NABUCCO: PIPELINE POLITICS AND THE U.S.-TURKEY STRATEGIC PARTNERSHIP

United States President Barack Obama will visit Turkey in April 2009. On his agenda will be a number of issues of mutual concern between the two NATO allies. One issue that should be placed high on the agenda is the expansion of the East-West energy corridor and Turkey's role in providing the requisite political and commercial security to bring the Nabucco project to fruition. This would not be the first time the U.S. and Turkey played a critical role in energy security. A decade ago, they championed the development of the Baku-Tbilisi-Ceyhan oil pipeline. Today, the strategic partnership should focus on playing such a role again.

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United States President Barack Obama will visit Turkey in April 2009. On his agenda will be a number of foreign policy issues of mutual concern between the two NATO allies. Obama will likely call on Turkey to maintain its substantial contribution towards the stabilization of Afghanistan through the International Security Assistance Force (which Turkey has led twice already), to continue logistical support in Iraq and additional support going forward as U.S. forces draw down, and to remain engaged in the Israel-Syria track for resolution of the status of the Golan Heights.

One issue that should be placed high on the agenda and has already been raised by U.S. Secretary of State Hillary Clinton is the expansion of the East-West energy corridor and Turkey's role in providing the requisite political and commercial security to bring natural gas from the Caspian and Middle East to European markets. Although the U.S. would not benefit directly from this effort, of course, the east-west corridor would bolster the sovereignty and economic development of its allies in Europe, the Caspian, and the Middle East. This would not be the first time the U.S. and Turkey played a critical role in energy security in this part of the world. A decade ago, they championed the development of the Baku-Tbilisi-Ceyhan oil pipeline. Today, the strategic partnership should focus on playing such a role again.

The planned Nabucco pipeline, which would run 3,300 kilometers from Turkey to Austria, passing through Bulgaria, Romania, and Hungary is the linchpin of the East-West energy corridor strategy for natural gas, affecting the fortunes of Turkey and the EU, the newly independent states of the Caspian and Caucasus, as well as future export options for Iraq and, when the political and commercial conditions warrant it, Iran.

Provided Nabucco can secure enough gas, it would go a long way towards reaching many EU energy goals. First, it would contribute to supply diversification. Second, it would reduce natural gas import exposure to Russia for Central European countries, thereby relieving some of the divisions inhibiting unification of EU energy policy. Third, it would strengthen EU bargaining power *vis-à-vis* Russia by presenting a source of supply competition. And lastly, by diverting some Caspian gas supplies to Europe via non-Russian controlled pipelines, it would increase the likelihood that Russia would reinvest in its flagging upstream sector in order to keep export volumes constant.

Turkey, along with many of its neighbors in the EU, recognizes the importance of this pipeline in terms of its commercial and its political value. Yet some states view it with skepticism, narrowly judging the commercial viability of Nabucco against the short-term economics of Russian-backed alternatives. The picture,

however, is far more complex. Nabucco is, at the outset, both a political and commercial project and should be viewed as such. This does not mean that the project lacks commercial viability, only that a necessary precondition to its development is political will, which must come in the form of high-level backing from the U.S., Turkey, the EU and multilateral banks and investment agencies.

Gas Wars

In January 2009, Gazprom, the Russian state-owned gas company with close ties to the Kremlin (President Dmitry Medvedev was formerly chairman of the board and the current Gazprom CEO, Alexi Miller, worked for Prime Minister Vladimir Putin in the St. Petersburg Mayor's office when Putin was mayor), cut gas supplies to Ukraine for the second time since 2006. In what is certainly a dispute mixed with commercial and political considerations in both Moscow and Kiev, customers suffered shortages in 18 countries as a result. Neither the politics of the day in Russia nor Ukraine is entirely to blame. The subject of pricing and supplies goes back to the end of the Soviet Union, when Ukraine inherited much of the Soviet gas industry's critical midstream and storage infrastructure. The two countries have been trying to sort out their energy relationship ever since, regardless of each country's changing political orientations. That legacy of Soviet infrastructure continues today, as Europe receives 80 percent of its Russian gas supplies via pipelines that cross Ukraine.

Russia has certainly used energy as an instrument of foreign policy. For former Communist Republics, the price of gas seems inversely proportional to political proximity to Russia. Declaring itself an "energy superpower", the Russian state, led by Putin, has tried to reassert its writ over territories lost with the dissolution of the Soviet Union. Foreign policy is also used as an instrument of the energy business, with Putin visiting European capitals to personally lobby for access for Gazprom. It is also true that Ukraine is not at the moment a reliable transit state and the stakes are too high to count on it for transit of 80 percent of Europe's gas supplies. Therefore, new direct lines need to be constructed between the EU and Russia and new, non-Russian controlled lines need to be built to import gas from countries besides Russia.

Yet more important than solving the latest installment of what appears to be a perennial conflict, the dispute should serve as a wakeup call in European capitals: it is time to diversify pipeline routes and natural gas suppliers. For the EU, however, the response has been less than unified. For some member states, the mantle of "reliable supplier", long cherished by Russia, has been irreparably damaged. To those states, energy security can only be achieved via non-Russian-controlled natural gas routes. For other states, the issue is one of transit-state

reliability. Ukraine, while it has made substantial progress towards consolidating democratic gains since the Orange Revolution, is beset by corruption and political wrangling over the gas transit industry and its spoils. For these EU states, security comes in direct pipelines from Russia. The proper policy is, however, to pursue both with vigor – diversifying pipeline routes and diversifying natural gas suppliers.

European Energy Woes

The European Union depends on imports for a majority of its natural gas supply. The largest single exporter is Russia, which supplies roughly a quarter of all natural gas used in Europe (Russia also supplies 28 percent of Europe's oil). Yet this statistic is somewhat misleading. Some countries in the EU are dependent on Russia for as much as 100 percent of their natural gas supply, while others import no Russian gas. Consequently, some countries tend to bear the brunt of supply shutoffs far more than others. From 2006-2007, for example, Germany and France relied on Russia for only 36 percent and 20 percent of their natural supplies, respectively, and the United Kingdom did not import any at all. Slovakia, Bulgaria, and the Czech Republic, on the other hand, relied on Russia for 100 percent, 96 percent, and 79 percent of supplies, respectively. This disparity largely cleaves along economic and political power lines, with the more established and powerful EU countries facing less exposure than the newer member states. This should come as no surprise, for just as Ukraine inherited Soviet infrastructure, the former Communist republics are both the newest members of the EU and the states that still rely on Soviet infrastructure for gas deliveries.

The gap in exposure to Russian imports has translated into divergent views as to the level of risk associated with reliance on Russia. Without costly new storage facilities, former Communist satellites see energy security as coming in the form of pipelines not controlled by Russia. For other EU members less reliant on Russia, the construction of direct, high-capacity pipelines with Russia –such as Nord Stream, a 1,200 kilometer pipeline along the seabed of the Baltic Sea from Russia to Germany– would afford greater security by eliminating transit states. Both are right. But the challenge for Europe as a whole, then, lies not simply in shifting away from overall dependency on Russia, but formulating a unified energy market in light of widely divergent import exposures among member states.

Europe's challenges in securing its natural gas supply will not disappear on their own. Still in abundant supply globally and emitting 40 percent less carbon per unit of primary energy content, natural gas is set to play an increasingly central role in powering Europe. Unlike many renewable energies, it can be easily stored.

Infrastructure costs are relatively small and siting permits are easier to obtain than for nuclear power plants. This is not to say that Europe should not pursue alternatives. It should, and with steady financial support. But with Europe's natural gas consumption set to rise 40 percent by 2030, from 550 billion cubic meters (bcm) per annum to 770 bcm (according to the U.S. Energy Information Administration statistics), Europe has little choice but to actively work to secure future supplies.

Although production is being expanded somewhat in Norway, European production looks as though it has peaked or will peak soon, forcing it to rely on imports for an ever increasing share of its natural gas needs, with Russia positioned to provide a plurality of those imports. Yet, it is equally worrying that even if Russia could be counted on to keep politics completely out of the energy trade, years of underinvestment have crippled its ability to meet rising or even steady demand levels from Europe. In fact, this lack of reinvestment has compelled Gazprom to rely increasingly on imports from producing states on its southern borders, which it secures at a deep discount and re-exports to Europe. Russia is also actively buying up capacity in Turkmenistan, agreeing in principle to rates of up to 250 dollars per thousand cubic meters, up from the 65 dollars to 100 dollars Russia paid in 2006. For Russia, this still leaves room for profit, as European customers pay more than 400 dollars per thousand cubic meters. Russia has also recently made an offer to pay rates of up to 360 dollars for gas from Azerbaijan's Shah Deniz field.

Indeed, the construction of major pipeline projects from Russia to Europe, which will increasingly rely on non-Russian supplies for line fill, actually diverts capital from much-needed upstream development in Russia, making long-term supplies less, not more, secure. This is not to argue that Nord Stream, for example, is not a sound investment. Rather, without alternative competing pipelines bringing non-Russian supplies to Europe, customers will run the dual risks of declining Russian production from lack of reinvestment and future price spikes to offset rising prices for Turkmen gas.

Security in Diversity, Security in Turkey

As for diversifying supply, the first step is to support projects that bring non-Russian controlled gas supplies into Europe. This means more imports from North and West Africa and the Caspian and Middle East. For the Caspian and Middle East, Turkey will inevitably play a central role. Supplies from both of these regions must cross the Anatolian land bridge if they are to avoid the shortcomings of Russian and Ukrainian supply and transit challenges. The center of this plan is Nabucco, a high capacity line that would bring supplies from the

Caspian and Middle East into Central Europe. Running from Turkey to Austria, the 3300 kilometer pipeline would have an initial capacity of eight bcm per annum, rising to 31 bcm per annum in the final phase. While this amount would only constitute roughly six percent of European demand, it would constitute 11-13 percent of imports, depending on domestic production levels going forward.

This is not to argue that Nabucco and the diversification of supply is a panacea for addressing a politicized energy trade, declining production in Europe, the leveling off of production in Russia, and increases in demand over the coming decades. Indeed, perhaps more important to EU energy security is the deregulation and integration of the EU energy market, expansion of the writ of the EU Commissioner for Energy, and an insistence on reciprocity from producer states seeking equity stakes in European distribution. With a unified market, energy companies will be able to finance and construct transport and storage infrastructure commensurate with demand and the EU will be able to ensure that supply shortfalls and surpluses are met with the appropriate market mechanisms. With empowered leadership in the energy policy sphere, Brussels will be able to ensure that Europe's companies are on equal footing with Gazprom in the gas distribution business. And with reciprocity in Russia, European companies can do the necessary investment to expand production in those areas where Gazprom has been unable or unwilling to do so on its own. But Nabucco will shore up energy security by providing critical diversity of supply.

Commercial Challenges met with Political Solutions

There are substantial commercial and political hurdles in Nabucco's path. Since Nabucco starts in Turkey, and not at the wellhead of a gas field, supplies must be imported from elsewhere. This raises a number of fundamental commercial issues. First, gas is traded on long-term contracts where producer and consumer lock in prices and volumes far in advance. Producers find more comfort in the long-term contractual relationship, for they rarely have readily available alternative shipping routes from the gas field. The main reason for this is the physical nature of natural gas, which, unlike crude oil, is not fungible and able to be simply placed on tankers and shipped to the highest bidder. Consequently, producers want to know that they have customers and customers want to know that they have a supplier. For pipelines, transportation options are limited by economics, technology, and politics, and with no dedicated producers and few predetermined customers, Nabucco investors will need political reassurances that supplies from the Caspian and Middle East will be forthcoming and a market for those supplies will be waiting at the other end of the pipeline.

Of course, the Nabucco consortium could simply start building the pipeline without supply commitments and fixed customers and expect producers to make supply available once the outlet is provided to them. The notion that a pipeline would "suck" gas from tributary sources is not unreasonable on its face, but given anemic international capital markets, low commodity prices, a looming gas glut caused by multiple LNG projects coming on line this year, and dramatic cuts in Asian demand, financing a multi-billion dollar project without customers and without producers seems like a tall order.

To be successful, Nabucco requires enough short-term commercial viability to get construction of the initial 8 bcm per annum phase off the ground and enough political backing to spur the necessary investments and political alignments to bring the pipeline up to capacity at 31 bcm, a step which should be eased by the existence of Nabucco's spare capacity after it reaches 8 bcm.

With U.S. and EU support, the gap between producer and consumer is not too far to bridge. The region possesses substantial natural gas reserves. Azerbaijan currently holds roughly 1.3 trillion cubic meters (tcm). Turkmenistan may have reserves approaching 20 tcm, although this is according to government estimates and not the work of independent assessors. Kazakhstan is estimated to have as much as 1.9 tcm. Bordering Turkey on the south and southeast, Iraq has 3.2 tcm and Iran upwards of 27 tcm. Additional supplies could be brought in via the Arab Gas Pipeline, which currently runs from Egypt to Syria and could be extended to Turkey.

Azerbaijan is the short-term solution. It has indicated it is willing to commit the 8 bcm Nabucco requires for initial viability and would use the existing route through which it already ships gas to Turkey, the South Caucasus Pipeline (SCP), which runs from the Shah Deniz gas field in the Caspian through Tbilisi to Erzurum in Turkey. This pipeline must be filled to capacity and later expanded to keep up with Nabucco, Georgian and Turkish demand, as well as additional commitments to the Turkey-Greece Pipeline (which will soon continue on to Italy). It is crucial, therefore, that Azerbaijan is able to expand production at the Shah Deniz field, as well as begin investing in associated gas production at the Azeri-Chirag-Güneşli structure (which currently supplies oil to Baku-Tbilisi-Ceyhan) and the Apsheron field, where France's Total has recently signed an exploration and production agreement. If Shah Deniz commitments shipped through SCP are adequate to grant Nabucco its critical initial commercial viability, the prospect of exporting Turkmen gas to Europe should be a driver for completion of the project's final phases. Turkmenistan sits on possibly the world's third largest reserves of natural gas. The U.S. can help here by encouraging Turkmenistan and Azerbaijan to come to a territorial agreement over the Serdar/

Kaypaz offshore gas field in the Caspian and perhaps participating in building a sub-sea pipeline across the Caspian from Turkmenistan to Azerbaijan outright, actions that would increases supplies available to Nabucco. Russia and Iran, however, have proclaimed blanket protests on trans-Caspian pipeline projects on either environmental or legal grounds. The U.S. should adopt the minimalist position of encouraging a final delimitation of the Caspian, but should oppose the notion backed by Iran that it should get an equal share of the Caspian Sea (not the proportional share allotted by international law) and that the Caspian's resources should be developed in condominium by all coastal states. There is a third option for Turkmen gas: building an overland pipeline through Iran. Until there is a final resolution to the Iranian nuclear question, however, this option should not be supported by the U.S. or Turkey.

Turkmenistan is not going to wait forever for Western investors. Russia is actively buying up much of Turkmenistan's export capacity in order to meet increased commitments to Europe (and evidently to lock up most of Turkmenistan's supply capacity so as to deny Nabucco those resources). China is also building a pipeline from Turkmenistan across Uzbekistan and Kazakhstan that will provide 30 bcm per annum, with the first volumes set to be delivered at the end of 2009.

Iran as a source for natural gas is of course the elephant in the room. Many European Nabucco backers believe the project will not have long-term viability without Iran, which possess the world's second-largest proven reserves of natural gas. Iraq, however, has ample natural gas located much closer to the Turkish border and could play the same role as Iran in terms of long-term Nabucco supply. Additionally, investors in the Iranian upstream face problems greater than U.S. opprobrium. Iran has not been able to keep its existing natural gas export commitments to Turkey through the Tabriz-Ankara pipeline. Although it enjoys large reserves, Iran must still import gas from Turkmenistan, in part a function of the fact supply and demand are not co-located – most of Iran's developed natural gas fields are in the south, while most of its demand is in the heavily populated cities of the north. Iran should instead be viewed as a viable over-the-horizon option that should encourage, not discourage, Nabucco's investors but nonetheless be an option tempered by the realities of the Iranian natural gas sector.

Lastly, Iraqi gas could make a substantial contribution to Nabucco in the future. Improved ties between Ankara, Baghdad, and the Kurdistan Regional Government augur well for future development. While Iraq does not produce large volumes of natural gas today, it will likely be a substantial player in the future and should be included in the menu of supply options for Nabucco.

The issue of customers for Nabucco's gas should not be much of a worry. One-third of Nabucco's capacity will be purchased by the states along its route and, with European demand expected to rise to 770 bcm per annum by 2030, the remaining two-thirds could be sold into the European pipeline grid at the end of the pipeline in Austria.

Nonetheless, in light of the substantial challenges concerning supply and demand for Nabucco, it is important to recall the doubt surrounding the viability of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline and the very idea of an East-West energy corridor. The pipeline, which today carries one million barrels per day from Azerbaijan's Caspian territory to the Turkish Mediterranean port of Ceyhan, was not certain to succeed from the start. There were questions about reserve sizes in Azerbaijan as well as transport options from the region (BTC in fact was only one of a number of export options). But the project succeeded because of sustained political leadership in Azerbaijan, Georgia, and Turkey, ingenuity on the part of international energy companies, the backing of key international development banks, and the support of the EU, and the Clinton and Bush administrations. Similar leadership today from the EU, the Obama administration, and Ankara could provide the necessary political security to make Nabucco a commercial and political success.

Turkey at a Turning Point

As the shortest point between the large resources holders in the Middle East and Caspian and resource hungry Europe, Turkey's role as an energy hub is in part a function of geography. Yet Turkey is and should be more than simply a transit state. Turkey provides what Ukraine cannot at the moment: reliability. As a stable NATO ally, emerging market, and parliamentary democracy, it can be counted on to ensure the smooth delivery of resources transiting its territory, much as it already does with BTC and the South Caucasus Pipeline.

For Turkey, the economic dividends are clear. It will collect transit fees, diversify its own energy mix, and perhaps in the future be able to re-export surpluses (such as when heavy rains allow for heavier reliance on hydroelectric power). Equally important, it will expand its critical regional security role in providing safe transport for energy resources from the Middle East and Caspian. The U.S. and the EU should recognize this as a win-win opportunity, allowing its NATO ally to capitalize on its strategic location while creating security in the countries on its border and in its neighborhood.

For energy producers, the advantages of Turkey as a transit state are equally clear. First, Turkey has already proved itself to be a reliable partner. When

producers sell gas to states that themselves produce and export gas, such as when Turkmenistan sells gas to Russia, the transit-producer state purchases gas at a discount and resells it at market prices for export. Since Turkey is not a gas producer, it can allow supplies to transit its territory subject only to a transit fee, since the gas would not be in competition with domestic production.

Turkish officials, however, have indicated they wish to purchase gas at the Turkish border for less than the prices other Nabucco consortium members would pay and be able to store it and –when profitable– re-export at a higher price. This would pose two problems for Nabucco. First, it would force other countries along Nabucco –Bulgaria, Romania, Hungary, and Austria– to build unnecessarily expensive storage facilities of their own to hedge against supply reductions caused by Turkish price arbitrage. Second, it would reduce the price paid to producer states farther upstream. That would mean Azerbaijan in the short-term and perhaps other Caspian and Middle Eastern suppliers in the long run. Given the level of expansion required in the Azerbaijan upstream sector and the amount of new infrastructure necessary to bring gas from Turkmenistan across the Caspian, Turkish insistence on these terms could fatally cripple Nabucco. President Obama should encourage Turkey to participate in Nabucco as other countries do – contracting for the gas it requires and paying market rates. After all, Turkey would still garner transit fees from Nabucco, which it can take either in the form of lift-off or cash. The Russians also seem nonplussed about a similar plan for their gas, so if this insistence stood in the way of Nabucco, it seems that it would also not work with supplies from Russia, which Turkey today depends on for 64 percent of its natural gas consumption. Moreover, if Nabucco fails, Turkey runs the risk of Russia succeeding in its counter-proposal South Stream, a pipeline across the Black Sea to Bulgaria, Serbia, Hungary, and Austria that would bypass not only Ukraine, but Turkey as well, leaving it without transit fees or additional natural gas supplies.

It is important to recognize Turkey's desire to play a larger role than a mere transit state. But a transit state is typically one that moves resources from one particular border and exports them at another, much as Ukraine transits Russian gas to the EU. Turkey, on the other hand, already plays a larger role than that of a mere transit state, importing energy from Russia, Azerbaijan, Iran, and Iraq and playing a key role in regional economic and political stability. The Turkish contribution to Nabucco, which will help spur unification of the EU energy market, will lead to Turkey –if it joins the EU or participates in the EU energy market– to be able to purchase imports at its borders from Iraq, Iran, and elsewhere and trade them on the market Insisting on the right to trade gas destined for Nabucco at this point in time, however, would deal a fatal blow to the project's prospects, leaving Turkey and the EU worse off and perpetuating reliance on Russian gas for both.

Turkey should of course only participate in Nabucco if it is advantageous for Turkey. But it is clear that it is. Nabucco will help provide future energy supplies for domestic consumption, generate substantial transit fees, and contribute to the conditions necessary for unification of energy markets in Europe. Nabucco will allow Turkey to play a bigger role in regional energy diplomacy by keeping open the window to the West for Caspian energy producers, especially Turkmenistan and Azerbaijan. And it will help build stronger relationships in the Middle East by providing viable export options from Iraq and perhaps one day Iran. Lastly, it will provide a critical alternative to reliance on Russia for natural gas supplies, both for Turkey and its allies, and it will have the secondary effect of actually boosting Russian production by spurring reinvestment in the Russian upstream instead of permitting Gazprom to continue to rely on cheap imports from the Caspian and Central Asia.

In policy discussions about energy security, it is sometimes hard to remember that energy deals by Western companies happen only if they make commercial sense, not just political sense. It is of course easy to draw up a map of crisscrossing pipelines and alliances. But privately held companies, for whom the bottom line is delivering value to the shareholders, a project is only worth investing in if the economics are there. For Nabucco, that commercial value will manifest itself so long as the governments of the region –supported by the U.S. and EU– provide the political backing necessary to bring this indispensible project to fruition. The famous expression from the Caspian energy game 15 years ago is as true today as it was then: "Happiness is in multiple pipelines."