

# 1 Introduction

Opening up the Southern Gas Corridor with gas supplied by Azerbaijan is among the best known current decisions related to the European Union's (EU) gas supply security. After the Baku-Tbilisi-Ceyhan (BTC) pipeline, that started to provide about one percent of daily global oil supply in 2007, had put Azerbaijan on the map of energy experts again and initiated the country's second oil boom, Azerbaijan's growing role on the gas market motivated this analysis of Azerbaijan's energy policy's susceptibility to foreign influence. Azerbaijan's increasing importance as energy supplier and concurrently growing income made it subject to lobbying by foreign actors with a multitude of interests. Some attempts to influence policy decision-making and implementation in Azerbaijan's energy sector appear more successful than others and this thesis aims to find out why.

The more abstract observation motivating this research is that on the one hand, international policy-making (notably on climate change and other aspects of sustainable development and equity) is generally perceived as "cheap talk", while on the other hand there is a tendency to attribute outcomes to external actors (e.g. when blaming international donors, other countries and private companies for negative outcomes). Given an increasing variety of and interdependence among global political actors (Stopford et al. 1991, p. 2), the augmented importance of „the international" and the growing pressure of global problems, this contrast warrants research into what might be going on.

The present analysis seeks to understand if and how external non-state actors influenced energy policy in Azerbaijan effectively and to explain why. It employs a non-formal comparison of four densely narrated policy-decisions reflected against an in-depth study of the political context in Azerbaijan to further understanding of decisions to adopt and decisions to implement a policy which is promoted by foreign non-state actors. In a broader sense, this study analyses decision-making and implementation in complex environments marked by uncertainty. It contributes to the body of literature that investigates international policy making and global governance. The study aims to fill a scientific void by tracing mechanisms of foreign influence beyond geopolitics (meta-schemes looking at black boxes of power) or unidirectional explanations, which account for outcomes either by agency (what foreign actors did) or circumstances (actors' given capacity vis-à-vis a concrete country) alone. It adopts a dynamic approach that embraces the complexity of politics and assumes interdepend-

ence between the developments of agency, circumstances and leverage over time.

The key argument is that uncertainty, bred by complexity and the orientation of policy on future developments, conditions policy-making and is the basis for (external) political<sup>1</sup> influence. Actors' success in convincing decision-makers of their propositions depends on the interplay between all actors' interests, capabilities and strategies. In aspiring to make rational decisions in complex environments, decision-makers seek information and interpretations to get a better understanding of their options. Actors wishing to influence a decision need to persuade the decision-maker that their solution is the alternative most in line with the decision-maker's own interests.

Azerbaijan<sup>2</sup> is an interesting policy environment for analysis, because it has experienced a fundamental change in 1991 that made it fair game for a great variety of foreign actors. The country's energy sector is the target of many different foreign interests, so that policy-makers actually do have choices, while its international environment<sup>3</sup> and the limits of notably its oil resources create pressure to actually make decisions. Resource dependence and foreign dominance, which are thought to have fundamental detrimental effects on developing statehood (Karl 1997) have affected Azerbaijan to varying degrees since the 19<sup>th</sup> century. The disintegration of the Union of Socialist Soviet Republics (Soviet Union) has left Azerbaijan with a defective institutional system and forced it to re-define its distinct national identity. Since independence, Azerbaijan can also decide how to use its resources. Only few states in the world have been able to translate this freedom of action into welfare and sustainable development against a comparable background, which could make international influence in favor of sustainable development more salient in such countries.

Four political decisions in Azerbaijan's energy sector, two advanced by private companies – obtaining and maintaining a license to operate – and two by international organizations – the Extractive Industries Transparency Initiative (EITI) and the Global Gas Flaring Reduction (GGFR) partnership – are analyzed. All decisions<sup>4</sup> are in fact affected by actors that could be considered

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<sup>1</sup> Sometimes criticized as the “irrational” part of decision-making as decision-makers forego “optimal” solutions because the (do not) like a particular stakeholder (see below).

<sup>2</sup> Azerbaijan's exclave Nakhichevan, which is surrounded by Iran and by Armenia with which Azerbaijan is at war, is excluded from the present analysis, because the little information that is available on the autonomous republic indicates a high level of independence from policy-making in mainland Azerbaijan.

<sup>3</sup> Azerbaijan has territorial conflicts with several neighboring countries.

<sup>4</sup> the privatization policy underlying the Barmek case was promoted by the World Bank and the IMF, see part 5.2.2

‘Western’. The first case is the struggle of the private power distributor Barmek to keep its license to operate Azerbaijan’s electricity distribution and the second case describes the competition of the Nabucco joint venture (JV) to obtain a license to operate the Southern Gas Corridor. The EITI aspires to improve the governance of countries’ resource revenues and the GGFR partnership aims to mitigate climate change by promoting the utilization of associated natural gas that would customarily be wasted. The EITI and the GGFR were chosen for analysis, because they appeared to be rare examples of successful international influence in support of good governance and sustainable development. The analysis showed that ultimately they were a repackaging of decisions that had already been made and of processes that were already going on. Therefore, the cases shed a new light on current practices of international cooperation and public-private governance. They illustrate and serve to explain how the framing and ambitions of a policy may lead to formal success and practical failure or redundancy while derogating international influence. The company cases Barmek and the Nabucco JV were deemed interesting for study because they present grandiose failures, although there were initial successes and high international expectations. With prominent political champions for electricity sector privatization and for the establishment of a Southern Gas Corridor via South Eastern Europe, the cases provide insights into how concrete strategies of non-state actors, multiple factors within the energy system and international developments interact and point to aspects that are important to obtain and maintain a license to operate in a foreign country. The first two cases illustrate the practical consequences of corporate diplomacy and the second two cases show and explain the successes and limits of influence international organizations can wield on formal versus informal decisions. All four cases indicate that even if decisions are successfully influenced, policy goals are not necessarily achieved. The case studies highlight several aspects of policy making in the energy sector in illustrating how foreign actors attempted to influence various political outcomes in Azerbaijan’s energy sector and explain the results of their interplay with local actors and interests. All case studies indicate how the political dialogue may come to separate from “real” outputs and issues. They also prove that international leverage on energy policy is in part ideational and may suffer when credibility is not properly managed, while the material circumstances and goals of decisions in the energy sector cannot be ignored either. Furthermore, the crucial importance of time and timing in policy-making are highlighted.

The political analysis emphasizes the decade 2003 (2002) to 2013 (2012)<sup>5</sup>, because the current President has been in power since 2003 and the time before

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<sup>5</sup> annual statistical data are available only after 31 December of each year

that is extensively covered by existing analyses (Cornell, Cornell 2010; Starr, Cornell 2005; Cornell, Starr 2006; Lussac 2011; Babajew 2009), to name a few. Large resource revenues started to accrue to the Government of Azerbaijan only in 2008, when official resource revenues jumped from 2.2 billion United States Dollars (USD) to 14.5 billion USD (State Oil Fund of the Republic of Azerbaijan 2012), which means one cannot start to assess the real impact of the second oil boom on governance in Azerbaijan before that. The first case study on Barmek's venture into Azerbaijan's electricity market focuses on 2001 until 2006 when the company operated in the country. The second case study on the competition for operating the Southern Gas Corridor starts in 2004, when the Nabucco JV was founded and ends in 2013 with the Shah Deniz consortium (SDC)'s decision on the export route to Europe. The third case study on the EITI covers ten years (2003 until 2013), because data on oil incomes in Azerbaijan are available from 2003 and, theoretically, as any policy needs time to show effects, the initiative's effect should be greater with time passing by. The fourth case study on the GGFR initiative starts in 2008, when Azerbaijan joined the initiative. Although this is very short for a policy to take effect, the technical nature of the GGFR allows an analysis.

## **1.1 Research object**

The study assumes that the evolvement of Azerbaijan's state capacity and its energy sector (see part 2.2.2.1 and 5.1) formed a relevant background for the interplay of Azerbaijani decision-makers and foreign non-state actors who shaped its energy policy. In analyzing complex issues such as energy policy-making, material factors, changes in real flows in the sector, of demand, supply and money, cannot be ignored or abbreviated (Hocker 2008, p. 69). Decisions related to the energy sector cannot be interpreted without considering what is known about the energy system and what decision-makers likely knew. Many analyses of Azerbaijan's macroeconomic situation based on data up to 2007, for example, attest that the country managed its oil income relatively well to achieve stability. However, these analyses ignore that foreign direct investment (FDI) was managed by international companies and massive oil revenues only started accruing to the government in 2008 – after the BTC pipeline had started operating and after the profit split between international oil companies (IOCs) engaged in the Azeri-Chirag-Guneshli (ACG) and the government was changed in favor of the government –, which makes it impossible to judge macro-economic policy based on data said data.

The energy system is highly complex. Onshore and offshore repositories of oil and gas that lie kilometer deep in the earth are penetrated with drilling bits to lift the resources out of the ground. The hydrocarbons are separated from the partially hazardous material produced with them and transported to storage terminals or any point of delivery. There, the resources may be traded before being transported through pipelines, on tankers or trains to petrochemical plants or power plants. They may then be bought e.g. by refineries (to turn crude oil into oil products, which may be transported in pipeline, tankers, trucks or on trains), used to produce base chemicals or transformed into electricity and may be traded again. The further transport and use depends on the concrete product. Electricity is transported and distributed via grids and it can be traded several times before reaching the final consumer. Heat, in the form of hot water, is transported via a distribution pipeline network to the end users. Natural gas intended for direct consumption is sold in containers or from the distribution pipeline network. Oil products are sold to the consumer by a wide array of distributors and transported in containers. These operations involve a multitude of corporations, some very specialized, almost all of which operate internationally and people. The energy system also involves large flows of money from the end consumers to companies active in the energy sector and to the governments of those countries that own the reserves. This money may increase or decrease safety and welfare in energy producing countries depending on how it is governed. One assumption central to case 3 on the EITI is that better revenue management can be promoted through transparency and will improve human security in producing countries (see part 5.3.1).

Common energy policy goals of energy consumers are reliability, affordability and security of energy supply while the priority of each goal and the means to pursue them vary (European Commission 2010, p. 2). The transnational nature of the energy system and its effects motivate foreign consumers and makes the energy policy of resource rich countries such as Azerbaijan susceptible to their interference as they attempt to secure access to energy resources either by creating efficient transnational markets regulated with global institutions or through direct control of reserves in resource-rich countries (Youngs 2009, p. 6; Jong, Weeda 2007, p. 21; Groenenberg et al. 2008, pp. 24ff).

Long-term security through efficient markets has structural preconditions, namely political stability in resource rich and transit countries, arguably better achieved through good governance than authoritarianism (Youngs 2009, p. 7). Sustainable<sup>6</sup> political conditions and the establishment of efficient systems to

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<sup>6</sup> Sustainability originally signifies a way of conduct that does not inhibit the opportunities of future generations to increase their standard of living. In practical parlance, the concept

produce, treat and transport energy reduce the capital needed and the cost of capital thus lowering the cost of bringing energy to markets (Correljé, van der Linde 2006, pp. 532, 536). Political and economic developments in resource rich countries such as Azerbaijan are therefore important for long-term energy supply security and affordability. They are important to companies involved in the production and trade of energy, because political change might entail a loss of their license to operate and of their sunk costs. Consumers may suffer higher energy prices when resource exporting countries become unstable and a loss of supply when new export routes are chosen, but as long as a government is able to export energy resources through existing infrastructure, it will likely do so for the rents. Current company initiatives to improve the equitability of their operation (e.g. within the World Economic Forum) are therefore aimed at the local communities of host countries to maintain their license to operate. A challenge for domestic energy policy is to harmonize incentives for a certain level of investment with a macro-economically viable price-level of energy. The economics of energy supply depend on technological and managerial capability (Khachatryan 2001) which is illustrated e.g. by Azerbaijan's electricity tariff policy (see part 4.4.1.3) as well as case 2 on Barmek (see part 5.2.2) and plays out in its domestic gas market, as described in case 4 on the GGFR (see part 5.3.2).

If energy resources are considered a political tool for international leverage (Correljé, van der Linde 2006, p. 534), the most important indicators of a consumer country's supply security are its import dependency and vulnerability to supply disruptions (Kruyt et al. 2009; World Energy Council 2008, pp. 5–7; Böske 2007). Long-term supply security in an antagonistic and politicized global energy system derives from autarky and the control of reserves (Correljé, van der Linde 2006, p. 541). The supply with energy from domestic sources in non-resource rich countries requires investments into energy efficiency and the development of alternative energy sources which may only be competitive in the long-term (Groenenberg et al. 2008, p. 17; Correljé, van der Linde 2006, p. 532). Therefore consumer countries may strive to align with suppliers regardless of their adherence to internationally accepted norms or gain military control of resources. Countries which possess energy resources enjoy great demand for their product. At the same time they are faced with a considerable amount of expectations regarding how, in what time and to whom they sell it. The importance of fossil fuels for industrialized countries seems to have, in some of them, led to the conviction that they have a right to fossil fuels. This translates

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is translated with durability or long-term success. More concretely, sustainability pertains to the acceptability of actions to various current stakeholders, usually in terms of ecological external costs.

into a foreign and military policy that places energy higher on the agenda than other goals which to resource-rich countries easily seems hypocritical. Resource-rich countries can use their resources to secure the political goodwill of energy importing countries. The leaders of Azerbaijan have utilized their energy riches as well as their geographical location between Russia and Iran to balance the foreign policy aspirations of the USA, member countries of the European Union and their neighbors (see part 4.6.1.4). Neither meaningful control over resources nor their global trade would be possible without the opportunity to transport the resources wherever needed. The transportation of natural gas over long distances costs about ten times as much as the transportation of crude oil (Jensen 10/17/2002) while natural gas currently (2013) yields only a tenth of crude oil per barrel oil equivalent (boe) at spot markets, which turned out to be a major factor influencing the decision on the route of the Southern Gas Corridor described in case 1 on the Nabucco JV.

The “West’s” approach to Azerbaijan, which arguably shaped its political reality as it provided the country with room for maneuver, is informed by both strategies to secure its energy supply. Support for the creation of conditions conducive to the export of energy resource and geopolitical initiatives were both offered by consumer countries as well as organizations such as the European Union and international donors and left the Azerbaijani government considerable political discretion as they were partially contradictory. The “West” is falsely perceived as a monolithic actor by countries that are not part of it and criticized for its ambiguous foreign policies which cost it credibility as a whole.

## 1.2 Current state of research

The emergent reliance on what might be termed global governance<sup>7</sup>, as a voluntary and cooperative mechanism to cope with transnational issues, calls for a bottom-up analysis of policy adoption and implementation to understand the role and motivation of governments in this system. My study analyzes how trust and credibility influence decision-making on policy adoption and implementation in a complex and uncertain environment populated with limitedly rational actors.

Existing theories on international influence do not sufficiently consider the perceptions of national policy-makers and underestimate the development of

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<sup>7</sup> “Governance, at whatever level of social organization it occurs, refers to the systems of authoritative norms, rules, institutions, and practices by means of which any collectivity, from the local to the global, manages its common affairs. Global governance is generally defined as an instance of governance in the absence of government.” (Ruggie 2014, p. 5)

state capacity as well as the dynamics of relations between governments and non-state actors over time. Recent research on international policy processes involving non-state actors tends to underestimate agency (Mayntz 2008, p. 46) and leaves establishing purpose (interests) to international relations (IR) theory (Mayntz 2008, pp. 55f), which takes the national and local context where policy is adopted and implemented too lightly.

A growing body of literature is concerned with global governance, because arguably, regulating political problems beyond the power of any one nation state has gained importance over the last decades (Ruggie 2014, pp. 8f; Biermann et al. 2010; Scherer et al. 2006; Rosenau 2006a; Jann 2009, pp. 493f; Murphy 2000; Graz, Nölke 2008). Studies on transnational or global governance tackle its legitimacy (Bernstein, Cashore 2007; Buse, Walt 2000; Murphy 2000; Biermann, Gupta 2011) and the emergence of effective international institutions (Breitmeier et al. 2011; Bedarff 2000; Bulmer 1998, p. 369; Provan, Kenis 2007; Lemos, Agrawal 2006) generally and in certain policy areas, e.g. energy (Lesage et al. 2009; Lesage, van de Graaf 2013; Karlsson-Vinkhuyzen 2010, p. 179) or fisheries (Costello et al. 2008; Gutiérrez et al. 2011). Global governance assumes that state and non-state actors cooperate to solve transnational policy problems<sup>8</sup>. The complexity of trans-, inter- and supranational governance and of policy-making (Rosenau 2007, pp. 94f; Cohen et al. 2001) is to be addressed with coherent policy (Morin, Orsini 2013), in other words the orderly management of complexity (Gehring, Faude 2013; Steyaert, Jiggins 2007), to effectively promote common goals. Literature on global governance recognizes that complexity leaves room for actor discretion, but considers this a threat to the effectiveness of international regimes and the spread of universal norms (Hafner-Burton 2009).

Within global governance the rising importance of public-private partnerships (PPP) to provide public goods “can be seen as a furtherance of trends towards greater reliance on multi-layered, multi-playered patterns of governance”. (Homkes 2011, p. 21) Literature on PPP is essentially research on the privatization of the management of public issues and goods (Pattberg 2005; Pattberg 2007) at all levels of governance including the transnational and focus has recently shifted to questions of effectiveness (Homkes 2011). It seems to be of immediate relevance for the analysis of the EITI and the GGFR partnership, which could be interpreted as PPP. However, meta-questions on the merit or superiority of transnational PPP over traditional private or public management of political issues (Börzel, Risse 2002; Vining, Boardman 2008, p. 18; Beisheim et al. 2008; Homkes 2011, pp. 27f) are inappropriate, because there is no universal decision of success (Hodge et al. 2010, pp. 85ff) and a PPP is not a policy but a

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<sup>8</sup> In the realm of human security.



modus operandi. From the perspective of global governance, which does not commonly question transnational actors' motives (Zürn et al. 2012), transnational PPP that incorporate powerful and competent actors to manage common political problems are clearly desirable. To understand why governments involve the private sector to regulate issues or to provide public goods and under what circumstances they cede control to the trans- /international level or use it to wield control, however, a bottom-up perspective seems more fruitful. With private companies being vital stakeholders of transnational governance, it seems logical to address how their interests translate into action. While analyses of corporations' political action (Boddeyn 1976; Boddeyn, Brewer 1994; Grosse 2010; Dieleman, Boddeyn 2011) and their effect on IR exist (e.g. Pittman 1976), companies are not examined in depth in research on international policy, with few exceptions (Lussac 2011; Smith 1998). Their role remains therefore under analyzed. Studies investigating the influence of different variables on political strategy indicate that the energy sector provides particularly relevant cases to analyze private companies' political agency (Holtbrügge et al. 2007; Dieleman, Boddeyn 2011, p. 72).

Another approach to understanding the emergence of poly-centered and complex (Paterson et al. 2014) governance patterns assumes the knowledge-based development<sup>9</sup> (Jörgens 2003) of overlapping institutional arrangements to further a common goal. The most important change that has led to the feeling of increasing globalization has happened in the realm of communication<sup>10</sup>, which has greatly contributed to learning that inspires policy diffusion and policy transfer (True, Mintrom 2001, p. 28; Holzinger et al. 2007, p. 13). The political decisions that form the background for some of the analyzed cases can be explained using existing literature on policy convergence (Holzinger et al. 2007, pp. 12f).

- The privatization of Azerbaijan's distribution sector which was a necessary precondition for Barmek's activity was a result of the economic burden the sector presented for Azerbaijan's government, a problem many countries had faced, and of international donors' activities against subsidies to the electricity sector.
- International oil companies had made the export of Shah Deniz gas, rather than its use on the domestic market, a precondition for their investment into the full development of the field and therefore the need to create an export route arose due to financial conditionality<sup>11</sup>.

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<sup>9</sup> Rather than negotiation among actors or pressure by any one policy entrepreneur

<sup>10</sup> notably with the development of the internet over the last three decades

<sup>11</sup> This term is not commonly used for foreign direct investment but reserved to soft loans.

- The creation of Azerbaijan's sovereign wealth fund (SWF) that turned out to be the basis for the country's commitment to the EITI can be explained with existing knowledge on other resource-dependent countries' experiences and with the conditionality of loans from international donors (Holzinger et al. 2007, p. 12).

Still, theories on policy transfer and policy diffusion (Holzinger et al. 2007, pp. 13f) aimed at understanding how governments adopt policy through international processes (Heilmann, Schulte-Kulmann 2011) are inadequate to fully explain the decisions analyzed below for they tend to exclude relevant stakeholders' motivation and policy effects over time (Jörgens 2003), which is problematic in "transition" countries such as Azerbaijan (see below). Effective global governance (Verbruggen 2013; Abbott, Snidal 2009) is dependent upon the shadow of hierarchy (Scharpf 1991) state capacity provides at the national level for implementation. Consequently, Jänicke speaks of state failure if the state fails to protect the common (public) good against private externalities (Jänicke 1990, p. 36). In governance literature, this is not a paradox, because strong and democratic states are assumed to secure policy implementation to solve public problems. However, more powerful states are also less susceptible to international influence and if political interest is brought back into the picture rather than assuming that policy-making serves common goals, powerful states may conceivably pose a problem to the transnational management of externalities. In their attempt to emulate the economic growth and some aspects of the modernization of developed countries (Casula 2008; Eisenstadt 1964a) by merging the economic and political spheres, Former Soviet Union (FSU) states behaved "just like capitalist corporations in a competitive environment" (Jänicke 1990, p. 6) – with no agent left to mitigate the external effects of economic activity, as the analysis of the GGFR shows in some detail. Modern governance mechanisms aim to increase governments' capacity to control or rather moderate private processes within their territory while fostering inclusion, thus strengthening legitimacy and effectiveness of state action. The government of Azerbaijan has tightened control over private processes since Azerbaijan gained independence, but did so by creating a highly exclusive state. State capacity is therefore conceptualized below to include the political dimension for analyzing Azerbaijan.

International relations (IR) has been opening up to problems of global governance (Rosenau, Czempiel 1992; Rosenau 2006b, pp. 20ff), e.g. within regime theory (Krasner 2012), and seems to be reinventing the policy analysis wheel (Rosenau 2007, p. 89; Barnett, Duvall 2005; Jann 2009, p. 493) to accommodate international non-state actors and processes (O'Neill et al. 2004; Young 1982) albeit often staying at an abstract level, because of its self-proclaimed exception-

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