

CONNECTING CASPIAN GAS TO EUROPE: NO LARGE SCALE INFRASTRUCTURE DEVELOPMENT IN NEAR FUTURE

There is enough natural gas in Caspian region to justify construction of the major pipelines and other elements of infrastructure to connect gas fields in Turkmenistan, Kazakhstan, Uzbekistan and Azerbaijan to Europe. The region can supply aggregate of up to 60 billion cubic meters of natural gas every year, allowing countries of Central and Eastern Europe to reduce their dependency on Russian gas and increase competition and diversity in European markets in general. However, recent political and strategic developments in and around the region, as well as global political and economic realities will not allow implementation of the large scale infrastructure projects any time soon. This article argues that the Southern Gas Corridor will be developing at a slower pace, through small scale interconnector projects such as those connecting Turkey with Greece and Greece with other neighbors.

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A combination of multiple factors contributed to the large scale energy infrastructure development in the Caspian region in the late 1990's and early years of this century. Geopolitical realities favored the Western orientation of oil and gas pipelines from the landlocked region. U.S. sanctions against Iran excluded Iran from the list of the potential export routes for Caspian energy resources. Multiple transit obstacles for Western producers in the region were created by the Russian state-owned energy monopolies, Transneft and Gazprom, and this made the Russian option also unattractive. In addition, there was clear desire by the United States and Europe to help the newly independent states of the former Soviet Union build their own, sovereign economies. As a result, the U.S. and regional countries supported the so called Multiple Pipeline Strategy which envisioned the development of multiple, new commercial pipelines crossing several countries, including Russia. The close collaboration between the United States, Turkey, Azerbaijan, Georgia and Kazakhstan in the process of implementing the Multiple Pipeline Strategy played a crucial role in building strong economic and trade links between Caspian Sea and Black Sea/Mediterranean Sea ports. The construction of major oil and natural gas pipelines between Azerbaijan, Georgia and Turkey solidified the region's dramatic break from the political and energy dominance of Russia. Despite serious ethno-political conflicts, political intimidations from Russia, and structural and institutional weaknesses, the countries of the region initiated world-class infrastructure projects through cooperative efforts that have changed the strategic configuration of the region. Among key factors for the success of this strategy were: 1) Favorable geopolitical and global economic conditions with increasing demand of energy 2) Strategic partnership between Turkey and the United States that allowed strong and coordinated leadership in the process of design and implementation stages of the pipeline strategy 3) Strong personal ties and a common ground for understanding between the regional leaders, Süleyman Demirel of Turkey, Heydar Aliyev of Azerbaijan and Eduard Shevardnadze of Georgia, that paved the way for the development and implementation of a coordinated strategy for energy development in the region 4) Lack of strategic vision in Russia about energy developments in the Caspian, and lack of strategy towards the Caucasus in particular; 5) commercial interest to deliver oil and gas from Azerbaijani fields to world markets. Because the supply and transit countries also wanted these strategic pipelines to be built, they offered BP attractive production and transit terms, which supported BP's already existing commercial interest. Those conditions are no longer in place and context for the energy development in the region is different today, although understanding grows in Europe that something needs to be done to meet growing energy security challenges.

The EU is concerned about declining domestic production and increased dependency on import of natural gas from Russia. Dependency varies from around 30

percent of consumed natural gas in France and Italy, to 40 percent in Germany, and close to 100 percent in most of the Central European and Eastern European countries, since these countries inherited Soviet infrastructure. The Southern Gas Corridor initiative is designed to ensure alternative supplies of natural gas to Europe from the Caspian, potentially from Iraq, and if political developments allow – from Iran. The infrastructure projects that are considered as part of the Southern Corridor initiative include:

Italy-Greece Interconnector- ITGI; this system will utilize a upgraded Turkish natural gas grid, the Interconnection Turkey-Greece (ITG), completed in 2007; and the 807 kilometers Interconnection Greece-Italy (IGI) line, yet to be built, which will have a transport capacity of eight billion bcm per year. The ITGI is currently counting on Azerbaijani natural gas that will flow from the fields operated by the state owned Azerbaijani company SOCAR, as well as the BP and Stat Oil operated Shah-Deniz field.

Nabucco, connecting Turkey with the Austrian natural gas hub Baumgarten, via Bulgaria, Romania, and Hungary; this project is developed by the consortium of six companies: OMV of Austria, MOL of Hungary, Transgaz of Romania, Bulgargaz of Bulgaria, BOTAŞ of Turkey and RWE of Germany. The final investment decision will be made at the end of 2010. If built, the pipeline is expected to be operational by 2015 and it will carry 31 billion cubic meters of natural gas per year. The sources for the pipeline are natural gas from Azerbaijan, Iraq, Turkmenistan, and potentially from other sources in Caspian region. Initial concept of Nabucco was counting on Iranian gas as well, but this source is no longer in consideration in short to medium range time perspective.

Trans-Adriatic Pipeline connecting Greece to Italy via Albania; this pipeline is designed to transport ten to 20 billion cubic meters of natural gas from the Caspian or Middle East via Greece and Albania and across the Adriatic Sea to Italy's southern Puglia region, and then further to Western Europe. The pipeline will have a total length of about 520 kilometers, including 115 kilometers offshore, on the Adriatic Sea bed.

White Stream pipeline, connecting the Georgian port Supsa to the Romanian port Constanta via the Black Sea with an extension to Ukraine, with the planned throughput capacity of 32 billion cubic meters, to be developed in stages, with the first stage development to carry eight bcm.

The Southern Corridor projects could provide the necessary transportation capacity to deliver between 60-100 billion cubic meters per year of Caspian and Central Asian gas to Europe. However, the physical endowment of natural gas

in Turkmenistan, Azerbaijan and Kazakhstan does not mean that natural gas will be available for those pipeline projects in near future. Developments of pipelines are linked to the development of the natural gas fields, and both these issues are linked to the existence of sufficient commercial demand to guarantee funding of the field development and construction of infrastructure.

The Prague declaration of the EU special summit on the Southern Corridor defined key policy directions and priority projects for the implementation of Southern Corridor projects. In the summit the Trans-Caspian natural gas pipeline, which would add Turkmen gas to Azerbaijani gas and supply Nabucco and ITGI pipelines, was supported. The Trans-Caspian-Black Sea Gas Corridor, including the White Stream pipeline was discussed and a feasibility study on the Caspian Development Corporation (CDC), an entity that would focus on Trans-Caspian projects, was called for.

All these projects have attracted political support from the EU, but there are no commercial entities representing the oil and gas industry that would take the lead and implement them. The excessive number of different states involved in these projects also requires very sophisticated and dedicated political and commercial leadership, similar to what we saw during the design and implementation of the “multiple pipeline strategy”, and BTC pipeline in particular. Neither political, nor commercial conditions are present today to demonstrate similar leadership.

New Strategic Realities in the Broader Black Sea/Caspian Region

Several developments have substantially changed the strategic environment in the Black Sea/Caspian region. First of all, Turkey is progressing towards building its own center of strategic gravity around its periphery. This development was long expected considering the uncertainty of European policies towards Turkey’s EU membership. The strained U.S.-Turkey relationship during and after the U.S. invasion of Iraq also encouraged Turkey to search for alternative strategies. Economic ties between Turkey and Russia are deepening, and several large scale energy projects are underway that will further increase the trade turnover –which already reaches 40 billion dollars on annual basis– between these two countries, Interdependency between Turkey and Russia leads to more coordinated foreign policy strategies that are not always in line with the interests of the EU, the U.S., or the smaller and relatively weaker and vulnerable states of the region. As Turkey is no longer willing to act as a security deterrent to Russian power in the region, these regional actors feel greater pressure from the Russian Federation to limit Western interest and presence in the region.

Secondly, the region has been greatly impacted by the new policy of the United States towards Russia. The U.S. strategy towards Russia under President Obama appears directed towards greater engagement and collaboration. Russia's willingness to allow military cargos to be delivered to Afghanistan and Central Asia via its territory is seen as a success of this new US policy. The direct flights over the North Pole from the U.S. to Central Asia may shorten the distance and time of delivery of cargoes. This development is seen as a factor that reduces U.S. interest in the alternative access to the Central Asia via the Caucasus.

Thirdly, the major shift in the strategic picture of the region is the larger and more aggressive Russian military presence in Georgia after the war in August 2008. Russian occupation of Georgian territories, including areas in very close proximity to the capital Tbilisi, creates an oppressive environment, characterized by the constant threat of follow-up military aggression, undermining the stability of entire region. Georgia's limited defense capabilities are no match to Russian power in the region, and the EU monitoring mission has very limited

capability to ensure the security in the areas adjacent to Russian military units. The events of August 2008 demonstrated that Russia is willing to use force against its neighbors, while the West is unprepared to provide active military support to its allies – going so far as to implement a *de facto* arms embargo on Georgia, while supplying Russia with state-of-the-art naval vessels.

Fourthly, new realities are also significantly impacting energy developments and have potential implications for European energy security. Responding to the Turkish delay on a natural gas deal, Azerbaijan has signed an initial agreement with Russia's Gazprom on the sale of 500 million cubic meters of natural gas in 2010, and later adjusted volumes to one billion cubic meters (bcm) for 2010. Gazprom plans to buy two bcm in 2011, or as much as Azerbaijan is ready to supply, thus ensuring that Gazprom's monopoly on supply of natural gas from the Caspian region is maintained.

Another dramatic development in the region with long term consequences is the opening of the two new natural gas pipelines from Turkmenistan: one going East to China, and the other going South, to Iran. The commissioning of these two pipelines substantially diminished the chances for the Trans-Caspian natural gas

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pipeline connecting Turkmenistan to Azerbaijan that was to serve as another key supply source for Nabucco. With existing commitments to Russia and plans to send 30 billion cubic meters of natural gas to China and 20 bcm of gas to Iran, it is difficult to see how an additional pipeline from Turkmenistan across the disputed areas of the Caspian Sea can be justified and commercially supported. The only chance for the Trans-Caspian pipeline to progress will be if the U.S. and/or EU decide to commit public financing to its implementation, but this is hard

to expect in the current financial environment. In addition, problems persist between Azerbaijan and Turkmenistan on demarcation of the Caspian Sea and division of the gas fields, making Trans-Caspian pipeline development even more difficult. On the other hand, the recent decision of the Turkmen government to send a small amount of its oil to markets through the BTC pipeline is a positive development.

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And finally, uncertainty exists about Northern Iraqi gas supplies for Nabucco or other pipelines. Neither Turkey nor the United States will support gas shipment from the Kurdish province of

Iraq to Turkey and beyond unless it is approved by the central Iraqi government. And the process of negotiations are delayed due to problems with the government. After an Iraqi government is in place, it will still take a substantial amount of time for negotiations to bring the project to the point in which it can be considered a source of gas for Nabucco, allowing the commercial development of the pipeline to proceed.

As a result of these and other developments in the region, we are witnessing the weakening of the strategic ties between the Black Sea-Caspian regional actors that have been built for more than decade around the energy and transportation infrastructure. These loosened ties between the regional actors are weakening the security and transportation system that connects the region to the West. The current commitment to soft power on the part of both the EU and the U.S. cannot match the the Russian Federation's assertive political-military and energy policy in the region. Turkey's new regional policy and the downgraded strategic interests of the United States in the region have allowed Russia to have a larger say in regional affairs.

Prospects for Future (Conclusions)

The new political realities are having a profound impact on the development of energy infrastructure in the region and, more importantly, on the prospects of integrating the region in the broader Euro-Atlantic security and economic systems. Facing more assertive Russian pressure, regional leaders are looking for stronger security guarantees before making risky decisions of committing themselves and their countries to a Western vector of energy developments. For example, now having an alternative established towards China, Turkmen leadership has no reason to rush and risk his country's relationship with Russia unless there are strong security guarantees coming from the United States and leading European countries. The same can be said about Azerbaijan, which has a substantial revenue stream from the sale of oil via the BTC pipeline and other outlets. While Azerbaijan is committed to sending at least 16 billion cubic meters of its natural gas to Europe, it has no reason to take any more political or commercial risks for the implementation of large scale development or transportation projects. That initiative should come from the European Union or a consortium of importing countries. In fact, at this point Azerbaijan is the only country in the region that has committed volumes to the infrastructure projects.

In the absence of substantial natural gas volumes being committed to any of the major pipelines of the Southern Corridor project, it is difficult to see how their construction can be commercially justified. That leaves small interconnector pipeline projects, connecting Greece with its neighbors and beyond, to serve as a major shipping channel of Caspian gas from Azerbaijan to Europe. The European Union has some funding available for the development of those interconnectors and, depending on the political will from the Eastern European countries, they can move forward with some of those projects. The positive outcome of this process will be the fact that some volume of Caspian gas will flow to Europe and will improve the energy security situation of several Eastern European countries who can then exchange gas volumes from different sources.¹

The negative side of interconnector development is that it spreads Azerbaijani gas volumes among several small projects and does not allow implementation of any large scale pipeline project. That may leave Europe without major alternative supplies of natural gas for the next decade. That serves Russian Gazprom's interests directly since, in absence of the LNG terminals in most of the Eastern European countries, Russia will be the only major source of gas to cover increased demand.

¹ On September 14 Azerbaijani, Georgian and Romanian presidents and prime minister of Hungary signed an agreement to start feasibility study for Azerbaijan, Georgian, Romania Interconnector, that envisions delivery of gas to port of Kulevi from Azerbaijan, liquefaction and delivery of LNG to Romanian port of Constanta and then after degasification shipment of gas by pipelines to Romanian system and beyond to Hungary. These project also has long way to go due to commercial and technical issues.

In order for the Nabucco or other large-scale pipelines to move forward under current circumstances, a combination of at least three conditions must be in place: 1) Availability of public funding to incentivize commercial entities' interest in pipeline development; 2) Proactive political steps taken to convince Turkmenistan's leadership to move forward with the Trans-Caspian pipeline. That will require strong commitment from both EU and perhaps NATO as well, to guarantee the infrastructure's security; 3) Strong collaboration between all of the transit countries and project sponsors to create commercial incentives, such as tariffs, for the development of the infrastructure.

The probability of such conditions emerging in next few years is small, justifying our assumption that Nabucco, or any other major pipeline will not be built any time soon.