d. Such volumes of Caspian crude would then service approximately 50% of their own northern market needs, in the region where the bulk of the Iranian population lives. But to become 100% fully market dependent on Caspian crude would be strategically imprudent. Likewise to take far greater volumes of Caspian crude by Iranian pipeline to the Gulf for onward marine transfer to E Asia or to US West Coast would be commercially impracticable. This would introduce an extended transportation cost to reflect the increased distances involved. It could not compete commercially with the far cheaper oil transportation of Caspian crude to more proximal markets in the South Mediterranean and Black Sea. Equally Iran and other OPEC Gulf producers would not wish to see large volumes of Caspian crude enter their already congested sea-way. But more importantly Iran would not wish to see their Asian markets undermined by competitive Caspian crude. Thus Iran is unlikely to access more than 10% of future Caspian production and arguments for a new main export

pipeline through Iran to the Gulf are commercially ill founded, making political opposition to this pipeline essentially irrelevant.

Market studies have already confirmed that the Mediterranean and Black Sea countries should have the capacity to absorb up to 3 million barrels a day of Caspian crude. Also as Caspian crude chemistry is environmentally attractive to both Mediterranean and Turkish refineries, it will displace supplies of less environmentally friendly crude from the Middle East and West Africa, on a cost-competitive basis. Therefore, the Caspian is essentially a niche producer positioned to service Southern Europe and the Black Sea only.

But the confrontational politics arising from opposing arguments for South Caspian mega- pipelines, have become a negative factor in regional development. The market demand for such Caspian oil export capacity is not yet in place. Expansion of existing pipeline infrastructure can accommodate both short to medium term market needs. Eventually, because of the Turkish Bosphorous marine bottleneck, a land pipeline to Ceyhan will be required. As for immediate priorities, there is a much needed \$3 billion oil development in offshore Azerbaijan, which has already been suspended for two years. The priority to unblock this impasse is self evident. The existing EU energy policy to support multiple pipeline options in the South Caspian, recognises the realities of commercial screening, and is politically well founded. To extend this activity to a regional acceptance of the European Energy Charter Treaty, could only reinforce the positive aspects of future Caspian pipeline development.

By 2020 conventional predictions place global Caspian oil production at between 3 to 5.5 million b/d. Pipeline projects capable of transporting 4.5 to 5.5 million b/d are already identified. These figures also tie to projected market demands within the Mediterranean , the Black Sea and within the Caspian itself. If demand is lower, or production increases more slowly than predicted, then export capacity would adapt to the lower pace. The pipelines would be built, but additional horsepower (i.e. increased operating pressure) would be added as capacity demand increased. Pipeline systems are highly flexible once the initial investment has been made.



Annex D: Turkey, Europe and Caspian gas

Unlike oil, gas (excluding liquified natural gas - LNG) is not such an easily transportable commodity. Regional markets therefore dominate long-term gas development. Likewise long-term (20 year) Sales and Purchase Agreements (SPA's) are required before investments are made. But there is a surfeit of gas resources in Russia, Central Asia and neighbouring countries in the Middle East (Table 1). These proven gas reserves already exceed any conceivable demand projections for the coming century. It is inevitable that their competitive development will continue to dominate the strategic gas debate in the capitals of South Central and Eastern Europe and the Black Sea. The resource exists and the demand is present. Competition focuses on the selection of eventual transportation routes.

Table 1: Proven gas reserves, in TCM (trillion cubic meters)

•	Russia	49
•	Iran	23
•	Turkmenistan	3
•	Iraq	3
•	Kazakhstan	2
•	Uzbekistan	2
•	Azerbaijan	1
•	Egypt	1

Total 84

(Source: BP-Shell 1999)

Although Southern Europe and the Balkan Black Sea markets represent the long term prize, in the short to medium term (2010) the Turkish gas market is set to be the primary target, with its rapidly expanding demand driven by gas-fired power generation. Turkey has already signed a number of loosely defined SPA's (Table 2), with a remarkable range of potential gas suppliers.

The final “winners” are yet to be singled out. Moreover, Turkey’s strategic gas planning is driven by conflicting needs: competitive pricing, diversification of supplies, and international and regional geo-political support.

Two current gas projects are competing head on: first, Russia’s innovative “Blue Stream” gas pipeline across the Black Sea to Turkey; and, secondly, the Transcaspian Gas Pipeline Project (TCGP) to carry Turkmenistan gas to Turkey, across the Caspian and through the Transcaucasus Energy Corridor . The latter is a solution favoured by the United States. Both projects are technically feasible. But the volume of demand from Turkey in the short to medium-term can only justify one of these two projects, as currently conceived. The gas market is too small to justify the levels of likely commercial investment required for both. In addition recent gas discoveries in offshore Azerbaijan have introduced further competitive complexity; either as a stand alone supplier to Turkey, or in combination with TCGP. Turkey is faced with a plethora of options, all of which carry some considerable risk and geopolitical consequence.

Table 2: Turkish Supply Purchase Agreements - fact or fiction?

(billions of cubic meters per year - bcm/y)

	Date	Volume	First
delivery			
Russia (Western land route)	1986	6	n.s.*
Nigeria (LNG)	1995	1.2	n.s.
Qatar (LNG)	1995	2	n.s.
Iraq	1996	10	n.s.
Egypt	1996	10	n.s.
Iran	1996	10	
1992/2000			
Russia (Blue Stream)	1997	16	
2000/2001			
Russia (Western land expansion)	1998	8	n.s.

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Algeria (LNG)	1998	4	n.s.
Turkmenistan	1999	16/30	n.s
Total		93.2/120	

\*n.s. = not specified

The outcome will rely on the concrete realities of the Turkish gas demand. Turkey today consumes some 20 bcm/y. This is projected to rise sharply by 2007 to 50 bcm/y. Demand is then planned to increase on a steady incremental basis, to 85 bcm/y by 2020. Two thirds of the expansion depends on the continuous development of the gas-fired energy sector. But these growth projections are predicated on a series of inherently risky assumptions, namely:

- that Turkish GDP will continue to grow at 7% p.a.,
- that the power sector will continue to expand at 9%p.a (i.e. the construction and timely completion of at least 7 major gas-fired power stations by 2010),
- that project financing of some \$3 to 4 billion/year will be available throughout the investment period,
- that effective project management is available to ensure that both external and internal pipeline infrastructure will be built on time, to deliver contractual gas commitments,
- that the supply projects themselves will also be built in a timely and effective manner,
- and that all systems will then have an operational effectiveness in excess of 85%.

These multiple risks and past track record would suggest that the official growth forecasts are optimistic. More modest and realistically paced developments will inevitably emerge. Consequently not all the currently conceived SPA's (Table 2) will achieve maturity within the period planned. So which are the likely short-term winners?

Current Russian gas supplies to Turkey use the pipeline infrastructure which transits through the littoral states of the Western Black Sea. The upgrading and expansion of this onshore infrastructure is well in hand. But both Russia and Turkey recognise the inherent supply risk involved, with their total dependence on continuing third party transit rights. This motivates the search for a more direct supply route for Russian gas to Turkey. Consequently, Russia has focused attention on a novel deep-sea gas pipeline across the Black Sea, the so-called "Blue Stream" project. This would take Russian gas direct to Turkey without an intervening transit. This Gazprom-ENI project is designed to supply 16 bcm/y to Turkey by 2001. However the project involves untested leading-edge technology, to lay some 375 km. of submarine gas pipeline in more than 2000 m. of anoxic waters. Maintenance and long-term operability inevitably represents a considerable challenge. Joint venture financing is apparently progressing for some \$2 billion of funding Italian, German and Japanese banks. It seems that onshore pipelay and gas storage is already under construction. But the delivery deadline set for a first phase of 8 bcm/y under the existing SPA is most unlikely to be met.

Moreover the project is under competitive threat from a trans-Caspian pipeline alternative. The TCGP project, lead by a US-Dutch consortium, envisages a phased supply of 16 to 30 bcm/y of Turkmenistan gas to Turkey via the "Transcaucasian Energy Corridor". The pipeline uses conventional pipeline technology for both land and marine transits. There is more than sufficient East Turkmen gas resources available to service the project (Table 1); and Turkmenistan has had all necessary experience of shipping such volumes in the past. Some 85 bcm/y of Turkmen gas was shipped to Russia and Europe, prior to the collapse of the Soviet Union. However the TGPC proposal is entirely dependent on the cooperation of Azerbaijan and Georgia. This was agreed in principle at the Istanbul OSCE Summit in November 1999, when a Joint Protocol of Cooperation was signed between the various Presidents involved, and endorsed by the President of the United States.

However, subsequent progress has been slow. With the discovery of a mega gas and condensate field at Shah Deniz (1 TCM plus) in offshore Azerbaijan, an attractive alternative or contributing gas supply for TCGP, has been introduced into the supply debate. Azerbaijan was itself in the 1980s a significant gas producer (14 bcm/y). However gas production since then went into serious decline (it is currently 5 bcm/y), which were insufficient to service their internal gas market. Consequently the new gas discovery at Shah Deniz has reversed this situation, and Azerbaijan sees an opportunity to capture the early gas market in Turkey itself. The fact that the Turkish

Government is already an upstream investor at Shah Deniz gives competitive advantage. Since the project would involve a trans-Caucasus pipeline transit, this would also reinforce the alliances that are already driving the Baku-Ceyhan pipeline project. Azerbaijan is therefore proposing an 'Early Gas' Project based on available gas reserves, to deliver up to 4 bcm/y to Turkey by 2003. They would rely on an upgrading of the existing pipeline infrastructure in Azerbaijan and Georgia. A progressive phased development of Shah Deniz gas would follow, to deliver 20 bcm/y by 2010 and 30 bcm/y by 2015, using a new gas pipeline system yet to be built. However, no Azeri SPA has so far been signed with Turkey, perhaps because of attempts to link this commitment to conclusion of the Baku-Ceyhan oil pipeline project.

The Shah Deniz project could put also into question the need for a Turkmen trans-Caspian pipeline. However the potential economies of scale from shared pipeline infrastructure could be substantial, and this is still a motivating force for cooperative dialogue between Ashgabad and Baku. On the other hand the issue of offshore Caspian title and trans-national seabed transits remains unresolved, which, together with the continuing challenge from Russia and Iran against construction of any offshore gas lines on ecological grounds, point to inevitable delays. At the same time political relations between Ashgabad and Baku are strained. The Turkmen leadership is apparently unwilling to dilute its volume of projected gas exports to Turkey in favour of Azerbaijan, and Ashgabad is still looking for alternatives. A potential contract for the export of 50 bcm/y to Russia is under review, involving a 60/40 barter/cash SPA to be negotiated. The Turkmen party is holding out for a substantially higher gas price than currently on offer, as well as a reversal of the cash/barter split. This arrangement also carries underlying risk. Turkey is unlikely to accept any Turkmen gas as a supply element through "Blue Stream". Also Gazprom's previous track record involving major unpaid gas debts to Turkmenistan, should mitigate against any early agreement. Ashgabad is also looking south to Iran, as an alternative land route to Turkey. Iran has concluded a separate SPA with Turkey (Table 2) for the early export of 10 bcm/y. Appropriate interconnecting gas infrastructure has already been built from Tabriz to the Turkish border. The connector on the Turkish side remains incomplete. Over the long term it is unlikely that Iran would wish to transit Turkmen gas, since this would undermine its own competitive advantage.

As one can see, Iran's future potential for increased gas export to Turkey and Europe is enormous (Table 1). In the short-term however, transit of Turkmen gas could be possible, to bridge a potential supply shortfall, before Iran builds up its own gas supplies to Turkey. Arrangements were in hand to

expand the existing West Turkmen gas line to North Iran from the present 2 bcm/y to 7.25 bcm/y, with some of this gas for onward transmission to Turkey. But for major gas transit from East Turkmenistan, under the current US-Iran containment policy, considerable pressure will be exerted on both Ashgabad and its foreign investors not to compromise ILSA. Facing such complexity, Ashgabad is likely to procrastinate. There is an increasing risk that Turkmen gas could well become an isolated asset in the future.

Russia has also recognised that an 'early gas' scheme from Azerbaijan through Georgia, could seriously undermine their own long-term supply ambitions to Turkey, and then on into Europe. Consequently Russia has already made a direct approach to Georgia for an 'early gas' initiative of their own. Gazprom have proposed the creation of a joint venture with Saktourgas (Georgian natural gas company), to acquire common rights over existing Georgian infrastructure, in return for a guaranteed Russian gas supplies of 8 bcm/y. This would then provide the joint venture with 2 bcm/y for internal use by Georgia, 2 bcm/y for supply to Armenia, and 4 bcm/y for early onward transmission to Turkey. The project could be expanded at a later date to transmit a further 16 bcm/y to Turkey, through new pipeline infrastructure. This Russian-Georgian 'early gas' project would then preempt the Azerbaijan and Turkmenistan initiatives, and allow perhaps for a delayed start for the "Blue Stream" initiative, which is already facing timing problems. As yet Georgia has not accepted the Russian proposal, but remains vulnerable to threat of winter isolation from potential Russian gas supplies.

Turkey is thus faced with several competing offers as between Russia, the Caucasus and Central Asia for its expanding energy market. However the choice of must be made soon, if Turkey's economic interests are not to be compromised. Whoever wins the 'early gas' prize will be preferentially positioned by 2010-2015 for the larger prize, that of the gas markets of Southern, Central and Eastern Europe. In all scenarios, Turkey will become the strategic gas supply conduit for this larger region.

Is a regional solution possible where all parties could participate? There is surely scope for regional cooperation between Russia and the Caucasus, if Blue Stream were to be suspended. Thus a major gas line from Baku carrying Azeri gas could join with Russian supplies arriving over the Caucasus into the Georgian gas network, flowing on into Turkey. For Turkmen gas also to flow into this supply route would however require agreement over constructing the trans-Caspian underwater gas line, as well as agreement

over how to share pipe capacity from Baku onwards. These seem at the moment very demanding conditions. However Turkish and EU interests in diversity of gas supply could be substantially met by the above combination of Russian and Azeri gas arriving through Georgia, together with increased supplies from Iran.

Annex E: Joint Statement of the Russian Federation and Georgia,  
Istanbul, 17 November, 1999

The Russian Federation and Georgia,

guided by Paragraphs 14.2.3 and 14.2.7 of the Decision of the Joint Consultation Group of 30 March 1999 concerning adaptation of the CFE Treaty.

confirming their intention to properly implement the adapted CFE Treaty as adopted,

wishing to promote the strengthening and development of cooperative relations between the Russian Federation and Georgia,

have agreed as follows:

The Russian Side undertakes to reduce, by no later than 31 December 2000, the levels of its TLE located within the territory of Georgia in such a way that they will not exceed 153 tanks, 241 ACVs and 140 artillery systems;

No later than 31 December 2000, the Russian Side will withdraw (dispose of) the TLE located at the Russian military bases in Vaziani and Gudauta and at the repair facilities in Tbilisi.

The Russian military bases at Gudauta and Vaziani will be disbanded and withdrawn by 1 July 2001.

The issue of the utilisation, including the joint utilisation, of the military facilities and infrastructure left in the dismantled Russian military bases in the above-mentioned locations;



A CONSULTATIVE DOCUMENT OF THE CEPS TASK FORCE ON THE CAUCUSES

- The Georgian side undertakes to give the Russian side the right to install temporarily the main part of the armaments and machinery limited by the Agreement in the installations of the Russian military bases located in Batumi and Akhalkalaki;
  
- The Georgian side shall assist in creating the necessary conditions for the reduction and withdrawal of the Russian forces. In the connections the sides note the readiness of the OSCE countries to support the process financially;
  
- During the year 2000, the sides shall finish negotiations on the rules and conditions of functioning of the Russian military bases in Batumi and Akhalkalaki, as well as other military installations on the territory of Georgia.

Annex F: Protocol on Territorial Ceilings for Conventional Armaments and Equipment limited by the Treaty on Conventional Armed Forces in Europe (CFE)

The States Parties hereby agree upon the following territorial ceilings and territorial sub-ceilings pursuant to Article V of the Treaty (data for states of Caucasus region only):

State Party	Battle Tanks	Armoured combat vehicles	Pieces of artillery
Armenia (3,4)	220	220	285
Azerbaijan (3,4)	220	220	285
Georgia (3,4)	220	220	285
Russia	6350	11280	6315
-of which (1,3,4)	1300	2140	1680
Turkey (3,4)	2795	3120	3523

(1) In the Leningrad Military District, excluding the Pskov oblast; and in the North Caucasus Military District, excluding: the Volgograd oblast; the Astrakhan oblast; that part of the Rostov oblast east of the line extending from Kushchevskaya to Volgodonsk to the Volgograd oblast border, including Volgodonsk; and Kushchevskaya and a narrow corridor in Krasnodar Kray leading to Kushchevskaya. This territorial sub-ceiling shall not be exceeded to Article VII for military exercises and temporary deployments in the category of armoured combat vehicles.

(2) ...

(3) States Parties which shall increase their territorial ceilings or territorial subceilings pursuant to Article V, paragraph 5, only in conjunction with a corresponding decrease, pursuant to Article V, paragraph 4, subparagraph (A),

in the territorial ceilings or territorial subceilings of other States Parties, as identified by this footnote.

(4) States Parties which shall not exceed their territorial ceilings or territorial subceilings pursuant to Article VII by more than 153 battle tanks, 241 armoured combat vehicles and 140 pieces of artillery.

(5) States Parties which shall not exceed their territorial ceilings or territorial subceilings pursuant to Article VII by more than 459 battle tanks, 723 armoured combat vehicles and 420 pieces of artillery.”

Annex G: Remarks by Eduard Shevardnadze, President of Georgia  
at the Informal Summit of the Black Sea Economic Cooperation Istanbul,  
November 17, 1999

Mr. Chairman, Dear friends,

Let me extend my sincere thanks to President Demirel for bringing us together for this meeting. As the initiator of the Black Sea Economic Cooperation, and one of our Organisation's largest and most active members, Turkey has proven once again to be a driving force behind deepening the cooperation among us.

Given the dynamics of processes in our region, we can hardly afford to wait until an official summit is convened to determine the common ground of our positions. The developments in the North Caucasus are of our particular concern today. I believe we must make it our common goal not to allow an expansion of hostilities, since the economic projects in the region, both those underway and those planned for the future, could be seriously impeded. Virtually all countries participating in these projects are members of this Organisation, therefore discussing them here is both justified and timely. The intensifying contacts between the BSEC members, including those at the highest level, give us hope that the Organisation will make its due contribution to the stability in the Black Sea area and will not permit any shadow of doubt, regardless of how small, to be cast on the safety and economic viability of these globally important projects.

Soon, the transportation of huge volumes of Caspian hydrocarbons via the Caucasus will begin within the framework of the New Silk Road. The movement of cargo and people will increasingly grow. Already we see signs in Georgia of dramatic growth in tourism which is an important source of income for our country. All this necessitates closer and more active cooperation in the matters of regional stability.

Under conditions where major international organisations are preoccupied with hot spots across the globe, they do not always give due attention to the

affairs of the Caucasus. This is why shared responsibility over the fate of the region must become one of our principal goals in this Organisation. Please do not interpret my words as a call for expanding the political dimension of BSEC at the cost of its economic activities. But you will perhaps concur that an increasing threat to the regional stability prompts us to think in this direction as well.

Perhaps the time is ripe for BSEC to strike an appropriate balance between economic cooperation and cooperation on regional security, and determine its place within the family of other regional alliances and intergovernmental organisations in the new European architecture of the 21st century. These issues are increasingly relevant and BSEC's ultimate success depends on them.

Many BSEC members aspire to a step by step integration into the European Union. With this in mind, the relations between BSEC and the EU acquire special significance. The establishment by the EU Council of Ministers of the BSEC-EU Co-operation Platform, which has already been approved by the Council of Foreign Ministers of BSEC, will provide a solid legal foundation for these relations. In this respect, BSEC is to identify and develop specific projects for collaboration with the European Union.

The mutually agreed legal frames provide us with an opportunity to adopt within the framework of BSEC, not only recommendations, but also binding decisions. Delay in this respect is inadmissible. Next year, a representative from Georgia will assume the position of the BSEC General Secretary. This individual will spare no effort to ensure that the Organisation's activities are effective and fruitful. The Georgian government will give him full support and help.

Annex H: Summary of the agreement between the Government of the United Kingdom and the Government of Ireland, signed at Belfast, 10 April 1998

Two sovereign states: United Kingdom and Republic of Ireland, both members of EU.

Sovereignty: Future sovereignty of Northern Ireland (NI), i.e. participation in either UK or Republic of Ireland) to be determined by referendum of people of NI (this is now recognised in British law and Irish constitution). Right of the people of Northern Ireland to hold Irish or British passports or both are recognised.

#### NI Government

1) NI Executive is accountable to a directly elected Assembly

very strong human rights safeguards and minority protections

10 ministerial departments

Agriculture and Rural Development

Culture, Arts and Leisure

Education; Enterprise, Trade and Investment

Environment; Finance and Personnel

Health, Social Services and Public Safety

Higher and Further Education, Training and Employment

Regional Development

Social Development

2) Northern Ireland Office (branch of UK national government) retains responsibility for constitutional and security issues, in particular law & order, policing and criminal justice policy. Also three agencies: NI Prison Service, Compensation Agency and Forensic Science Agency.

#### Sharing of sovereignty

1) North/South Ministerial Council - NI Executive and Irish cabinet to meet as equals.

Joint implementation of policy on:

inland waterways

food safety

special EU programmes

minority languages (i.e. Irish/Gaelic and Ulster Scots)

coastal waters

trade and business development

commitment to co-operate on:

transport

agriculture

education

health

environment -

tourism

2) British-Irish Council (BIC) (also known as “Council of the Isles” - modeled on Nordic Council)

British and Irish governments,

devolved institutions in Northern Ireland, Scotland and Wales,

representatives of the Isle of Man and the Channel Islands.

An assembly for dialogue, rather like the Balkan Stability Pact

3) British-Irish Intergovernmental Conference

regular summit meetings between British and Irish governments

to discuss issues not covered by NI Executive (and thus outside N/S Council remit)

#### Security issues

All participants to work for paramilitary disarmament by May 2000 (!)

British government commits to reform policing and criminal justice system

Both governments commit to release prisoners

## A STABILITY PACT FOR THE CAUCASUS

### Annex I: Bosnia and Herzegovina - immediate urgent post-war reconstruction costs

Population of BiH pre-war was 4.5 million, of whom at least half were displaced during 1992-95 war, and at least 250,000 were killed. Pre-war GDP was \$10.6 billion, \$2,400 per capita

Total cost requirements of the Priority Reconstruction Program endorsed by the donor community just after Dayton (early 1996) came to \$5.1 billion. This divides as follows:

- a) Reconstruction of physical assets: \$3.3 billion
  - i) Network infrastructure \$1.3 billion
    - 1) Transport \$542 million
    - 2) Telecommunications \$134 million
    - 3) Electric Power and Coal \$623 million
  - ii) Community revival \$1.4 billion
    - 1) Water and Sanitation \$350 million
    - 2) District Heat and gas \$166 million
    - 3) Housing \$710 million
    - 4) Landmine Clearing \$170 million
  - iii) Social sectors \$0.6 billion
    - 1) Health \$340 million
    - 2) Education \$275 million
- b) Restart of economic activity: \$1.1 billion
  - i) Industry and finance \$593 million
  - ii) Agriculture \$260 million
  - iii) Employment generation \$225 million
- c) Building and strengthening institutions/initiating the policy reforms of transition: \$0.7 billion

Original estimates were so heavily revised that it is better to use actual expenditures as follows:



- i) Fiscal/government support inc. balance of payments support  
\$485 million
- ii) Social Protection \$163 million
- iii) Transition technical assistance \$37 million
- d) Peace implementation – was not included in the PRP but actual  
expenditure was \$320 million.

Reconstruction of physical assets

Network infrastructure \$1.3 billion

Transport \$542 million

2000 km of road needed immediate repair

70 bridges had to be reconstructed

all bridges between BiH and Croatia were destroyed

all railway lines were rendered inoperable

Sarajevo airport was partly destroyed and closed to civilian traffic

no maintenance of infrastructure for 4 years

Telecommunications \$134 million

224,000 subscriber lines – almost a third – were destroyed

call completion rate dropped from 38% to less than 2%

international lines decreased from 4,000 to 400

fixed lines penetration dropped from 15% to 12%

pre-war network split into three

need to digitalize network

Electric Power and Coal \$623 million

more than half of electrical generating capacity out of commission

most of the electricity transmission network and control system severely  
damaged

electricity distribution network likewise

## A STABILITY PACT FOR THE CAUCASUS

whole electricity network split into three  
coal production dropped from 18 million tons to 1.5 million tons  
most mobile mining equipment damaged beyond repair  
“improper mining operations” caused “overburden removal problems”  
no maintenance of mining equipment

Community revival \$1.4 billion

Water and Sanitation \$350 million

water leakage increased to 50% (from already high 30% pre-war)  
in Federation 40% of population did not have 24 hour water supply  
everywhere lack of maintenance of water and sewage systems  
landfill sites unusable due to landmine threat  
whole system well below European environmental standards  
revenue collection system needed restructuring

District Heat and Gas \$166 million

heating system in Sarajevo damaged by direct shelling  
gas system in Sarajevo massively increased with improvised, unsafe  
connections  
everywhere lack of maintenance  
revenue collection system needed restructuring

Housing \$710 million

over 1 million refugees and 1.2 million internally displaced persons  
in Federation, 33% of housing stock damaged and 6% destroyed  
in Republika Srpska, 29% of housing stock damaged and 5% destroyed  
overcrowding everywhere

Landmine Clearing \$170 million

17,000 registered minefields throughout country

Social sectors \$0.6 billion

Health \$340 million

health sector finance collapsed

loss of health professionals (40-50%)

200,000 people (inc. 50,000 children) wounded

13,000 people with permanent disabilities (inc. 5,000 who lost limbs)

incidence of communicable diseases increased two- to five-fold

doubled infant mortality

35-50% of health infrastructure damaged or destroyed

35% of hospital bed capacity lost

shortages of drugs and supplies

Education \$275 million

60% of all school buildings damaged or destroyed

teaching force decimated

educational funding ceased for three years

need for textbooks and teacher training

need for curriculum reform

need for policy support

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Source: BiH 1996-1998 Lessons and Accomplishments: Review of the Priority Reconstruction and Recovery Program and Looking Ahead towards Sustainable Economic Development (European Commission and World Bank, May 1999)

A STABILITY PACT FOR THE CAUCASUS

Annex J: Kosovo: “A programme for Reconstruction and recovery”, EU Commission and World Bank, in support of UNMIK, November 1999

External Financing Requirements for Kosovo (in US\$ million)

Activity	First Phase (until December 2000)			Second Phase (2001-2003)	Total
	Until March 2000	April to Dec. 2000	Total		
Agriculture	8	86	94	141	235
Private Sect. Dev./Industry	16	104	120	110	230
Institutions	15	35	50	50	100
Housing	36	270	306	214	520
Water and Waste	30	49	79	181	260
Landmine-Clearing	7	14	21	9	30
Education	11	38	49	36	85
Health	16	24	40	45	85
Telecommunications	15	26	41	54	95
Energy	51	78	129	281	410
Transport	12	57	69	96	165
Subtotal	217	781	998	1,217	2,215
Budgetary Support	68	60	128	TBD	TBD
Total	285	841	1,126	1,217	2,343

Annex K: Members of the CEPS Task Force for the Caucasus

Dr. Terry Adams, former President of the Azerbaijan Oil Company

Sergiu Celac, Ambassador at large, Ministry of Foreign Affairs, Bucharest, Co-Chair

Professor Bruno Coppieters, Free University of Brussels

Michael Emerson, Centre for European Policy Studies, Brussels, Co-Chair

Alexander Liono, Danish Institute for International Relations, Copenhagen

Professor Jean Radvanyi, Observatoire des Etats post-Sovietiques, Paris

Nathalie Tocci, Centre for European Policy Studies, Brussels, Rapporteur

Marius Vahl, Centre for European Policy Studies, Brussels

Professor Thomas Waelde, Centre for Energy, Petroleum, Mineral Law and Policy, University of Dundee

Dr. Nicholas Whyte, Centre for European Policy Studies, Brussels

Collaboration with:

Dr. Oksana Antonenko, Institute for International Strategic Studies, London

Sergei Arutunov, Department of Caucasian Studies, Academy of Sciences, Moscow

Yuri Borko, Institute of Europe, Moscow

Robert M. Cutler, Institute of European and Russian Studies, Carleton University, Ottawa

Igor Leshukov, Centre for Analysis of Integration, St. Petersburg

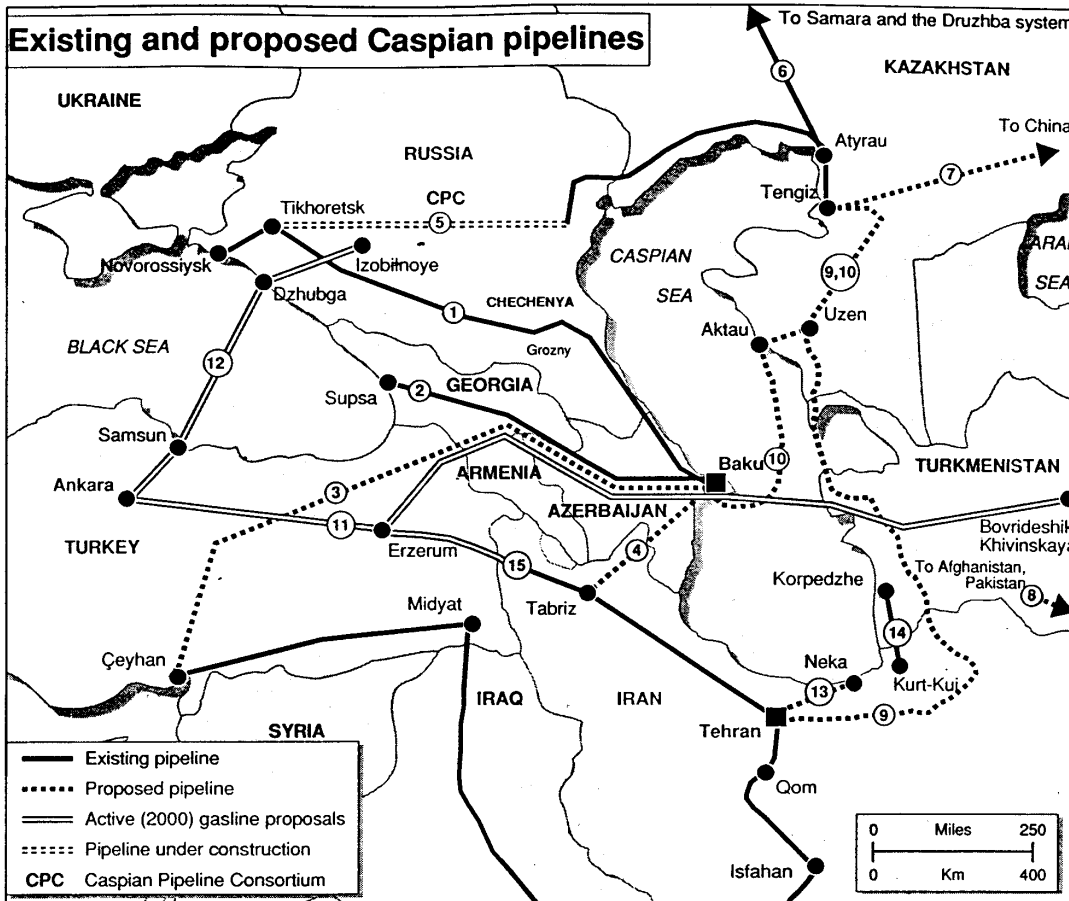
Abbas Maleki, International Institute for Caspian Studies, Tehran

Anna Matveeva, Royal Institute for International Affairs, London

The Task Force appreciates having been able to read a so far unpublished analysis of Professor Gareth Winrow of University of Istanbul.

A STABILITY PACT FOR THE CAUCASUS





- 1 Baku-Novorossiysk. In existence; used by AIOC.
- 2 Baku-Supsa. "Early Oil" line for AIOC fully operational March 1999; possible route for Azerbaijan's Main Export Pipeline (MEP).
- 3 Baku-Ceyhan. Designated by governments of Azerbaijan, Georgia, Turkey and United States as MEP route in a series of agreements signed in Istanbul in November 1999. But financing still required.
- 4 Baku-Iran (possibly Tabriz); possible Azerbaijan option, studied by Total, 1998.
- 5 Atyrau-Novorossiysk. Project now under construction, with completion scheduled for 2H2001.
- 6 Atyrau-Samara-Druzhba system. Line exists; Kazakhstan would like to see its capacity increased.
- 7 Tengiz-China. Under study by China National Petroleum Corporation. Not likely for several years.
- 8 Chardzhou-Pakistan. With possible tie-in from Turkmen and Kazakh fields on/near the Caspian; former Unocal/Delta proposal under study by Delta. Unlikely in near future.
- 9 Tengiz/Uzen-Kharg. Preliminary proposal by Total.
- 10 TransCaspian Oil. (Tengiz/Uzen-Aktau-Baku) Alternative proposals by BP-Amoco, Texaco and Turkish government. Line would be a de facto extension of Azerbaijan's MEP.
- 11 TransCaspian Gas. PSG appointed by Turkmen government in February 1999 to lead the development of this project. Shell took half-share in project in August 1999 and in December signed agreements for field development to serve TCP gasline.
- 12 Blue Stream Russia-Turkey gasline. Italy's Saipem has pipelaying contract for subsea section. Major works due to start early 2000 but some financing issues not finalised. 84
- 13 Neka-Tehran. Financing being sought for line which could constitute major element in swaps/pipeline export system from Caspian to Gulf.
- 14 The KKK gasline. Opened in 1997, this is Turkmenistan's only current export line that does not transit Russia. It runs from the Korpedzhe gasfield to Kurt-Kui, a terminal on Iran's existing east-west pipeline system.
- 15 Tabriz-Erzerum gas connector. Iran completed Iranian section by end-1999 but Turkish section not ready for use.

The Caucasus region has become one of the world's most tragic humanitarian, political and economic disaster zones. Governments and clan leaders are embroiled in a complex set of linked conflicts. In the south, the conflict situations are deadlocked. In the north, the new war in Chechnya has been fought at terrible cost in human suffering, but the peace is far from won. The political leaders of the region call for some kind of security or stability pact, without specifying what or how. In the absence of common membership in international organisations such as the OSCE, there has been a slide into sets of opposing virtual alliances involving the great powers, which discourages regional leaders from reaching solutions. The region is entering the 21<sup>st</sup> century still drinking the deadly cocktail of 19<sup>th</sup> century nationalism and great power rivalry. The insecurity of the region also blocks the development of the wider Caucasus-Black Sea-Caspian-Central Asian economic axis.

A fresh, comprehensive strategy for the whole of the region is indeed needed to break out of the deadlock, and bring the region into the norms and structures of modern Europe and the international community. A huge political and diplomatic effort is needed to complete the shift of paradigms – “from the 19<sup>th</sup> century to the 21<sup>st</sup> century” – with new regional cooperation and integration structures. The Caucasus is not the Balkans, however, in spite of some similarities, which is why something different from the Balkan Stability Pact is needed. The pay-off from a comprehensive solution in terms of economic and societal welfare could be enormous, compared to the disastrous status quo. The political renewal in Russia also marks an opportunity for fresh initiative.

A coherent set of political initiatives could turn the trends, consisting of:

- a trilateral initiative (EU/Russia/US) in response to the calls of leaders of the region, leading to:
- formation of a contact group of 8 principal actors, to sketch the agenda,
- settlement of existing conflicts,
- initiation of a South Caucasus Community,
- negotiation of a regional security agreement under OSCE,
- Russia/EU/US “Southern Dimension” cooperation,
- a boost to Black Sea-Caucasus-Caspian cooperation, and
- optimisation of oil and gas development.

Together these could make a Stability Pact for the Caucasus.