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The EU and Central Asia: Commercialising the Energy Relationship

Michael Denison

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Introduction

The European Union (EU) wants to establish a commercial energy relationship with Central Asia. Making this strategic objective a reality is a complex and challenging undertaking. Although the prize is considerable given the region's abundant reserves of oil and gas (not to mention uranium, which could be used to service the next generation of European nuclear reactors), the constraints are equally daunting.

The principle underpinning the EU's energy outreach towards Central Asia is based on self-interest and focused on gas. The objective is to diversify supplies in order to reduce the dependence of EU member states on gas supplies from Russia, the potential volatility of which has been demonstrated by supply disruptions to core transit/customer states, notably Ukraine, Belarus, Moldova and Georgia since 2006¹. These have followed disputes over pricing, payment and unregulated offtake. Yet, it is by no means certain that Central Asia is the answer to the EU's wider diversification strategy. A number of alternatives that exclude Central Asia altogether have gained currency in policy-making circles for a variety of reasons. These include: development of the EU's liquefied natural gas (LNG) importation and processing capabilities; new supply routes from Russia that bypass "problem" transit states (Nord Stream and South Stream pipeline projects being the most developed); reductions in long-term EU gas demand through greater energy efficiency; improvements in gas storage capabilities; and the creation of an effective single gas market enabling the commercialisation of non-Russian gas from Western Europe to Russia-dependent EU member states through reverse flows, an emergency measure used successfully in the Russia-Ukraine dispute of January 2009².

The purpose of this working paper is to assess where Central Asia fits into this broader debate. The broad assumption in this paper is that a southern corridor strategy encompassing Central Asia is still somewhat speculative but nevertheless worth pursuing, bringing as it does tangible benefits to both regions and to connecting transit states. A number of subsidiary issues flow from this assumption. Firstly, the overall southern corridor strategy may not live or die with Central Asia's involvement, important though the region's reserve base is; Azerbaijan is far

more pivotal to its success and both Georgia and Turkey present very different but substantial transit state challenges. Secondly, the EU has to decide how it can square its ambitions to be a normative foreign policy actor while dealing on a commercial basis with states such as Turkmenistan and, possibly down the line, Uzbekistan, where there are substantial deficits in the observance of human rights. Thirdly, timing is crucial. Turkmen foreign policy is presently in flux, accentuated by disruptions of gas exports to Russia since April 2009. Uzbekistan continues to resist further integration into the post-Soviet institutional space. If engagement is to proceed, then individual EU member states, EU energy companies and the EU as a collective actor must move more decisively to create a bridgehead into the region.

Some preliminary qualifications are in order. Space does not permit a full examination of the Europe-Central Asia energy relationship, so greater focus is imperative. Given the comparatively fungible and global nature of the oil market, and the EU's own emphasis on diversification of gas supply, the paper will focus on potential gas trading between the two regions. Thus, although Kazakhstan is and will be the principal hydrocarbon exporter from Central Asia for the next two decades and has more developed and proximate gas fields, its export profile is and will be much more oriented towards oil than gas³. This is, in part, due to lower comparative production volumes, greater domestic gas usage, and also the close Russia-Kazakhstan gas trading nexus which will be difficult for the European Union to penetrate (see section III below). This paper will therefore dwell at greater length on the prospects for cooperation with Turkmenistan and, to a lesser extent, Uzbekistan, because they offer the greatest medium to long-term potential, albeit with greater political risk and infrastructural constraints.

Moreover, the materiality of the southern corridor is likely to be affected by a number of external political factors. These include: the broader relationship between the EU and Russia; Ukraine's domestic political environment and its short to medium-term foreign policy capabilities; the orientations of various non-EU "swing" states, notably Turkey and Serbia; the geopolitical dynamic in the South Caucasus surrounding Georgia and Turkish-Armenian rapprochement; and developments in other potential source states, notably Iraq, but also Iran and Egypt. These considerations must necessarily fall outside the scope of this paper, although they will inform its content.

The remainder of the working paper is structured as follows: Section I sets the procedural context for the EU's energy outreach to Central Asia since 1992. Section II focuses on the southern energy corridor, the mechanism by which EU-Central Asia energy relations might be concretised. In particular, it highlights the intrinsic and extrinsic risks to the project's realisation. Section III considers Central Asia's specific role in the EU's energy strategy, assessing the contributions each gas exporting state might make, finding that Turkmenistan should be the EU's clear strategic priority. Section IV analyses the specific opportunities and obstacles of bringing Turkmen gas west: these include political, commercial, infrastructural and trade factors, none of which, in themselves, are insurmountable but, taken together, present a formidable set of challenges. Section V considers how EU energy companies might build a sustainable and ethical

About the author:

Michael Denison is Research Director at Control Risks, a leading international business consultancy. He was formerly Special Adviser to the UK Foreign Secretary, Lecturer in International Security at the University of Leeds, and Associate Fellow at Chatham House. He has published widely on Central Asia including in IISS Strategic Survey, Europe-Asia Studies, OstEuropa, The World Today and for the Centre for European Policy Studies.

business offer in Turkmenistan, adumbrating various ground rules for effective commercial entry. Section VI sets out a list of recommendations for the EU to pursue to realise its objectives, and a short concluding section summarises the main report findings.

I. Development of the EU's Central Asia energy agenda

The European Community Regional Strategy Paper (RSP) for Assistance to Central Asia for the period 2007-2013 adopted in June 2007 classifies diversification of energy supplies as a central overall external policy goal of the EU, stating that "Central Asia, with its significant hydrocarbon resources and favourable geographical location for transport routes to European markets, will play an important role in ensuring the EU's energy supplies." Beyond this, there is no further detail in the RSP as to how this might be achieved⁴.

However, the Joint Progress Report (JPR) by the Council and the European Commission to the European Council on the implementation of the EU-Central Asia Strategy, released on 24 June 2008, notes that "regional dialogue is intensifying in the framework of the Baku Initiative", and that the "INOGATE [Inter-State Oil and Gas Transportation] mechanism remains the main tool in continuing to support cooperation on energy projects of mutual interest and in collaboration with leading international lending institutions"⁵. More specifically, the EU Energy Security and Solidarity Action Plan (ESSAP) arising from the Commission's Second Strategic Energy Review (SEER2), published on 13 November 2008, identifies the promotion of infrastructure and diversification of supplies as essential to the EU's energy needs. This head of the five point action plan includes various "priority infrastructure actions", including: improving LNG and gas storage facilities; the completion of a Mediterranean gas ring; development of electricity and gas interconnections within Central and South Eastern Europe and the North Sea offshore electricity grid; and the creation of a southern gas corridor linking Caspian basin and Middle Eastern sources to the European Union⁶.

The importance of Central Asia as an energy source to SEER2 and the EU as a whole should, therefore, be put into perspective. Within the ESSAP, Central Asia's contribution to the proposed southern gas corridor represents one half of one component of several wider infrastructure action priorities. Moreover, infrastructure development itself represents only one component of five broader action points, which also include intensive work to improve energy efficiency, build a framework of external energy relations, improve crisis response mechanisms, increase oil and gas stocks and storage, and make best use of the EU's indigenous energy resources. Thus, although bringing Caspian gas directly into the EU's energy mix is arguably the most geopolitically contentious aspect of the ESSAP, Central Asia cannot be described as an indispensable component of EU strategic planning on energy security.

Although 2006 and 2007 were undoubtedly the "game-changing" years in EU-Central Asia energy relations, it is

important to note that attempts to develop commercial cooperation predated the first Russia-Ukraine gas crisis in January 2006. Thinking on diversification of energy supplies can be traced back to the initiation of the Technical Aid to the Commonwealth of Independent States (TACIS) programme in 1991. Further way stations were INOGATE's inception in 1995, the Commission's Green Paper on energy supply diversification published in 2000, and the Baku Initiative of November 2004, which was the first attempt to bring together all key supply and transit countries on the EU's eastern flank including Russia, Iran, the Black Sea and Caspian Sea littoral states, as well as Central Asian states that would, at best, be marginal contributors to EU energy needs.

The Baku Initiative set out the parameters of future engagement on energy issues: harmonisation of legal and technical standards; integration of energy systems; modernisation of existing infrastructure and development of new infrastructure to improve safety and develop new supply interconnections; and promotion of the financing of new commercial projects. While this demonstrated the EU's convening power and established a mechanism and process for future cooperation, it also laid bare the formidable obstacles for engagement. In statements annexed to the conference conclusions, Azerbaijan stated that it would not cooperate with Armenia while the Nagorno-Karabakh conflict remained unresolved; the Russian delegation expressed its formal reservations about the final communiqué; the Kazakh government reserved its position; the Armenian representation insisted that the process should be of a purely technical character; and no representative from the Turkmen government even attended the Baku conference⁷.

The second ministerial conference, held in Astana in November 2006, illustrated how much the political landscape had been changed by the Russia-Ukraine gas dispute 10 months previously. The number of participants narrowed. Iran dropped out of the picture; Russia attended only as an observer. States not integral to the supply and transit of Caspian gas to Europe, such as Armenia and Belarus, were designated as "partners". A detailed Road Map annexed to the final ministerial declaration set out in much greater detail the objectives of the process and the mechanisms by which they might be achieved through a series of approved actions. The Road Map set out four broad medium-term objectives:

- 1 Converging of energy markets on the basis of the EU internal energy market principles taking into account the particularities of the Partner Countries;
- 2 Enhancing energy security by addressing the issues of energy exports/imports, supply diversification, energy transit and energy demand;
- 3 Supporting sustainable energy development, including the development of energy efficiency, renewable energy sources and demand side management;
- 4 Attracting investment towards energy projects of common and regional interest.

The explicitly commercial dimensions of the Astana declaration were therefore threefold: (i) to establish the conditions for

developing a new architecture of supply capable of transporting Central Asian gas from the eastern seaboard of the Caspian Sea to and through existing supply networks direct to the European market, in essence a Southern Energy corridor; (ii) to establish a framework, through the convergence of energy markets, for the purchase of Central Asian gas; (iii) to create the commercial conditions for greater up and mid-stream investment capable of generating sustainable medium-term supply volumes.

The RSP, SEER2 and the broader Southern Corridor strategy should therefore be viewed as the culmination of a longer accretive process of engagement, albeit given greater salience and urgency by structural increases in European gas demand, and increasing doubts over Russia's long-term reliability as Europe's principal source of natural gas.

II. Realising the supply imperative: the Southern Corridor

The proposed Southern Corridor consists of two pipeline projects. The centrepiece is the Nabucco pipeline from Erzerum in Turkey to Baumgarten an der March in Austria, designed to transport up to 31 bcm per year of gas from 2014-16 to the Central European market. This would cover approximately 5% of future European gas demand. The second is the Turkey-Greece-Italy Interconnector pipeline (TGII), which currently supplies 0.5 bcm per year to Greece, but would be expanded to supply 3.5 bcm to Greece and 8 bcm to Italy by 2014 (see Appendix One).

The principal source of gas slated to make the projects commercially viable is Azerbaijan's offshore Shah Deniz field operated by BP. Phase One of this project is onstream and currently supplying 8.5 bcm annually to Georgia, Turkey and Greece through the South Caucasus gas pipeline, a companion to the better known Baku-Tbilisi-Ceyhan (BTC) oil pipeline. To make Nabucco a commercially viable prospect, an absolute minimum additional throughput of 8bcm per year will initially be needed for Phase One, with guarantees of additional supply from further sources. The development of Shah Deniz II, likely to come onstream in 2014 or later, should be able to meet the minimum initial conditions⁸. A major question thereafter is where additional volumes can be found to fill Nabucco in its second and third phases from 2016 and 2020 respectively to reach the target throughput of 31 bcm. Two separate regional supply complexes have been identified: the Greater Middle East and Central Asia, each of which is potentially problematic.

Moreover, there are a number of extrinsic and intrinsic complications to the realisation of the southern energy corridor. Nord Stream and South Stream are clearly factors, aggravated by the propensity of both large (Germany and Italy) and smaller (Hungary and Bulgaria) EU member states to "peel off" and make bilateral supply deals with Russia (see Appendix One for potential diversified pipeline routes for natural gas into the EU). The case has not been persuasively made to prioritise the southern energy corridor above other supply sources (LNG in form and the Maghreb as location). Indeed, it is a point of debate whether the principal emphasis of the EU should be a shift away from gas altogether towards renewable energy sources.

Intrinsically, Turkey's transit position has been problematic. Its

demand for an offtake of 15% of Nabucco throughput for its own use at subsidised prices has been rejected by Azerbaijan, which is concerned that, in periods of lower domestic demand, surplus gas will then simply be resold by Turkey at a profit on the secondary market. The Turkish offer on price – reportedly around \$140 per thousand cubic metres - is unacceptable even at a time of falling global gas prices, and the volumes demanded by Turkey, 8bcm per year from Shah Deniz II, are sufficient to undermine the overall rationale of the Nabucco project. Turkey has also linked the viability of the Southern Corridor to its stalling EU membership bid, in particular the opening of new accession chapters⁹. Intensive EU and private sector negotiation appeared to have softened the Turkish position by summer 2009, following a "southern corridors summit" hosted by the Czech EU presidency in Prague in May 2009. Members of the Nabucco consortium seem to be prepared to offer Turkey guarantees on emergency supplies, while there has been some Turkish movement on price and volume, including an undertaking not to resell its share. However, unless the Intergovernmental Agreement (IGA) between the contracting parties, signed on 13 July 2009, can be underpinned by a Heads of Government Agreement (HGA) and supplemented by specific project support agreements and financing, the wider southern corridor strategy will remain a theoretical endeavour.

Development of the southern corridor will also be contingent on an array of complex geopolitical calculations, involving multiple players in the wider region, for some of whom supply of Central Asian gas to Europe is either a marginal concern or one that needs to be balanced against other considerations. The Turkish-Azerbaijani relationship is again critical. Turkey closed its border with Armenia in 1993 in solidarity with Azerbaijan during its conflict with Armenia over the disputed territory of Nagorno-Karabakh. The unfolding diplomatic rapprochement between Turkey and Armenia, which has gathered momentum since autumn 2008, may lead ultimately to the normalisation of relations, possibly decoupled from a wider agreement on the status of Karabakh. On one level, there are considerable pay-offs for several parties: Turkey, alongside its advocates within the EU, will believe that it has removed one obstacle to EU accession, while increasing Turkey's presence as a stabilising influence in the wider Caucasus region; Armenia would "localise" the Karabakh dispute and reduce its commercial and diplomatic isolation by forging new trade and transport links to the West. The new US administration and the EU will neutralise a foreign policy issue that has proved sensitive and divisive among various domestic constituencies.

Against this, Azerbaijan may, in response, threaten to turn to Russia as its principal gas customer. When Gazprom CEO Alexei Miller met with Azerbaijani President Ilham Aliyev on 2 June 2008 in Baku, he reportedly sought to buy all current and future Azeri gas at competitive prices, an offer reiterated and developed by Gazprom Deputy CEO Alexander Medvedev on 8 September 2008¹⁰. While the MoU signed between Azerbaijan's state energy company SOCAR and Gazprom on 27 March 2009, providing for gas sales at the Russian border and subsequent upgrading of the 228 km Baku-Novo-Filya pipeline, does not indicate a strategic realignment on Azerbaijan's part, it certainly lays the commercial foundation for a much closer relationship

between Gazprom and SOCAR, presenting a new and potentially damaging ingredient of “negotiating tension” for the EU¹¹.

The ongoing failure to secure a comprehensive and lasting international peacekeeping mandate in Georgia’s secessionist regions, following the conflict in South Ossetia in August 2008, presents an important residual security concern for a key transit state.

Assuming that these issues can be resolved, which is far from certain, sufficient gas has to be found. Iran, with its world-class gas reserve base, in excess of 28 tcm, has undoubted potential but broader geo/political factors are likely to prove prohibitive. At present, engagement with the Iranian regime is not on the agenda. Even if it were, the challenges to doing business are considerable. On a technical and commercial level, the Iranian government has proven to be a very difficult partner for Western investors. The gas sector itself is woefully underdeveloped to the point where, scarcely believable though it is, Iran is actually still a net importer of gas.

Iraq is a more realistic prospect. The reserves are believed to be in place but the legal environment for investors is far from settled and security concerns persist. Kurdish regional authorities and Iraqi central government each claim presumed competences over the ownership, development and management of hydrocarbon resources in the north of the country where Nabucco gas would be sourced. Considerable resources for investment will also have to be found, including the funding of a spur to the Arab gas pipeline. Nevertheless, the likelihood is that Iraq will play a part if Nabucco is realised. Egypt may emerge as a small supplementary supplier, again through the extension of the Arab gas pipeline through Syria to Turkey, but its projected contribution of around 3 bcm would only top up a project that had attained pre-existing viability¹².

III. Central Asia’s contribution to the EU energy strategy¹³

Summary: *This section finds that the commercial energy relationship between the EU and Central Asia will be structured around gas above other hydrocarbons and minerals. More specifically, it would entail the provision of medium- to long-term volumes of around 15 bcm annually to supplement the core supply base from Azerbaijan’s Shah Deniz II project. The crucial Central Asian state in this equation is Turkmenistan, which alone has the requisite volume availability for export. As such, the initial finding of this paper is that Turkmenistan should be the EU’s strategic priority for engagement on energy issues.*

Central Asia is therefore very much in the frame as a key resource base for the EU’s southern corridor strategy. The three gas rich states in the region are Kazakhstan, Uzbekistan and Turkmenistan, each with differing production and consumption profiles (see Table 1) and differing potential as gas exporters to Europe.

Table 1: Gas production and consumption in Central Asia in billion cubic metres (bcm) (Source: BP Statistical Review of World Energy 2009)

	2007	2008
Kazakhstan: Production	26.4	30.2
Kazakhstan: Consumption	19.5	20.6
Turkmenistan: Production	65.4	66.1
Turkmenistan: Consumption	21.3	19.0
Uzbekistan: Production	59.1	62.2
Uzbekistan: Consumption	45.9	48.7

(i) Kazakhstan

Estimates of Kazakhstan’s overall probable and proven reserve base range from 1.9 trillion cubic metres (tcm) according to BP, up to 3.7 tcm claimed by Kazakhstan’s Ministry of Energy, of which 2.5 tcm is proven¹⁴. This could rise to between 6 and 8 tcm with the development of new fields. Over 70% of its reserves are located in the big three fields of Kashagan, Tengiz and Karachaganak, all conveniently located in the west of the country.

Kazakhstan’s gas production in 2008 stood at approximately 33 bcm but is projected to rise steeply to around 70 bcm by 2015 and higher still by 2020 as Kashagan comes onstream, and Tengiz and Karachaganak move into new production phases. Gas production is associated with domestic oil production. Only 45% of gas output is marketed to customers – the remainder is flared, re-injected to enable liquids to be extracted, or converted for petrochemical use. Moreover, domestic demand is rising as gas is increasingly used for local power generation, mirroring the domestic gasification strategies of several post-Soviet states, led by Russia.

In 2008, Kazakhstan exported approximately 15 bcm to Ukraine and Russia through KazRosGaz, a 50/50 joint venture between state oil and gas company KazMunaiGaz and Gazprom. Volumes likely to be available for annual export in the period 2015-20 are likely to be between 20 bcm and 30 bcm depending on the proportions re-injected, converted to petrochemical use, or used to service domestic demand.

Of this availability, 15 bcm is likely to go to Russia in line with existing agreements. Given that President Nazarbayev insisted that gas from the Karachaganak field be exported to Russia’s Orenburg gas processing plant, notwithstanding that the field’s operator BG had earmarked some of these volumes for re-injection or conversion to petrochemical use, it is unlikely that Kazakhstan will set aside its supply agreements with Russia lightly¹⁵. Of the remaining 5 to 15 bcm some, if not all, should be expected to go east on completion of current pipeline projects connecting Turkmenistan and Kazakhstan to China, which will jointly have a capacity of 40 bcm.

The inescapable conclusion, therefore, is that Kazakh gas cannot be relied upon in any significant volume for European use up to 2020 and, even beyond that, scope is limited.

(ii) Uzbekistan

Uzbekistan's current probable and proven gas reserve base is estimated to be between 1.58 and 2.1 tcm¹⁶. This is likely to be an underestimate, particularly as there are promising prospective structures in the Aral Sea basin and Ust Yurt plateau in western Uzbekistan, which could potentially be linked quite comfortably to the broader regional transit infrastructure. Uzbekistan has adopted a state-led development model, which has been suited to domestic requirements but not ambitions it has to be a regional exporter.

The principal foreign investors in Western regions at present are Lukoil, Gazprom (through its Zarubzhneft subsidiary) and the Malaysian national oil company Petronas, which heads a consortium of Russian and East Asian companies involved in exploration and Gas to Liquids (GTL) production in the Aral Sea and Ust Yurt regions. Overall production levels are around 60 bcm per year, of which around 80% is consumed domestically. Of the export volumes of 11-12 bcm, a small amount is exported to Central Asian neighbours and the remainder has been bought by Gazprom.

Export volumes are projected, by the Uzbek government, to rise to around 15 bcm in 2015 and 20 bcm by 2020, which is a realistic target assuming the relevant investment is forthcoming. There is a small amount of spare capacity but an agreement was reached between President Karimov and Russian Prime Minister Putin in September 2008 to move to a European pricing formula for Uzbek exports, and to construct a new gas pipeline alongside the existing Central Asia-Center and Bukhara-Urals pipelines to take up the extra volume.

President Karimov emphasised throughout 2008 that Uzbekistan would, in future, sell its (non-regional) export gas exclusively to Russia, either at the Uzbek or Kazakh borders, and expressed contentment with the in-country activities of Lukoil, the nominally independent Russian energy company. Moreover, EU energy companies have a very limited foothold in Uzbekistan. Only two companies are active: UK-listed Rosehill Energy, which works on a service contract extracting oil in the North Urtabulak field, and the Czech company Eriell Corporation, which is drilling for gas condensate in the Kashkadarya region.

The EU and European energy companies appear, therefore, to be in a weak place with Uzbekistan, a position compounded by the imposition of EU sanctions between 2005 and 2008 (currently suspended) following the violent suppression by the government of an uprising in the eastern Uzbek city of Andijan in May 2005, and the reluctance of European majors to take the reputational risk of working in a state prominently cited as one of the world's worst human rights offenders.

Uzbekistan's domestic gas consumption profile means that it will never be a large volume exporter to the EU even if domestic political and sectoral reforms are enacted. Furthermore, Uzbekistan has proved to be an extremely challenging operating environment for Western investors, as the tortuous experience of US mining company Newmont Mining illustrated. The energy sector is a key arena for rent-seeking elites to secure revenue, and corruption is engrained at almost all levels.

However, there is a case for keeping dialogue alive. President Karimov's foreign policy has been punctuated by switchbacks rather than balance. There are signs that Tashkent wants to put economic relations with the EU on a qualitatively different footing. Karimov made overtures to Italian and Spanish companies to invest in the energy sector in May 2009, a significant departure from policy over the past decade. Uzbek representatives attended the EU's Southern Corridor summit in Prague in May 2009. Clearly a tactical element is likely to be in play: Karimov has alternately sought distance and rapprochement with Russia over two decades, and the latest shifts in rhetoric may be designed to force Gazprom to increase the pace of its activity in its Ust Yurt/Aral region concessionary blocks, where its licenses have been threatened by revocation. However, the EU's Partnership and Cooperation Agreement (PCA) with Uzbekistan does have an established energy dimension. EU energy companies should look beyond the incumbent regime to a potentially more outward-looking and reformist post-Karimov successor government, which may move towards a more consistent (and traditional) Central Asian foreign policy stance of balancing the influence of the major regional powers. Thus, while putting Uzbek export gas through the southern corridor remains a distant prospect at present, many of the fundamentals suggest that it could be a useful long-term (beyond 2025) supplementary supplier to Europe.

(iii) Turkmenistan

Turkmenistan's gas reserve base is unknown. Estimates range from BP's conservative assessment of 2.67 tcm (BP) to the Turkmen government's optimistic evaluation of 26 tcm. The independent audit (using a mixture of Soviet and newer data) conducted in 2008 by UK company Gaffney, Cline and Associates of the south-eastern South Yolotan-Osman and Yashlar fields estimated their reserves at between 4 and 14 tcm. When adding in other onshore fields to be audited in 2009, then even working from the bottom range of the independent audit, earlier concerns about the adequacy of Turkmenistan's reserve base appear to have been assuaged. The apparent shelving in June 2009 of the Turkmenistan-Afghanistan-Pakistan-India (TAPI) gas pipeline project over pricing differences and construction costs will only increase the available volumes for export to Europe.

Gas output is likely to be around 70-80 tcm in 2009 with domestic consumption no higher than 20 bcm. Given that the reserve base is much higher and domestic demand is relatively low, a much higher proportion of production is available for export. The government has three export contracts. A small volume of around 7-9 bcm is exported through a dedicated export pipeline to Iran completed in 1997. China will receive between 30 and 40 bcm per year from fields on the right bank of the Amu Darya once the Central Asia-China pipeline is completed and capacity increases, probably in 2012. Russia has a 25 year framework agreement for an escalating supply of gas (up to 80 bcm per year), principally from the Dauletebad gas field, which transits through the Central Asia-Center trunk pipeline, although production and pipeline capacity is currently nowhere near this amount, even with out disruptions. However, given that the export destination of gas from the South Yolotan/Osman

structure is unassigned (although Turkmenistan accepted a \$3 billion soft loan from China on 6 June 2009 to develop the field), and that there is considerable scope for use of products from the Caspian coastal shelf, it is reasonable to assume that Turkmenistan is the indispensable state in any commercial gas trading between the EU and Central Asia.

IV. Materialising the EU-Turkmenistan energy relationship

Summary: *The secondary findings of this working paper are that there is both a role for the EU in Turkmenistan and a willingness on the part of the Turkmen, if only on a tactical level, to engage. The EU, with European energy companies, can up their game by: (i) actively seeking to resolve the long outstanding maritime boundary dispute between Turkmenistan and Azerbaijan; (ii) seeking to secure a supply commitment on gas volumes from specified sources flowing through the proposed East-West pipeline; (iii) working to promote EU companies as the best technical and most environmentally responsible commercial partners to develop new onshore fields under a legal formula that protects all parties' interests. For their part, EU energy companies must stay engaged and consider whether they would be prepared to work under commercial arrangements short of PSA and closer to JAA models.*

If the EU is to seriously activate the supply, purchase and investment objectives set out in SEER2, the RSP and the Baku Initiative, both it and EU energy companies will have to figure out how best to engage with Turkmenistan on transit, trade and investment issues. The EU has made a start, securing an MoU in April 2008 for the supply of 10 bcm annually to the EU, and building contacts with senior Turkmen officials, from President Gurbanguli Berdimuhammedov downwards.

The decision made by the European Parliament in April 2009 (currently awaiting action by the Council) that the EU proceed with an Interim Trade Agreement (ITA) after several years of stalling was also significant in setting a new agenda. The PCA with Turkmenistan also requires ratification. This is likely to be linked to progress under the EU-Turkmenistan Human Rights dialogue strand (established in June 2008) in relation to Turkmenistan's responsibilities under the Convention against Torture and treatment of prisoners. The Turkmen government's renewed engagement with the UN Human Rights Council and the Organisation for Security and Cooperation in Europe (OSCE) since December 2008 has been encouraging. The diplomatic building blocks are slowly being put into place, therefore, for a more comprehensive and mature bilateral relationship.

The EU next has to secure the gas itself and move it across the Caspian Sea: it is not at all clear whether there will be sufficient offshore volume to supply 10 bcm or more per year in accordance with the MoU. RWE signed a framework agreement, presumably as precursor to a Production Sharing Agreement (PSA) in April 2009 for Block 23, an undisputed offshore parcel close to the Turkmen shore, but this may have been a "sweetener" designed to demonstrate the sufficient country commitment necessary to pitch for onshore

concessions over time¹⁷. Most other offshore blocks, apart from the Serdar/Kyapaz field in the central Caspian, which is under dispute between Azerbaijan and Turkmenistan, have attracted little interest and their prospects do not look particularly good¹⁸. Two options are thus unfolding: either onshore gas is secured, ideally from the South Yolotan field, and/or a concerted diplomatic effort is made to resolve the Serdar/Kyapaz issue. The EU should work on both fronts: firstly, through the promotion of Azeri-Turkmen dialogue which, after a promising thaw in 2007, has now stalled. Both parties have indicated a willingness to settle the matter and have indicated informal concessions but now appear to be in deadlock. If an agreement around joint development can be reached, then it would be possible to link offshore Azerbaijani infrastructure at Shah Deniz into Serdar/Kyapaz at an economic cost. Picking up other offshore gas products, perhaps from Kazakhstan further up the coast, may just prove sufficient.

The other alternative is to bring across onshore gas from the east of the country. In March 2009, the Turkmen government announced an international tender for the construction of an East-West internal gas pipeline from South Yolotan to the Caspian Sea. This could take gas north through the PreCaspiskiy pipeline to Kazakhstan and Russia or across the Caspian in some form. South Yolotan will be a very difficult field to develop on a technical level, which should create some pitching leverage for EU energy companies with the capital and expertise to work complex structures. While the Turkmen government will not (in public at least) entertain the idea of new onshore PSAs, it might be possible to work through a hybrid service contract/PSA model – the Turkmen petroleum law provides for Joint Activity Agreements (JAAs) – that would protect Turkmen sovereignty issues, while incentivising the best foreign investors to develop the country's most challenging fields.

Moving Turkmen gas across the Caspian Sea is likely to be a contentious process: a formal Trans-Caspian pipeline will encounter serious and sustained opposition from Russia and Iran on environmental and sovereignty grounds. It may not be worth the trouble. Much safer politically is to ship gas in LNG, Gas to Liquids (GTL) or Compressed Natural Gas (CNG) form across the Caspian Sea to Azerbaijan by tanker. This will be expensive and require a sustained long-term investment commitment. However, the Turkmen government is keen to add value by processing its gas domestically. The tax advantages of setting up such facilities in the coastal Special Economic Zone are considerable. A third option is to link up existing Azeri and Turkmen subsea infrastructure with a number of short subsea pipes. This technical solution should not be as contentious as a new pipeline but might be able to transit sufficient volumes to satisfy the requirements of Nabucco. RWE and OMV, from Germany and Austria respectively, in December 2008 established the Caspian Development Corporation (CDC), registered in London, as a block purchasing mechanism for Turkmen gas designed to provide the contractual security necessary to finance these linkages. Regardless of the merits of the CDC approach – and it will need to be calibrated carefully so as not to breach the EU's own competition rules – the EU and energy

companies will be required to work together more effectively to promote the optimum transit solution.

Timing is also crucial: as of 20 July 2009, gas exports to Russia had not resumed following an explosion on the Central Asia-Centre trunk pipeline on 8 April 2009. The Turkmen government is short of money and short of friends. The decision by the Chinese government to advance a \$3 billion loan in June 2009 to develop South Yolotan underlines the importance for the EU of using diplomatic “vacuums” to advance essential interests. Committing gas volumes west will be viewed in Moscow as a further erosion of influence in Turkmenistan and may provoke resistance both formally and through informal channels. The Turkmen government therefore needs cast-iron contractual guarantees to face down Russia. These can only be given if the relevant IGAs and HGAs are signed with all Nabucco project partners but, most importantly, with Turkey and Azerbaijan.

V. Building a sustainable and ethical European business offer

Summary: *Operating in Central Asia successfully is possible in the energy sector. The EU and European energy companies have realised that simply isolating or “punishing” Central Asian regimes does not effect behaviour change. Rather, an embryonic strategy for commercial engagement on energy issues is emerging that moves beyond the sterile “interests versus values” debate to secure energy needs through application of normative values in business practice and diplomatic engagement. The Caspian Development Corporation is a step towards understanding the local business environment, while the CSR offers being formulated by European majors interested in working in Turkmenistan recognise the importance of the social dimension. In this respect, the EU needs to catch up with commercial actors.*

SEER2 implicitly acknowledges that the EU must eliminate various competitive disadvantages if it wishes to buy gas directly from Central Asian suppliers. The governments of Turkmenistan and Uzbekistan prefer certain ways of doing business, which entail:

- 1 sale of gas at their border;
- 2 sale to single rather than multiple entities, particularly state owned oil and gas companies;
- 3 long-term political framework agreements on sale, within which adjustments on tariffs and volumes can be made either annually or semi-annually depending on internal production factors, domestic requirements and prevailing market conditions.

CDC is a response to these preferences: a mechanism to build confidence and trust and provide the security of demand necessary to produce long-term supply commitments. Moreover, OMV Gas & Power and RWE Supply & Trading in December 2008 established the Caspian Energy Company (CEC) in the UK as a corporate mechanism to explore the transit of Turkmen gas across the Caspian Sea. The Commission

is supportive of CDC and CEC and is establishing a parallel political track, which includes a feasibility study, although there is concern that the Commission will move too slowly to seize the commercial moment and may, in effect, prove a hindrance. Nevertheless, CDC and CEC are an important recognition that to succeed commercially in Turkmenistan (and Uzbekistan) it must be imaginative and flexible enough to understand local preferences.

However, building closer, politically backed business ties into the region creates risks: for the EU the risk is that it sees progress on human rights and democratisation in the region where it does not exist. “Whitewashing” the record of local regimes or over-promoting phantom or cosmetic reforms, as senior EU officials have been prone to do on their recent visits to Ashgabat, may compromise the EU’s aspiration to be a model international power and a normative foreign policy actor. Publicly listed European energy companies face a similar reputational risk in doing business with repressive regimes.

To work through this risk requires an initial shared recognition between the Commission, Parliament, member state governments and commercial actors that, first of all, Central Asian governments fall short, often substantially, in attaining international norms of acceptable conduct, as set out in their responsibilities as full members of the UN and OSCE. Secondly, there must be a shared commitment between these parties to improve regime behaviour by seeking to embed norms of responsible sovereignty through adherence to basic standards of human rights. This does not involve prescriptions on types and pacing of democratisation but is designed to prevent the exercise of arbitrary governance that is as harmful to good business practice as it is to the rights of local citizens. Once these points of departure are agreed, the question is how, not whether, improvements should and can be sought.

Critical to understanding this problem is to look at the leverage of the regimes themselves. Both Turkmenistan and Uzbekistan will, in the near-term, have readily available export markets to both Russia and China (and maybe, in future, South Asia) that will provide a sufficient inflow of export revenues to satisfy domestic patronage networks and rent-seeking elites. These relationships extract no behavioural conditionalities: indeed, they thrive on opaque transactions and informal networks. In other words, the pressure points available to the EU are severely circumscribed; the Turkmen and Uzbek regimes can survive with or without Europe, as they have proven since 1992. Instead, therefore, the emphasis must shift to incentivisation.

The biggest card European energy companies can play is their technical excellence and efficiency, but they must also build into their commercial offers the norms and tools of long-term political and social development, through comprehensive packages of targeted training, education and welfare provision with clear linkages and impact beyond the energy sector. By doing so, they will meet local content requirements, build a more efficient local workforce, and foster the development of a middle-class likely to engender broader social progress. Integral to this process is assistance on specific technical issues, for example, in developing a framework of commercial law

administered by a competent judiciary. There must also be recognition that investment benefits should be spread across regions rather than geographically focused on areas close to field operations or the capital city. Thus, for European investors, the building of social capital cannot be simply an arm of the companies' corporate social responsibility functions. Rather it should be seen as an effective instrument of reputational risk mitigation that has long-term commercial value.

Finally, successful Western investors in Turkmenistan have normally followed a basic set of ground rules, which should be respected. These include:

- (i) no involvement in domestic political activity, which should be left to diplomatic actors
- (ii) a robust corporate position on the issue of bribery and side-payments
- (iii) avoidance of local pressure on recruitment by using international country managers on long-term contracts
- (iv) delivery on time and to budget (particularly important where there is frequent turnover of state officials)
- (v) assiduous compliance with environmental, safety, local content, employment and tax legislation, and an assistance offer to build local capacity in these areas
- (vi) working commercial disputes through the domestic court system regardless of the competence or bias of the judiciary to demonstrate respect and incrementally improve the capacity of the local court systems to hear commercial cases
- (vii) high ratio of local employment
- (viii) comprehensive (international) training programmes for local employees
- (ix) build/import, operate and transfer in relation to plant
- (x) use of state insurance schemes if necessary in addition to external insurance cover

VI. Recommendations to the EU

1. Work intensively to resolve downstream contractual issues with Turkey and Azerbaijan in order to give Central Asian gas suppliers the confidence to move gas west in the face of likely Russian pressure.
2. Offer to assist in brokering a settlement on territorial disputes between Turkmenistan and Azerbaijan that would unlock vital offshore gas volumes.
3. Prioritise Turkmenistan as a commercial partner of choice through a range of diplomatic interventions and confidence-building measures including concrete proposals on transit and trade: the Turkmen government requires direction, reliability and certainty following which it will respond positively, as has been the case with China.
4. Support human rights observance both formally and in more nuanced ways by promoting the integration of

social and environmental capital building measures into commercial engagement.

5. Establish a standing mechanism for dialogue between the Commission, European Parliament and representatives of EU energy companies to share information, improve standards of transparency and accountability, and coordinate commercial and political engagement.
5. Identify where Turkmen gas would be sourced from and work to provide technical assistance on upstream and midstream development by reorienting external spend at the next budget allocation round in November 2009.
6. Support CDC and CEC more explicitly as volume-building mechanisms for gas purchase and transit.
7. Work to define transit alternatives: with commercial partners cost, finance and present clear plans to the Turkmen government.
8. Provide assistance on building a framework to support inward investment by advising on petroleum, taxation, environmental, contract and local content legislation with appropriate improvements in judicial capacity.
9. Support EU energy companies in defining and promoting their commercial offer of technical excellence, environmental impact management and corporate social responsibility and by informing them of mechanisms such as the Human Rights Dialogue.
10. Remain engaged with Kazakhstan and Uzbekistan as potential supplementary sources of gas for the Southern Corridor.

Conclusion

The objectives of this working paper were as follows: to review the EU's current energy needs and to establish the role that Central Asia might play in helping to meet them. It concluded that Central Asia was not pivotal to EU energy strategy but would be an important component of the southern corridor project, which itself forms one component of the strategic review. The focus of interaction will be on gas and on Turkmenistan, as a supplementary supplier to the projected Nabucco pipeline and therefore a useful new source to balance dependence on Russian gas. Such a project will increase the commercial and geopolitical options, and presumably the market power, of Central Asian exporters themselves. The EU has moved constructively to develop relations with Turkmenistan since 2007, but there are numerous technical, political, commercial and legal issues to resolve before Turkmen gas can be moved to Europe directly. Some of these risks are extrinsic to Central Asia, notably revolving around Turkey's increasingly pivotal position as a Eurasian gas hub, and its relationship with Azerbaijan, or the extent to which individual EU member states prize good diplomatic and commercial relations with Russia. Resolving these will give the Turkmen government the confidence to take its own risks in the form of sending future export volumes west in the face of potential Russian opposition.

Other issues are intrinsic to the region: securing gas volumes, building transit infrastructure across the Caspian Sea and

building the appropriate commercial relationships that will secure long-term supply commitments. Individually they appear surmountable. Put together they present a formidable set of thresholds to cross. It cannot, therefore, be said with certainty that the southern corridor will be realised, or that the Nabucco pipeline will be built. However, the stars are now more closely in alignment than ever before, and there is a strong case for arguing that, if the EU is committed to supply diversification, it should continue to force the pace and volume of engagement in order to keep up with emerging commercial opportunities in the region.

The EU has rightly identified energy as a pivotal source of interaction between Europe and Central Asia. Progress has been made, both by the EU and its constituent energy companies, to establish a working relationship on a governmental and commercial relationship. However, for a commercial relationship to develop and prosper, the EU needs to act more quickly, more deliberately and more strategically in support of commercial activity both as a mechanism to improve energy security and as an opportunity to pursue the EU's normative foreign policy objectives.

Endnotes

1 Notwithstanding the current decline in European gas demand, the International Energy Agency (IEA) has forecast that global primary energy demand will, on average, grow by 1.6% to 2030, and that EU demand for gas may increase from 489 billion cubic metres (bcm) to 694 bcm in this period, with European (including Norwegian) gas production declining from 59% of European consumption at present to 25% in 2030. Russia accounts for 40% of EU gas imports, of which 80% transits through Ukraine. Natural gas imports from Russia account for over 50% of domestic consumption in Austria, Greece, Hungary, Slovenia and the Czech Republic and over 98% in Finland, Bulgaria, Slovakia, Lithuania, Latvia and Estonia. Western and Central European dependence is lower but still considerable. Imports from Russia account for 43% of Polish domestic gas consumption, 39% in Germany, 31% in Italy and 24% in France, although the overall fuel mix in these states is diverse, with Poland a heavy user of coal and France having a developed nuclear power sector. 30% of gas imports were cut during the Russia-Ukraine gas dispute of January 2009. For European gas demand data, see: Fatih Birol: "Outlook for European Gas Demand, Supply and Investment to 2030" available at <http://www.iea.org>.

2 This last point has been made by Pierre Noel in "European Gas Security after the Crisis", a paper presented to the European Council on Foreign Relations, Brussels, 23 April 2009.

3 EU energy companies do have oil interests in Kazakhstan, principally through the stakes held by ENI, Shell and BG in various major projects, in addition to the 14.3% stake held by EU companies in the Caspian Pipeline Consortium (CPC), a major export route for Kazakh oil to global markets, the capacity of which will increase from 33 million tonnes per year to 67 million tonnes per year by the end of 2013 following the signing of an expansion protocol between its shareholders in Moscow in December 2008.

4 The RSP can be viewed at http://ec.europa.eu/external_relations/central_asia/rsp/07_13_en.pdf

5 The JPR can be viewed at <http://delkaz.eceuropa.eu/joomla/images/Strategy/jint%20prgress%20report%20on%20eu%20ca%20strategy.pdf>.

6 SEER 2 can be viewed at http://ec.europa.eu/energy/strategies/2008/2008_11_ser2_en.html

7 Baku Initiative documents can be viewed at http://ec.europa.eu/dgs/energy_transport/international/regional/caspian_en.html.

8 Private communication with BP, June 2008.

9 EU Observer, 19 January 2009 (<http://euobserver.com/9/27431>).

10 Rovshan Ismayilov, "Azerbaijan: Baku likely to reject Russian offer to buy natural gas" Eurasianet.org, 3 June 2008.

11 Shain Abbasov, "Azerbaijan: Gazprom deal means no change for Baku's energy policy" Eurasianet.org, 1 April 2009.

12 An EU-Egypt Memorandum of Understanding was signed in Brussels on 2 December 2008. An agreement was signed on 17 May 2009 on gas supply from Iraq between Nabucco consortium members OMV and MOL and UAE companies Dana Gas and Crescent Petroleum, who operate a gas site in northern Iraq. The agreement was supported by the Kurdish controlled regional authorities but condemned by Iraqi Oil Minister Hussain al-Shahristani on 18 May 2009 (see Yigal Schleifer, "Potential Iraq connection keeps Nabucco pipeline on life support", Eurasianet.org, 19 May 2009.).

13 Data on output compiled from BP Statistical Review.

14 Data in this section can be found in Shamil Yenikeeff, "Kazakhstan's Gas: Export Markets and Export Routes" Oxford Institute for Energy Studies, November 2008 (<http://www.oxfrdenergy.org/pdfs/NG25.pdf>).

15 Information based on private communications with BG.

16 The lower estimate is from the BP Statistical Review of World Energy 2009; the upper estimate is that of Uzbekneftegaz.

17 International Oil Letter, 25 (17), 27 April 2009.

18 Private discussions with representatives of Nabucco consortium members, April 2009.

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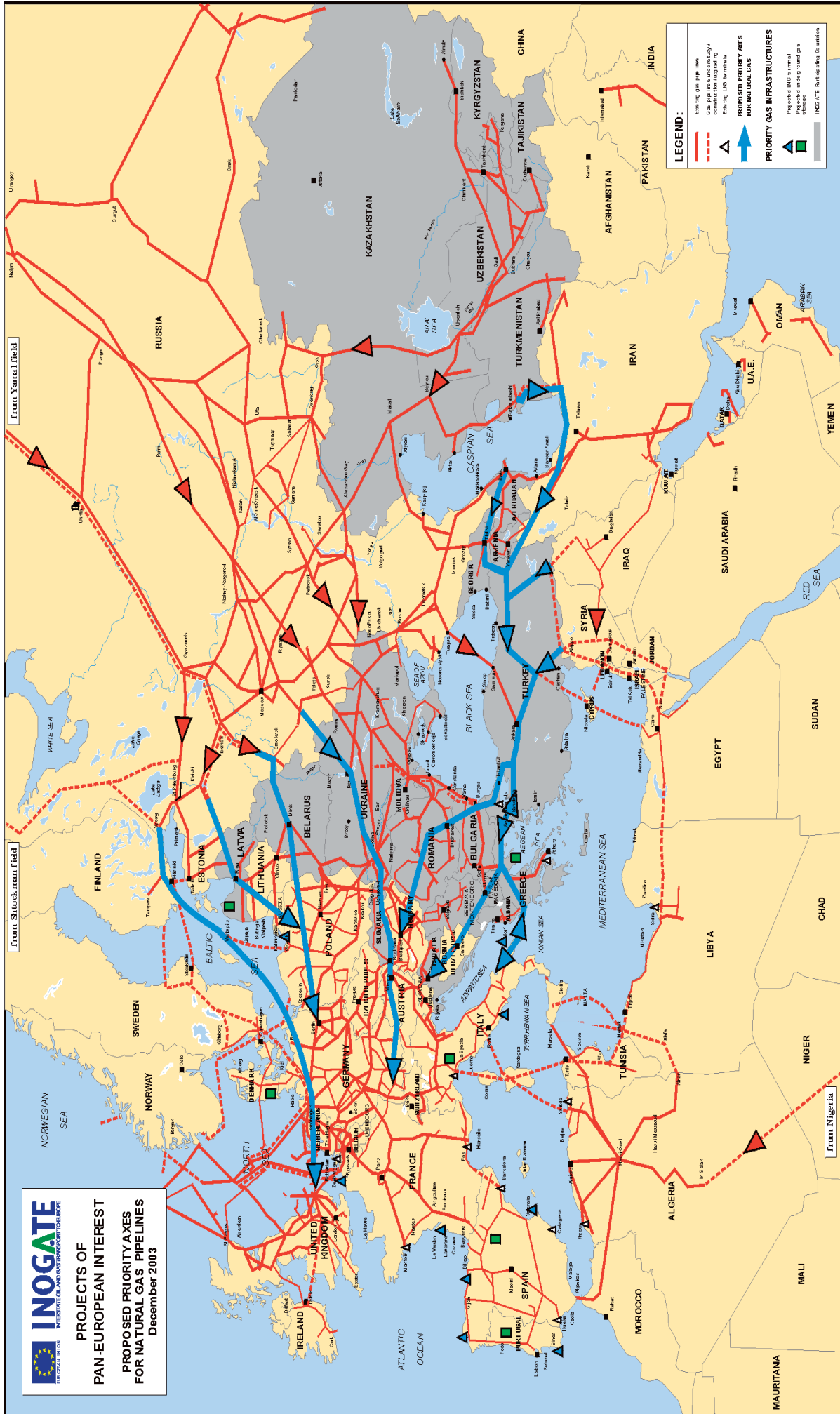
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Acronyms

BTC	Baku-Tbilisi-Ceyhan oil pipeline
CDC	Caspian Development Corporation
CEC	Caspian Energy Company
CNG	Compressed Natural Gas
CSR	Corporate Social Responsibility
ESSAP	EU Energy Security and Solidarity Action Plan
GTL	Gas to Liquids
HGA	Heads of Government Agreement
IGA	Inter-Governmental Agreement
INOGATE	Inter-State Oil and Gas Transportation
ITA	Interim Trade Agreement
JAA	Joint Activity Agreement
JPR	Joint Progress Report on the implementation of the EU-Central Asia Strategy
LNG	Liquefied Natural Gas
MoU	Memorandum of Understanding
OSCE	Organisation for Security and Cooperation in Europe
PCA	Partnership and Cooperation Agreement
PSA	Production Sharing Agreement
RSP	European Community Regional Strategy Paper for Assistance to Central Asia
SEER2	EU Second Strategic Energy Review
TACIS	Technical Aid to the Commonwealth of Independent States
TAPI	Turkmenistan-Afghanistan-Pakistan-India gas pipeline project
TGII	Turkey-Greece-Italy Interconnector pipeline project

Appendix One: Potential diversified pipeline routes for supply of natural gas to EU member states

Pipeline project	Route	Timetable	Volume	Gas source	Consortium Participants
Nordstream	Russia Germany via Baltic Sea	Phase 1: 2012 Phase 2: 2015	27.5 bcm 27.5 bcm	Russia	Gazprom (Russia); EON (Germany); BASF (Germany); Gasunie (Netherlands)
Nabucco	Turkey > Bulgaria > Romania > Hungary > Austria (possible spur to Poland)	2015	8 bcm rising to 31 bcm by 2020	Azerbaijan; Turkmenistan; Iraq; Egypt (possibly Iran, Kazakhstan and Uzbekistan)	OMV (Austria); MOL (Hungary); Transgaz (Romania); Bulgargaz (Bulgaria); Botas (Turkey); RWE (Germany)
Turkey-Greece-Italy Interconnector (TGI)	Turkey > Greece > Italy	Turkey > Greece: operational Greece > Italy: 2014	11.5 bcm (3.5 bcm to Greece; 8 bcm to Italy)	Azerbaijan; Russia	Botas (Turkey); Desfa (Greece); Edison (Italy); DEPA (Greece)
Trans-Adriatic Pipeline (TAP)	Greece > Albania > Italy	2011	10 bcm	Unknown – possibly Azerbaijan; Russia; Iran	Statoil (Norway); EGS (Switzerland)
South stream	Russia > Bulgaria > Serbia > Hungary > Austria AND/OR Russia. Bulgaria > Greece > Italy	2015 at earliest	31 bcm or 63 bcm if both spurs constructed	Russia (possibly volumes from Central Asian sources)	Gazprom (Russia); ENI (Italy)
White stream	Georgia > Romania via Black Sea	No date	8 bcm to 32 bcm with Caspian sources	Azerbaijan; later phases from Caspian states and Iran	Georgia Ukraine-EU (GUEU) (UK based consortium)
Blue stream I & II	I. Russia – Turkey II. Extended to Bulgaria > Serbia > Croatia > Hungary > Austria	I. Operational II. No date	10 bcm to 2010 16 bcm after 2010 Blue stream II: unknown	Russia	Gazprom (Russia); Botas (Turkey)



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