The regional game-changers in Energy, Investment and Geopolitics
Content

Overview,
*Mehmet Öğütçü*

REGIONAL GAME-CHANGERS
In Energy, Investment and Geopolitics

Four Prospective Game-Changers in the Geopolitics of Caspian Energ
*John Roberts, Energy Security Specialist, Methinks Ltd*

China’s shadow behind the TAPI pipeline?
*Danila Bochkarev, Senior Fellow, EastWest Institute (Brussels)*

The rise of the gas independents: an answer to Russia’s declining energy influence?
*Danila Bochkarev, Senior Fellow, EastWest Institute*

Creating hope for joint regional upstream development and marketing of Eastern Mediterranean resources: Opportunities and Risks
*Míchal Franco Kedmi, East Med energy consultant*

All change: the Unfolding Geopolitics of Oil and Gas in the US and the Middle East
*Dieter Helm, Professor of Energy Policy at the University of Oxford, Fellow in Economics at New College, Oxford*

Rivalry in the Eastern Mediterranean: The Turkish Dimension
*Mehmet Öğütçü*
Overview

This is a preliminary compilation of some contributions made to The Bosphorus Energy Club. We are grateful for valuable inputs to R. Andreas Kraemer, Charles Bland, Danila Bochkarev, Dieter Helm, Dimitar Bechev, Erik Houleberghs, Filippo Gamba, Ian Walker, Jaroslav Kinach, Jean-Arnold Vinois, John Roberts, Marat Terterov, Michal Franco Kedmi, Mohammad-Mahmoud Ould Mohamedou, Murat Çolakoğlu, Xu Jiaojie, and Tatsuo Masuda. After the Club discussions, a final full White paper will be prepared and distributed to participants.

Mehmet Öğütçü
Top 12 questions we need to address effectively

1. What are the major game-changers in world energy, which will potentially create profound implications for our region?

2. Move towards new energy pricing models: how would this affect competitiveness in the region?

3. Is it economically and politically viable for EU energy markets to move towards greater use of renewables and coal instead of traditional emphasis on natural gas and nuclear?

4. How would Russia’s declining influence and difficulties in natural gas markets evolve over the next decade?

5. How would China’s expanding presence in Central Asia and the Gulf as well as improved prospects for TAPI affect the energy-investment-geopolitics nexus?

6. How far would the Arab Spring go in further transforming the geopolitical, energy and economic scene in the Middle East/ North Africa and Gulf? The impact of unconventional fuels on the region?

7. Would Iran’s normalisation of relations with the West be quicker than expected? If so, what could be its energy, investment and geopolitical implications?

8. Prospects and challenges for increased hydrocarbon exports from Iraq including those from KRG?

9. Is there any realistic hope for joint development and marketing of Eastern Mediterranean resources? What kind of creative mechanisms could be developed to overcome the political obstacles?

10. How do we factor in climate change, water, environment, and efficiency in our region’s commercial and political energy map?

11. Where would the new sources of funding come from for energy investments at a time when the global financial markets are in trouble and there are many competing projects across the world?

12. Can Turkey become a genuine regional hub for energy flows from Russia, Caspian/Central Asia, Iraq/KRG, Iran, and East Mediterranean? How?
The game has changed in energy. Its rules and players, too. It is no longer business as usual. This “powershift” many parts of the world have serious implications for the world’s energy as the lifeblood of our global economy is now being reshaped.

The “game-changers” are what we will continue to hear often, particularly in relation to world economy, energy, investment and geopolitics, over the coming decade. They require effective responses and adjustment to existing governance structures, strategies, government policies and business decisions.

**Energy is no longer a simple commodity** – it is an instrument of national security, economic prosperity and competitiveness. It touches upon almost every aspect of state, company, military and human endeavour in our era, generating wealth, power, sustaining levels of modernity, fuelling further industrialization, enhancing competitiveness and economic development. The changing energy landscape and the resulting trade opportunities it affords will continue to provide consumers with more choices, more value, more wealth and more good jobs.

The gravity of the world economy and established balances have also been upset. The combined output of the emerging world accounted for 38 percent of world GDP (at market exchange rates) last year, twice its share in 1990. If GDP is instead measured at purchasing-power parity, emerging economies overtook the developed world in 2008 and are likely to reach 54 percent of world GDP this year.

Almost a quarter of the *Fortune* Global 500 firms come from emerging markets including some of the major international national oil companies such as CNPC, Petronas, Aramco, Petrobras, Gazprom and QatarGas; in 1995 it was only 4 percent. They are also responsible for over half of the global consumption of most commodities, world exports, inflows of foreign direct investment, and energy reserves.

**Two key megatrends will shape our world** out to 2030: demographic patterns, especially increasing young population in developing world, aging population in the OECD world; and growing resource demands which, in the cases of food, energy and water, might lead to scarcities. These trends, which are virtually certain, exist today, but during the next 15-20 years they will gain much greater momentum.

As globalisation lifts millions out of poverty, the demand for energy worldwide will continue to grow, and the world risks ending up with a volatile, “beggar thy neighbour” style of competition between countries to control sources of supply, especially in the developing world, giving rise to conflict and confrontation rather than co-operation and collaboration.

Uncertainties and technological breakthroughs are rocking the foundation of what many believed two decades ago to be a steady roadmap into our energy future. There are also still opportunities for private-sector companies in the traditional oil-exporting countries where the industry is under state monopoly, but generally these will involve cooperation with the state-controlled oil or gas companies.

**What makes the world energy somehow unstable are mostly the “above-the-ground factors”, such as technological breakthroughs, revival of nuclear power, new renewable initiatives, price volatility, emergence of a new Atlantic energy market, massive need for investment, shifting trade flows, resource nationalism, novel forms of IOC vs. NOC relationship, excessive, restrictive energy regulations and policies, fuel-to-fuel competition, rather than the “below-the-ground realities” which seem to be sound and in place.**

In this new world order we face further vulnerabilities such as the ones that occur in the Straits of Hormuz, the Malacca Straits, the East China Sea, the Caspian Sea, the KRG vs. Baghdad, and the Eastern Mediterranean as well as the domestic instabilities triggered by the Arab Spring, the Nigerian labour strikes, the attacks in Algeria and the ongoing unrest in Iraq.

It is not only resource-rich countries that are gaining the upper hand in the new energy game. Industrialised importing countries are also resorting to what is called “economic patriotism” to protect their strategic sectors. Regionalism, characterised by ASEAN, APEC, GCC, NAFTA, Shanghai Co-operation Organisation, African Union, is gaining added impetus and substance, thus further eroding the pillars of globalisation.

In such an atmosphere, the lives of everyone will be affected in one way or another - with poor and middle-class consumers in the energy-deficit states experiencing the harshest effects.
It is critical to **strike the right price level in the market.** It should be high enough to guarantee adequate return on investment for oil and gas producers and international investors and low enough to stimulate economic growth in the oil and gas consuming countries. In the new, energy-centric world, the price and availability of oil and gas will continue dominating our lives and power will reside in the hands of those who control its global ownership, financing, production, transportation, and marketing of energy.

The US is enjoying lower oil and gas prices compared to its major competitors. In Europe, gas costs three times as much as in the US, cutting competitiveness for industrial users such as Germany’s BASF, the world’s largest chemical maker, which intends to relocate some of its facilities to the US. US oil prices range between 10 and 20 percent below the Brent crude price.

These **competitive advantages are ushering in a profound change in the US economic position.** Energy intensive industries now potentially have a bigger energy cost advantage when located in the US than the labour cost advantage China holds. Very little energy intensive investment is now taking place in Europe. Henry Hub natural gas prices are now in the $3.50-$4.00 Mbtu range, which is high enough to engender some optimism, but still too low to prompt a rush back to gas, especially when compared with returns on liquids and oil.

Facing new realities of the convergence of gas pricing between the three regions (North America, Europe and Asia Pacific), China found itself in weaker position competing with the rest of the world for gas production and imports. However, prospects we project are encouraging when reviewing the developments of gas sector inside China and its interactions with neighbouring countries and regions.

Investors and entrepreneurs often identify **project funding as the biggest barrier to sustainable energy projects and technologies.** Private banks put heavy conditions for project financing, more often than not higher than the international average, while the government hesitates to offer the necessary support for start-up clean energy projects.

The investment decisions of the major oil- and gas-producing countries are of crucial importance, as they will increasingly affect the volume and cost of imports in the consuming countries. To meet this rising demand, huge amount of investment (to the tune of $37 trillion between now and 2035) are needed. This immense investment will not happen without a significant improvement of institutional framework, and effective partnership.

**Money was never cheaper** and more readily available than today, globally speaking. The challenge is to make renewable energy projects “bankable”, which requires stable policy frameworks and, especially, feed-in tariffs. The risks overhanging the fossil energy sectors are going to increase. Subsidy supports are not expected to fall below today’s levels before 2035 at the earliest and could continue at high levels through to 2050. These costs need to be weighed against the wider benefits to the macro-economy and society.

East Asia now accounts for over 57 percent of all the Gulf Co-operation Council (GCC)’s external trade, supplanting falling trade volumes from Western countries. East Asia and India are already considerably dependent upon the GCC for their oil and natural gas needs. Strong economic growth in the region will ensure that this hydrocarbon dependency increases, creating the potential for a gradual geopolitical shift on the part of the GCC member countries towards East Asia and away from the West.

The traditional **concept of energy security has evolved** with a particular focus on the challenges of the 21st century in which the global shift to a complex system of energy mix play significant roles. The narrow understanding of energy security (based on amount, price, location, and time) is then transformed to a broader understanding (with environmental and societal concerns).

In this context, the pattern of the international petroleum sector is under serious transformation due to the emergence of new powers, such as China, or old players being equipped with new powers, such as Russia, Central Asian countries and the Gulf States. The shift of petroleum market accompanies the shift of power and the mechanism of rebalance needed, and new partnerships established among players. These major consumers and producers are interacting with each other, taking active measures to conduct energy diplomacy, establishing new strategic partnerships with a view to changing rules in a way that will better serve their national interests.

The **expansion of government-owned companies** from hydrocarbon importing developing countries such as China and India into oil and gas exploration activities on a global scale is gaining added momentum. Seven major state controlled energy corporations (i.e. Saudi Aramco, Gazprom, PDVSA, China’s CNPC, Iran’s NIOC, Petrobras of Brazil and Petronas of Malaysia) presently control over 30 percent of the global oil and gas production and over 30 percent of reserves, while. ExxonMobil, BP, Chevron and Shell now control just 10 percent of production and 3 percent of reserves.
“Energy democracy” has gained ground. The public worldwide has taken a strong interest in how their energy future will be shaped, as they are likely to be affected seriously from the climate change, local pollution, high-energy prices, energy poverty, and geopolitical conflicts. Indeed, the impact of the Fukushima nuclear disaster is vivid, and has multiple dimensions. It has awakened the Japanese general public to energy issues for the first time since the oil shocks of the 1970s.

People have started to think that energy policy should not to be left only in the hands of a small number of people, those in the government and relevant energy sectors. This phenomenon could be called “energy democracy”. Today, even in China, the “energy democracy” works. The Beijing leaders feel the need to take into account the local protests on heavily polluting fuels, nuclear power plants, fuel price hikes, and low carbon/cleaner energy.

The Arctic region is widely believed to hold the Earth’s sole remaining significant deposit of untapped hydrocarbon reserves. Furthermore, given the rapid thinning of the Arctic shelf due to climate change (easing access to the Arctic’s hydrocarbon ‘riches’), competition over the region is becoming fiercer. The region is slowly emerging as a geopolitical flashpoint. The stakes are high in the region, with Russia, Canada, the US, Norway and Denmark jostling for what they regard as their sovereign piece of the Arctic pie. True to its Petrostate form, Russia is leading the Arctic carve-up, with firm rhetoric proclaiming its ownership of the region.

The real game-changer in this new age is the rising gas production in North America from shale basins, which is transforming the global gas market. The “shale gale” sweeping across North America the past few years has more than doubled the size of the discovered natural gas resource in North America - enough to satisfy more than 100 years of consumption at current rates.

Although the future of shale revolution is full of “unknowns” such as the possibility of global replication and the environmental impact, the share of natural gas in the energy mix changes the US energy picture fundamentally— and the global energy scene significantly. In a striking turn of events unforeseen just a few years ago, the US could surpass Saudi Arabia as the world’s biggest oil producer in 2017, and it could eclipse Russia as the world’s largest natural-gas producer by 2015.

Rising US natural-gas output and falling natural-gas prices have put severe downward price pressure on wind and solar power. In the long term, that pressure could help these variable energy sources, both because it forces them to become more cost-efficient and because it provides lower-priced gas as backup when the wind doesn’t blow and the sun doesn’t shine. But in the short term, cheap oil and gas is stymieing alternative-energy sources.

Hence, although the US success story has inspired many other countries, including China, Argentina, Poland, South Africa and the UK, to develop their own reserves, no country other than the US has as yet what could be termed a shale gas industry. Gas production from tight oil and shale plays is still negligible outside the US. Most production increases will only come after 2020, as countries need time to develop the commercial unconventional gas sector due to various geological, technological, logistical and regulatory challenges.

Another development that has and is transforming the landscape of the natural gas industry is the advent of Liquefied Natural Gas. Pipelines are expensive and once built indefinitely bind producers and consumers while LNG allows both exporting and importing countries to escape this form of captivity. This understandably has both commercial as well as geopolitical consequences. The approval process for shale LNG is essentially automatic for exports to countries that have a free trade agreement with the US.

These implications range from higher energy investment to the domestic impact of lower energy costs (i.e. on manufacturing), as well as the cross-border implications of these developments for countries in the region. Cheaper domestic energy could contribute to spurring a “manufacturing renaissance” in the US and the NAFTA region.

Keen on diversifying gas supplies away from Russia, the EU is hopeful a Transatlantic Trade and investment Partnership with the US will soften the regulatory approval process needed for American LNG cargoes to be sent to Europe. Under the US Natural Gas Act, LNG exporters must seek approval from the Department of Energy before sending cargoes abroad.
Some of the new regional “game-changers” in energy include, inter alia, uncertainty over the EU’s future energy policy and resultant loss of competitiveness, Russia’s declining influence and recognition of the need for a new mind-set in its Kremlin-led energy strategy, Iran’s re-emergence soon in the international energy scene, Iraq’s increase in production of oil and gas and the completion of TANAP as the forerunner of the Southern Corridor.

China’s expanding energy presence in Eurasia and MENA/Gulf region, the possible start of hydrocarbon exports of the Kurdistan Regional Government area of Iraq via Turkey, the Gulf region reorientating its oil and natural gas exports away from Western markets towards emerging markets in Asia, and the widening political rift between the US and several Gulf countries are also significant developments.

The prospect of the East Mediterranean gas flowing to Turkey and high-value international markets and Turkmenistan gas being transported through TAPI to Afghanistan, Pakistan and India is still uncertain but, if realised, could represent another game-changer.

Although much has been done in terms of energy conservation, building interconnections, and building up storage, reserves and alternative supplies, there is still no real wholesale pan-European gas market comparable to that in the US. Gas is traded at spot prices in Southern and Western Europe; with a huge divide still separating Europe, both east and west, owing to the absence of adequate cross-border infrastructure. Gas still accounts for about one quarter of the energy mix of the EU28.

Out of the weak foundations created by the internal energy market and the climate change package, the shape of a much better European energy policy is beginning to emerge. The Commission is finally taking infrastructure seriously. Smart grids, smart meters and electric cars have all the makings of an energy transformation.

For years Europe has been at the forefront of the renewable energy revolution, promoting and establishing global rules in this sector. There are signs however that this trend might change. The economic crisis has forced many European countries to reassess their clean energy policies, heavily reliant on substantial, and often-irrational subsidies, that have started to severely bite into the seriously strained European budgets. So far, Spain, the Czech Republic and Bulgaria have decided to retroactively tax renewable energy operators.

Russia’s energy influence has declined recently as a result of global game-changers, Moscow’s inability to effectively and swiftly respond to them and domestic re-positioning of its energy actors. Global economic slowdown, unconventional energy revolution in the U.S. and the emergence of new conventional actors like Qatar have led to the global “gas glut”, diversification of oil and gas supplies, and lowered energy prices, especially in the North American market.

Regardless of the fact if these trends are temporary or not, they have challenged Russia’s dominance in the traditional markets – such as Europe – and complicated Moscow’s expansion to the new markets elsewhere in the world. Both abroad and inside Russia, the key impact has been that Gazprom, Russia’s main “energy arm”, has lost market share.

Russia’s top concern is its vulnerability to fluctuations in the price of energy. With half of the Russian budget coming from energy revenues (of that, 80 percent is from oil and 20 percent from natural gas), the government could be crippled should energy prices fall. The Kremlin has already decreased its budget projections for oil prices to $93 per barrel -- though even at that price, the government is playing a game of chance.

There is a growing understanding among Russian elites of the need for strategic change of the national energy policy. On the one hand, Russia should not exclusively rely on Gazprom as a market expansion agent; on the other hand, access to new markets, especially by the means of LNG cargos, is rightfully perceived as the most efficient export solution.

Two key Russian gas market “independents” - Novatek and Rosneft - last year announced their plans to increase annual gas production to 112 and 100 bcm, respectively, by 2020. Both companies have also conducted aggressive merger and acquisition policies, focused on the extension of their reserves and client base. Overall, the share of “independent” gas production in Russia (oil companies and non-Gazprom producers) increased from 9.6 percent (55.5 bcm) in 2010 to 27 percent (176.2 bcm) in 2012.

The independent gas producers as “unbounded” companies are indeed more “compatible” with the EU Internal Energy Market. They might, therefore, help Russia to re-gain lost market share in Europe. Independents will access new market segments in Europe and Asia, previously inaccessible for Gazprom. Independents’ expansion will also contribute to the federal budget, increase positive competition in the domestic gas market and facilitate implementation of the Russia’s new industrial policy.
The re-shuffling of the major actors will require major shifts in the Russian strategy. **We will soon witness several major changes by the Kremlin, which will drastically change Russia’s energy landscape.** On 15 November 2013, the State Duma partially liberalized natural gas exports, allowing independent gas producers to export LNG to global markets. The relaxation of export control is just a first step – other, more important actions, will follow soon.

Seemingly, Russia is losing its edge against the changing gas market. But this could be changed if innovation and liberalization could be introduced into its monopolized gas sector, especially LNG and relevant infrastructure. President Putin has realized this and will be reacting accordingly. It is too early to jump into any conclusions at this moment about who will be the winners and losers.

Today, China is the most obvious power on the rise. Likely to dethrone the US as the world’s economic superpower over the next two decades if things progress as has been widely predicted. But Beijing is not alone: India and other dynamic Asian economies now boast growth rates that could outstrip those of major Western countries for decades to come. Many in the West are already aware of Asia’s growing strength. This awareness, however, has not yet been translated into preparedness in the form of either effectively challenging or accommodating it.

**China will lead the incremental energy demand growth for many decades to come.** It is one of the biggest traders and investors in energy. It is also emerging as a key geopolitical power to reckon with in our region.

China is on oil and gas shopping spree. **Deep-pocketed Chinese energy firms have started to flex their muscles.** They are snapping up foreign oil and gas companies at an increasing clip. Of the 10 biggest foreign mergers or acquisitions by Chinese companies this year, seven have been in the energy sector. The targets range widely in their geography. The state-owned CNPC has invested almost $10 billion in 2013 in oil and gas fields in Mozambique and Kazakhstan. Another state-owned company, Sinopec, spent $3.1 billion on a 33 percent stake in Apache’s Egypt fields. So far in 2013, over 20 percent of oil and gas deals globally have involved a Chinese firm.

The same trend was on display in 2012, capped by the blockbuster $15 billion purchase of by Canada’s Nexen by China National Offshore Oil Corporation -- a big play for oil sand and shale gas. In recent years, American companies have focused more on the shale gas boom in North America, opening the door for Chinese firms in countries like Iraq, Mozambique and Egypt. But Chinese oil companies have been willing to pick up the slack -- signing deals in which royalties, taxes and other fees typically take 90 percent or more of a firm’s profit.

There are few reasons to think China’s interest in the energy sector will subside. China is the most populous country on earth with 1.3 billion citizens. It already consumes more oil than any other country save the US. And it’s set to soon surpass the United States as the world’s largest oil importer. The country is also rapidly urbanizing, with hundreds of millions of Chinese moving from rural areas to the cities. China is also adding millions of cars to the roads each year, a trend that only adds to demand for oil-based products.

**Central Asia, as the repository of huge gas and oil deposits, is sandwiched between China, Russia and India.** China and India will surely develop in these countries the infrastructures they need to ensure their supply through pipelines, LNG terminals and ports. The question is how the suppliers will use their new wealth and educate their own population. Without strengthening their governance, these countries will be dominated by their customers who have great geopolitical ambitions too. The next round of Chinese investments in Central Asia is likely to focus on comprehensive cooperation approach in order to build up the “New Silk Road Economic Zone” proposed by Chinese President Xi Jinping last summer.

The US and China have been forging a growing bond in combating climate change. President Obama and President Xi made a landmark agreement to work towards reducing hydro fluorocarbons, a potent greenhouse gas. And both countries are leading global investment and development of clean energy. The US invested $30.4 billion and added 16.9 GW of wind and solar capacity in 2012. **China invested $58.4 billion and added 19.2 GW in capacity.**

With only one supplier, depressed European demand and other alternatives available, it is **difficult to speak yet of a genuine Southern “Corridor”**. Its fore-runners, TANAP and TAP, are about to be started with final investment decision to be taken in December 2013. This Corridor is expected to cultivate partners in the Caucasus and Central Asia and bolster their sovereign independence, and perhaps most importantly, curtail Russia’s energy leverage over European NATO allies. Among EU countries, Austria, Bulgaria, the Czech Republic, Estonia, Finland, Latvia, Lithuania, Poland, and Slovakia all depend on Russia for over 60 percent of their gas imports; EU aspirants such as Moldova, Turkey, and Ukraine rely on Russia for over 65 percent of their imports.

Beyond Shah Deniz II gas, **securing additional supplies for the Southern Corridor is crucial.** Turkmenistan’s conventional natural gas supply, the world’s fourth largest, could join the Southern Corridor by constructing a Trans-Caspian Pipeline. However, a combination of inscrutable leadership, geopolitical pressure by Russia, and an investment climate unfriendly to energy majors has hampered progress, and the window for Turkmenistan’s participation in the Southern Corridor may be closing.
A serious challenge to the Shah Deniz gas and the opening of the Southern Corridor is the “shale gas revolution”. Shale gas, in less than five years, is transforming the US from a net importer of natural gas to a net exporter. The shale gas production has led to an international over-supply of gas, and consequently to the decline of natural gas prices. Moreover, the US is investing in new LNG terminals for exporting purposes, mainly to the European markets.

To fulfil the potential of the Southern Corridor, gas from new sources should be mobilised. For now, the only certain source for the Southern route to European markets is Azerbaijan. This has undoubtedly been the most important factor impacting the delay in bringing to life the Southern Corridor, its current smaller than originally envisaged capacity, as well as the bitter competition between rival projects.

Once the connection is completed further sources of supply may start to follow, but that is dependent on the domestic political developments in these potential supplying states (such as Turkmenistan), developments in the region (Iraqi Kurdistan, Cyprus and Israel) and geopolitical changes (Iran), and these all currently remain for the time being distant possibilities.

Iran is an enigma – a country always expected to become a major exporter that became a net importer. For those concerned with the future of international gas trade, it is the perennial “elephant in the room” – a country which could, one day, become a major exporter. Its resource endowment means that Iran can never be ignored in discussions of potential future gas trade, but such discussions need to be tempered both by the history of pipeline and LNG projects which have meant that, since the 1970s, the country has never been more than a marginal player in international gas commerce.

The quick comeback of Iran in world trade may have significant consequences in the region and on oil and gas prices with additional supply to the markets. A more stable region will offer good prospects for everybody but again the normalisation may take time too. As we see at the moment the lifting of sanctions will be very gradual. In addition Iran has very big needs for its large population (close to 80 millions).

If all goes well, the preliminary agreement between Iran and the five permanent members of the UN Security Council plus Germany would ensure the peaceful nature of Iran’s nuclear programme and ultimately reintegrate it into the international community. In doing so, it would not only remove the threat of a debilitating war with Iran and prevent a nuclear arms race in the Middle East and North Africa but also return the Islamic republic to the centre stage of the region’s energy and geo-politics.

It would force regional powers such as Israel and Saudi Arabia to focus on their most immediate issues rather than use the Iranian threat as a distraction, while offering the US the opportunity to revert to its stated policy of pivoting from Europe and the Middle East to Asia.

Nonetheless, Iran’s return to the international community is likely to provide the incentive for it to constructively contribute to ending the bitter civil war in Syria, breaking the stalemate in fragile Lebanon where the Shiite militia Hezbollah plays a dominant role, and furthering efforts to achieve peace between Israelis and Palestinians. That would also take some of the sting out of the region’s dangerous slide into sectarian Sunni-Shiite conflict.

Iran’s incentive to become more cooperative is the fact that the resolution of the nuclear issue would involve acknowledgement of the Islamic republic as a legitimate regional power, one of seven regional players - alongside Turkey, Egypt, Iraq, Saudi Arabia, Israel and Pakistan - that have the ability or economic, military and technological strength to project power. It would also allow Iran to capitalise on the geostrategic gains it has made despite its international isolation. Iran is likely to be further motivated by an easing and ultimate lifting of the sanctions that will allow it to address boiling domestic social and economic discontent.

The Middle East will remain a fundamental energy player, and global energy markets and geopolitics will continue to be dominated by conventional hydrocarbons and traditional energy players. It is true that US preferences for providing energy security abroad can tend to be diminishing, but this is unlikely to result in a strategic retreat in key regions like the Middle East. European policy-makers should not be comforted by the hope that the unconventional revolution will reduce their suppliers’ market power. In any case, conventional supplies will endure at the core of the EU’s energy geopolitics.

As the US demand for GCC natural gas and oil exports wanes thanks to the “shale revolution”, the importance of Asian markets to the region will grow. The US, once the most important market for GCC oil producers, has reduced its total oil imports from 60 percent of total oil consumed in 2005 to 40 percent in 2012. Overall trade between the GCC and East Asia (South Korea, Japan, Taiwan, China) grew from $480 billion in 2008 to $814 billion in 2012, nearly doubling in four years. While the US and the EU together accounted for about 85 percent of trade with the GCC in 1980, this number had shrunk to 21 percent by the end of 2012.
Some projections indicate that up to 90 percent of GCC oil exports could be destined for India and China as these markets mature. Cross-border investment between East Asia (led by Japan, South Korea and China) and the GCC (led by Saudi Arabia and the United Arab Emirates has grown along with rising Asian demand for GCC hydrocarbons, and many investments revolve around energy projects to ensure market access for East Asian countries.

Further evidence of the Gulf’s orientation eastwards is evident in Saudi Arabia and Kuwait’s funneling of investments into refineries located in China, Indonesia, Vietnam and India, where consumption of GCC hydrocarbons and petrochemicals is expected to continue rising.

**The commercial case for selling Eastern Mediterranean gas to Turkey is overwhelming**, both in terms of cash returns and in terms of regional contributions towards development of the Southern Gas Corridor. But while the most coherent commercial logic points in one direction, which is to combine the gas resources of Israel and Cyprus and, at least initially, to process them jointly and to involve Turkey as both customer and conveyor, development in such a manner faces considerable geopolitical obstacles and, indeed, appears blocked by one seemingly insurmountable barrier: the Cyprus question.

Turkish and Israeli interests in a pipeline solution would require such a line to pass through waters that are either Cypriot territorial waters outright or comprise part of the republic's Exclusive Economic Zone. In the latter case, these would, de facto if not de jure, require Cypriot government approval. Such approval cannot be expected in the absence of a general Cyprus settlement.

But the prospect of a two-stage solution, with initial deliveries by pipeline to Turkey followed by longer-term development of LNG, would suit the likely timeline for actual development of Cypriot offshore resources and, if trilateral support were there from the outset, could actually contribute to a Cyprus settlement.

**A settlement could thus help promote several major objectives:** energy cooperation in the Eastern Mediterranean; the enhanced energy security of Europe though further development of the Southern Gas Corridor, and resolution of the Cyprus question. And that, in turn, would vastly transform the atmosphere for any resumption of negotiations for Turkish entry into the European Union.

In these still unsettled powershift, Turkey has the potential to be one of the main beneficiaries of the game-changing developments across the globe in general and in its region in particular in terms of avoiding supply disruptions, easing the burden of high energy prices on its international competitiveness, curbing the current account deficit and enhancing people's purchasing power.

What **Turkey possesses to compensate for its energy supply deficiency is the best geographic position** between the world’s second-largest natural gas market, continental Europe, and the substantial gas reserves of Russia, the Caspian and Black Sea basins, the Middle East/Gulf and the Eastern Mediterranean. Turks are not content only to be a simple “bridge” over which energy flows; they aspire to become a regional “hub”.

The country's inherent geography -- its classic position as a crossroads between East and West, between North and South -- makes it natural choice to become such a regional center for trading in oil, gas and petrochemicals. Yet, being a regional energy hub is not just having pipelines crisscrossing your territory.

For Turkey to function as a regional, trusted hub, it must be able to import enough gas to satisfy both domestic demand and any re-export commitments. It should also liberalise the markets following good international practices, develop an integrated multi-disciplinary energy management system, pursue “soft-power diplomacy” avoiding sharp confrontations, **invest in human capital and technology innovation, build “energy champions” operating like their successful international peers, and put in place right governance structures and sound infrastructure.**
Four Prospective Game-Changers
In the Geopolitics of Caspian Energy

John Roberts, Energy Security Specialist, Methinks Ltd

1. A major fall in energy prices

A collapse in energy prices would be bad for Caspian producers and potentially disastrous for Russia.

Azerbaijan has built up a reserve fund, which, in extremis, it can use to transition into an era of lower energy prices. The fact that so much of its energy development is being handled by commercial companies also means that much of the burden of developing energy resources will fall on the companies, so while the authorities will have less funds available for state funded ventures at home or abroad – or for domestic social and security programmes – they will not have to worry to the same extent about the requirement to use state funds to develop energy projects.

Kazakhstan may have less of a buffer. But the increasing role of Chinese investment should enable it to weather the storm – albeit at the cost of increasing its dependence on Chinese contracts and investments. Some major projects, notably the further development of the Kashagan field, would be cancelled. There would be significant prospects for further unrest at onshore oilfields.

Turkmenistan would face particular problems given that its finances already appear to be on a knife-edge. But since reduced income for Turkmenistan is vastly outweighed by reduced expenditures for China, Beijing’s ability to prop up the Turkmen economy would be improved. Thus the greatest consequence would likely be to cement Chinese control over Turkmenistan.

In all three states, the share of per capita GDP attributable to hydrocarbons is much greater than in Russia. But Russia requires its oil and gas income both to project its influence abroad, not least via such projects as Nordstream and South Stream, but also to buy off key sections of its population: notably the middle classes in the key cities and the various populations of its violence-prone territories in the North Caucasus. A reduction in government income, and thus in government expenditures, would be likely to have enormous political consequences domestically.

Russia has no stabilisation fund and its energy revenues constitute the core of basic government revenues used to provide basic governmental services for a much larger population, 140m, than those of the Caspian producers.

But unless any price collapse was both major and long-lasting, neither Russia nor Turkmenistan can be expected to make any significant change to their domestic hydrocarbon regimes to improve prospects for either new or existing foreign investors in oil and gas development. But in Kazakhstan, there would be at least a prospect of improved conditions for foreign operators whilst in Azerbaijan the pressure would be on companies to maintain or increase production, and might therefore result in the speeding up of new PSAs

2. TANAP doesn’t get built

TANAP faces huge financial problems. They will probably be resolved but, should energy prices start to fall significantly between the FID for Shah Deniz Phase Two (expected on 17 December 2013 and TANAP’s own FID, expected in or around April 2014, then at least some of the prospective partners in Tanap might decide not to take part.

Should that happen, Socar, as majority owner, would still be able to go ahead with the project – so long as it could raise the cash. In the event of a price fall, the availability of the necessary funding (Socar would have to raise at least $5bn on its own account and perhaps several billion more) could not be taken for granted.

Produced for The Bosphorus Energy Club, but the views expressed in this paper do not necessarily represent those of the Club.
The Shah Deniz consortium might have to turn to the Botas-operated Turkish system to provide a connection between SCP and the start of the TAP pipeline at Kipoi on the Turkey-Greece border. The limited volume of spare capacity in the Turkish system, and a probable slow pace of expansion of the system, would severely impact on the Azerbaijani upstream. SD2 would continue, but a further wave of Azerbaijani gas production, which Baku currently hopes will start almost as soon as SD2 reaches full production in or around 2020, would be delayed several years.

3. **Renewal of conflict in the Caucasus**

Reduced income would likely contribute to social unrest in Azerbaijan, and it is quite possible that some elements in the Azerbaijani government might be tempted to divert attention away from this by seeking to focus attention on the key issue uniting almost all the nation: the Armenian occupation of Nagorno Karabakh and surrounding Azerbaijani districts.

Any resumption of the NK conflict would clearly jeopardise the BTC and SCP pipelines which pass so close to the current line of control separating Azerbaijani and Armenian forces. It would also bring Russia into play, since Russia, which sells weapons to both sides, has both a defence agreement with Armenia and is in the process of strengthening economic ties with Armenia.

The issue of whether Russia will be able to ensure the continued separation of Abkhazia and South Ossetia from Georgia may pose a lesser risk to the stability of the region than expected. But the deterioration of Russia's security position in the north Caucasus could well exacerbate tensions further south, not least through the creation of another generation of displaced people/refugees and, just possibly, the establishment of new statelets, or the militarisation of existing statelets, by Russian military units whose direct land links to Russia have been severed.

4. **Iran reforms its hydrocarbon production legislation**

What happens if Iran reforms its internal policies on hydrocarbon development as well as resolving the nuclear issue?

In order to reverse the decline in Iranian oil output and to speed up the relatively slow pace of gas production, it is not enough simply for Tehran to secure a resolution of the nuclear issue and an end to sanctions. At the same time, the Rouhani administration has to implement a major overhaul of Iran's domestic oil and gas production policies. It will have to secure major foreign investment in a way that balances its own deep-seated rejection of production sharing agreements with the desire of international companies to secure agreements based on balancing risk and reward.

There is, just possibly, a way of squaring this circle. While it may be unconstitutional to award concessions – imtiaz, in Farsi – it is not forbidden to award permits – jawaz – for exploration and development. There is an argument that genuine joint ventures for exploration and production activity should not automatically be considered concessions but as permits for specific activities. This would help to boost output from new fields and to retain production in existing fields.

Both concepts share the same underlying rationale: they allow for a significant element of risk and reward, thus encouraging the investor to take great care to pursue the path that best maximises long term revenues from a particular field, rather than simply following the ‘buyback’ roadmap which essentially provides for service contracts that are less attractive to foreign investors since their prime element is the fee per barrel of oil (or cubic metre of gas) produced, with the risk-and-reward element minimised.

If Rouhani's team were to change their policy and start to consider permitting joint ventures between Iranian and foreign firms in which there was real profit sharing on a risk-and-reward basis, then, so long as international sanctions were also being lifted, there would be major consequences. It would prompt both a flood of foreign companies seek real work in Iran and, almost certainly, speed up Iran's hydrocarbon recovery—and thus its exports.
Overview
Lack of access to primary sources of energy, especially natural gas is the key challenges for India and Pakistan, producing an increased frequency of power shortages, and depressing GDP growth by 3 – 4 % per annum.

The situation is particularly challenging in Pakistan where natural gas has traditionally dominated thermal power generation. However, stagnation of domestic production and increased competition for gas from the country's transport sector and producers of fertilizer has led to a considerable decline of the share of gas in the country's electricity production.

This, in turn, increased Pakistan's reliance on fuel oil for electricity generation. The cost of one KWh produced from fuel oil increased by 40 percent, while the cost of one KWh produced from gas for the same period rose only by 8.86 percent. The access to natural gas both at home and abroad is, therefore, becoming a crucial challenge for the country.

There is no shortage of energy resources in this region and major centers of energy consumption in Pakistan and India are in close proximity to the major producers of gas (Iran, Qatar and Turkmenistan). The reality, though, is still shaped by obstacles, which often outweigh the advantages that geography offers. These obstacles should be overcome in the nearest future in order to guarantee adequate energy supply to India and Pakistan and there is a growing hope for a breakthrough deals, especially for the Trans-Afghanistan Pipeline (TAPI).

What is TAPI?
TAPI is a $7.6 billion Asian Development Bank backed project, which will bring 33 billion cubic meters (bcm) of natural gas from Turkmenistan to Pakistan, India via Afghanistan's territory. The pipeline, which is scheduled to be built by 2018, would cover up to 25 percent of Pakistan's energy shortfall and also will help to alleviate the growing energy deficit in northern India.

Recently we witness a significant progress in advancing the TAPI project. In April 2012, Afghanistan, India and Pakistan agreed on a transit fees. India and Pakistan have already signed their bilateral Gas Supply Purchase Agreements with Turkmenistan on 23rd May 2012, while Afghanistan and Turkmenistan concluded a Memorandum of Understanding on “Long Term Cooperation in Gas Sector”. Furthermore, investment road show, held on 9th – 20th September 2012 in London, New York and Singapore were favourably received by key investors and international energy companies.

China’s Energy Interests and TAPI
While there is a certain appetite of investors for TAPI, the precarious security situation in Afghanistan is still a major challenge is preventing TAPI from going forward. China's relationship with Turkmenistan as a major consumer of the country's gas is the second important factor affecting the regional energy landscape, including transit of energy via Afghanistan.

China is the world's largest energy consumer and Chinese energy companies, such as the CNPC, are among top “movers and shakers” in the Central Asia region and all over the world. China is already the largest buyer of Turkmen gas and Ashgabat is Beijing biggest supplier of natural gas. According to BP Statistical Review of World Energy, in 2012 China imported over 21.3 bcm of gas (51.4 % of total imports) from Turkmenistan.

2 Produced for The Bosphorus Energy Club, but the views expressed in this paper do not necessarily represent those of the Club.
The supply gap in China is expected to grow by 10% this year which will force Beijing more gas abroad, especially in Turkmenistan. In January – September 2013, China’s natural gas imports increased by to 38.8 bcm – a 27.3% increase compared to the same period in the previous year. This trend forced Beijing to conclude a new supply agreement with Ashgabat. This September Turkmenistan President Gurbangulì Berdymukhamedov and his Chinese counterpart Xi Jinping agreed on increasing Turkmen gas exports to China from 25 bcm this year to 65 bcm in 2020. This deal will increase Ashgabat’s already important role in Beijing’s energy agenda.

**International Consortium for Galkynysh?**

Though Beijing never publicly voiced concerns regarding TAPI, one can safely assume that it is clearly not in Beijing’s interest to share its access to Turkmenistan’s gas supplies unless China can feel confident that its own rapidly growing energy demand will be adequately met.

Current energy planning in the region heavily depends on China’s vested interests as a very major consumer of Turkmen gas. By comparison, India and Pakistan may be standing last on line for Turkmen gas if a joint consultative process with Turkmenistan, China and other consumers of Turkmen gas does not take place.

It is, therefore, in everybody’s interest to help Turkmenistan to rapidly increase gas production from the super-giant Galkynysh gas field. Despite some difficulties with development of the super-giant Galkynysh gas field, Turkmenistan would have, with an application of the proper investment incentives, enough natural gas for its existing and potential clients.

The increase in Turkmenistan’s natural gas production could be achieved through an international consortium designed to help Turkmenistan increase its gas production, with membership open to all relevant energy companies, especially CNPC and energy enterprises participating in TAPI project.
Global economic slowdown, unconventional energy revolution in the U.S. and emergence of new conventional actors like Qatar led to the global “gas glut”, diversification of oil and gas supplies, and lowered energy prices, especially in the North American market. As a consequence, buyers temporarily got the upper hand in the energy markets.

Regardless of the fact if these trends are temporary, they have already drastically changed the global energy landscape and challenged Russia’s dominance in the traditional markets – such as Europe – and complicated Moscow’s expansion to the new markets elsewhere in the world. Both abroad and inside Russia, the key impact has been that Gazprom, Russia’s main “energy arm”, has lost market share. The story has been similar to when Qatari LNG first started to compete in Europe: traditional pipeline gas suppliers lost market share because of the competitive pricing policy of the newcomers.

There is a growing understanding among Russian elites of the need for strategic change of the national energy policy. On the one hand, there is a quasi-consensus in Moscow that Russia should not exclusively rely on Gazprom as a market expansion agent. On the other hand, access to new markets, especially by the means of LNG cargos, is rightfully perceived as the most efficient export solution. Indeed, global trade in LNG will grow from 330 bcm in 2013 to 650 bcm in 2030. In Europe alone, consumption of LNG will grow from 64 bcm in 2012 to 139 bcm in 2030. Currently, Russia accounts only for 3% of the global LNG trade (or 10 million tons/year). There are, however, plans to increase production to 30 – 40 million tons/year by 2020, but these volumes cannot be solely provided by Gazprom.

In 2012, two key Russian gas market “independents” - Novatek and Rosneft - took important steps to consolidate their position both within Russia and abroad. The two companies have significant ambitions, which look set to alter the dynamics of the domestic and even international gas markets. Novatek and Rosneft last year announced their plans to increase annual gas production to 112 and 100 bcm, respectively, by 2020. Both companies have also conducted aggressive merger and acquisition (M&A) policies, focused on the extension of their reserves and client base. Overall, the share of “independent” gas production in Russia (oil companies and non-Gazprom producers) increased from 9.6% (55.5 bcm) in 2010 to 26.9% (176.2 bcm) in 2012.

**Rosneft.** The nomination of Igor Sechin as Rosneft’s Chief Executive favored the company’s expansion. In 2013, Rosneft finalized the high-profile acquisition of a 100% stake in TNK-BP, which has important gas assets both in Russia (Rospan) and abroad. Rosneft also bought the same year independent gas producer Itera, Alrosa’s gas assets and purchased a 19.6% stake in an important independent gas producer Severenergia. Russia’s largest oil company also managed to expand its presence on the domestic gas market by signing two supply contracts in November 2012. Rosneft will supply InterRAO with 875 bcm during the period 2016-40. The company also signed a supply contract with Fortum and will ‘inherit’ the recent TNK-BP contract with KES Holding. These agreements were followed by other supply deals with the customers in Russia and abroad.

**Novatek.** By November 2013, Russia’s biggest gas independent managed to get consolidate 40.2% of Severenergia (reserves 1.3 tcm, 155 mt of condensate, 699 mt of oil). Other 40.2% is controlled by Novatek’s partner – Gazpromneft. In 2011 Novatek received 4 exploration & production licenses in Yamal, northern Siberia and in 2012 also acquired 49% of NorthGaz (reserves 1.7 billion boe). The company also managed to get into the gas distribution infrastructure. E.g. in 2011, Novatek bought 100% of Mezhregiongas Chelyabinsk and in 2012, majority stake of Gazprom’s Mezhregiongas Kostroma. Russia’s largest gas independent also expanded its supply portfolio. Novatek secured deals to supply utilities E.ON Russia ($8.5 billion worth deal), Mosenergo (27 bcm in 2013-15) and Germany’s EnBW (20 bcm in 2012-22). The company also signed deals with Russia’s largest petrochemical (Sibur, $17 billion worth deal) and potash (Uralkali) companies. Novatek also signed LNG supply deals with Spain’s Gas Natural Fenosa and China’s CNPC.

---

3 Produced for The Bosphorus Energy Club, but the views expressed in this paper do not necessarily represent those of the Club.
This expansion coincided with a set of negative trends for the vertically-integrated companies --in particularly for Gazprom -- in the European Union. Necessity to comply with the host market regulations (3rd Package) complicated access to downstream, unbundling/TPA issue affects Gazprom’s investment in Europe (South Stream, OPAL, Lietuvos Dujos). The EU Commission’s investigation challenges Gazprom’s contract & pricing model. There are even growing concerns in Moscow whether Gazprom is really “welcome” in Europe.

In this context, independents might present a good solution, which will help to at least partially mitigate current negative trends. The independent gas producers, as “unbounded” companies are indeed more “compatible” with the EU Internal Energy Market. They might, therefore, help Russia to re-gain lost market share in Europe. Independents will access new market segments in Europe and Asia, previously inaccessible for Gazprom. Independents’ expansion will also contribute to the federal budget, increase positive competition in the domestic gas market and facilitate implementation of the Russia’s new industrial policy.

The re-shuffling of the major actors will require major shifts in the Russian strategy. We will soon witness several major changes by the Kremlin, which will drastically change Russia’s energy landscape. On 15 November 2013, the State Duma partially liberalized natural gas exports, allowing independent gas producers – Novatek and Rosneft – to export LNG to global markets. The relaxation of export control is just a first step – other, more important actions, will follow soon.
Creating hope for joint regional upstream development and marketing of Eastern Mediterranean resources: Opportunities and Risks

Michal Franco Kedmi, East Med energy consultant

There are a number of examples for energy cooperation in the east Mediterranean area. For example, Israel and Cyprus are already working on the €4 billion power Interconnector, a subsea power cable with a third link to Greece and to the European power grid. This mutual collaboration was formalised last August by a trilateral agreement between Greece, Israel and Cyprus on this matter. Can this sort of collaboration be performed in the oil and gas sector as well? Will the east med countries collaborate to bring East Mediterranean gas to the global and regional markets?

With absence of financial resources in Cyprus, a lack of LNG expertise to establish facility by the Israeli side and with the growing demands in the local markets of Egypt and Turkey - there are plenty of excellent reasons for the East Med countries to cooperate in the gas sector and to create some sort of interdependency in the east med region. Apart from the financial and commercial reasoning for it, such a move can serve as a stabiliser in a region that isn’t famous for its stability in the last couple of years.

In last June the Israeli government adopted its gas exports policy. The amount of gas that was approved by the government for export is sufficient for a two-train LNG project, retaining 60% of Israel’s estimated 900 Billion Cubic Meters (31 Tcf) of reserves. If and when more discoveries would be made it is fair to assume higher export volumes in the future. The remaining question and the most interesting one of all at the moment is how would the gas be commercialised, and would it involve joint regional upstream developments?

It is very possible that such joint regional upstream corporation would materialize. There are a number of possibilities that can be chosen: Setting a pipeline from the Israeli gas reserves of the Leviathan field to Turkey or Egypt or constructing an LNG facility that will enable the gas to be exported to China and the markets in the East through Cyprus or Israel’s EEZ.

A country with a deep interest in regional’s collaboration is Cyprus that wishes to construct an LNG installation at Vassilikos, in southern Cyprus, and to ship the gas to the Asian market. Resources at its Aphrodite field (partnered by American Noble Energy and Israeli Delek) in Block 12 were recently estimated at 5 TCF, a quantity that would make it impossible to justify an LNG facility. Moreover, due to recent financial crises, Cyprus suffers from a low credit rating; the island recently received $13 billion of aid from the EU - which would make it harder to raise finance for local projects. Therefore, Cyprus is keen to establish joint regional upstream corporation in order to guaranteeing sufficient gas volume for a two-train LNG facility, as a way of monetizing both countries’ resources and to enable it to be established until the end of the decade.

According to publications, Cyprus reached out to Israel to try and gain 7BCMA from the Leviathan field in order to enable the LNG option. This potential corporation can lead to another question – will the potential joint-volumes influence Europe dependency on Russian gas? In case the gas will eventually be supplied to the European market rather than to the Asian market it won’t have a significant and material impact on the equation of gas supply to Europe. However, the expected south corridor pipeline from Azerbaijan together with gas supply from the Eastern Mediterranean can have a greater influence on the matter.

Constructing a pipeline to Turkey is another possibility to commercialise the current gas supply from the Eastern Mediterranean. Turkey at the moment receives supply from Russia, Iran and Azerbaijan. Additional supply can be relevant for diversification of its gas sources.

1 Produced for The Bosphorus Energy Club, but the views expressed in this paper do not necessarily represent those of the Club.
Supplying gas to Turkey would give Israel an entry ticket to Europe and can be completed within several years depending on the geopolitical considerations and concessions that would need to be made. Regarding the local Turkish market demand - even though, Turkey can perform as the gateway of Israel to Europe, the Turkish market is a growing market which currently consumes up to 55 BCM of gas a year.

This market by itself could alone absorb Israel’s gas supply. However, the option of supplying gas to the Turkish market includes geopolitical risks as the Russian supplier – Gazprom wishes to keep its European customers and not to enable additional gas supply by rival sources to be underway. Part of the reason is the desire to keep up the gas prices and therefore even in a situation where the Eastern Mediterranean gas supply won't reach the European market; Russia is likely to be against additional gas supply reaching the Turkish market.

An additional option is to commercialise is through Egypt. The growing demand in the local Egyptian market together with the fact that it will be fairly easy to commercialise the gas through the existing LNG facility without additional major investments other than for laying a cross-interconnecting pipeline – makes this option a very attractive one. However, similarly to the other options, – there are some inherent risks such as the need for a bilateral agreement and willingness of the sides to deal with geopolitical and internal politics.

Laying the ground for commercialising the gas is the next step for Israeli supply, which, in the far future, would be joined by the Lebanese supplier. The question of gas supplies in Lebanon would soon be investigated, but for the time being, it still did not grant any licenses and has a long process underway (10 blocks were tendered for proposals – The latest 5 in September. It is likely that despite the growing interests in these blocks eventually only 4 out of the 10 blocks would eventually be granted exploration licenses). Lebanon needs to establish its regulation and its local demand scenario (there are different views, but the estimate is between 2.5 and 5 BCMA) as it’s a preliminarily step before it sets out any sort of policy or regulation.

But for all the challenges Eastern Mediterranean gas monetising has posed, a more macro consideration could further face the monetisation’s wishes.

The Eastern Mediterranean countries (Israel and Cyprus) only have a very narrow window of opportunities to commercialising the gas before it would face increasingly competitive new supplies to Europe set to come online over the next several years. The New LNG supply from Australia and East Africa is expected in 2018-2020. An increased gas supply from the South Corridor; bringing an additional supply of 6 BCMA from the Shah Deniz field (stage 2) in Azerbaijan is expected.

And to add to it all, one needs to consider the expected decline in LNG prices due to the US shale developments. In this scenario, the new Eastern Mediterranean suppliers would find it difficult to compete in the global and maybe even in the regional market unless they will find ways to establish regional collaboration sooner rather than later.
All change: the Unfolding Geopolitics of Oil and Gas in the US and the Middle East\textsuperscript{1}

Dieter Helm

Professor of Energy Policy at the University of Oxford, Fellow in Economics at New College, Oxford

The geopolitics of oil has remained remarkably static for the last 40 years since the Iranian Revolution at the end of the 1970s. The stylized facts have been that the US would have to import ever more oil to meet its ever growing demand, and that the Middle East would increase its dominance. To meet this demand, the US remained committed to keeping the Gulf open, and to support Saudi Arabia as its key ally against the pariah state of Iran.

Partly in the name of this policy, the US has fought three wars – the first and the second wars against Saddam Hussein’s Iraq as well as in Afghanistan – none of which can be regarded as an unbridled success. The first Iraq war left Saddam Hussein in power and sowed the seeds of the next conflict. The second Iraq war played into the hands of Iran, establishing a Shia-led government in southern Iraq.

The reliance on Saudi Arabia worked in keeping output up and prices down for the 1980s and 1990s. It did not however protect the US from the growth of terrorism. The 9/11 attack on the US was carried out mainly by Saudi Arabian nationals. Al Qaeda not only benefitted from Saudi money, but also had Saudi Arabia as its ultimate target.

The established order relied on three related key features: the paramount role of Middle Eastern oil for the west; and the fault lines between Sunni Saudi Arabia and Shiite Iran; and the Iranian-US hostility.

Though the consequences will take decades to work out, it is already apparent that after more than 30 years this order is undergoing profound changes. The coming of US shale oil and gas portends a future in which US has an element of energy independence, and in any event the US demand for oil is falling. It will quite soon no longer need the Middle East in the narrow physical resources sense. The prospect of a gradual thaw in relations between the US and Iran substantively changes the balance of power within the Middle East. For the Saudis this is a frightening new world.

To understand how these fundamental changes may play out, the starting point is the US and its new energy abundance. Section 2 sets out the background. Section 3 then turns to the Middle East, and what the US independence might mean for its role in the region. Section 4 considers how a US-Iran rapprochement might play out both in terms of oil supplies from Iran and Iraq, and also from the perspective of their neighbours. Section 5 traces the impacts on Turkey and the reliance that the Europeans may need to place on its pivotal position for both oil and gas supplies. Section 6 concludes.

1. The new US energy abundance

The US energy position has been transformed in less than a decade. The old assumptions of ever-rising demand and ever-falling supplies of oil have given way to a very different prospect. The US now has amongst the fastest rising oil production in the world, rapid increases in gas production, and falling oil demand. Within a decade it is quite possible that the US will approach an energy balance so that although it will continue to trade oil and gas, it will no longer be a net importer.

\textsuperscript{1}Produced for The Bosphorus Energy Club, but the views expressed in this paper do not necessarily represent those of the Club.
Better still, the US is enjoying lower oil and gas prices compared to its major competitors. US gas prices are around a third to a quarter of those in Europe, and the margin is even bigger when compared to China and Japan. US oil prices range between 10 and 20% below the Brent crude price.

These competitive advantages are ushering in a profound change in the US economic position. Energy intensive industries now potentially have a bigger energy cost advantage when located in the US than the labour cost advantage China holds. Against Europe, US petrochemical industries benefit from a plentiful supply of ethane, whilst Europeans rely on oil-based feedstocks.

The result is re-shoring. Whilst most of the focus is on “leakage” – the relocation of existing businesses – the largest effect comes in terms of new investment. The contrast with Europe is perhaps the strongest. Very little energy intensive investment is now taking place in Europe. The choice of locations, within similar political and legal frameworks, between the US and Europe for new investment is painfully clear to the Europeans.

Re-shoring has a wider context when it comes to US-China competition. When North America is considered as a whole, Mexico has considerably cheaper labour than the US or Canada, a reforming political regime and much lower transport costs because it is a near neighbour. Mexico, like Canada, also brings lots of its own oil and gas as well. Adding together Canada, the US and Mexico’s oil and gas resources, and Mexico’s cheaper labour, and the energy independence of North America becomes ever more apparent as a new “fact” in geopolitical terms.

The good news for the US goes further. Around half of the US trade balance comprises energy imports, pointing towards a significant improvement in the US external deficit. Shale oil and gas have created a significant employment boost and together these factors make for a much more benign macroeconomic outlook.

Finally, the shale gas has had a dramatic impact on US carbon emissions. Whereas the Europeans have been increasing the coal burn (and building new coal-fired power stations) the US has been switching from coal to gas in electricity generation. The result is that, contrary to Europe, and despite European’s economic crisis, it is the US not Europe which has sharply falling carbon emissions. Without much by way of energy or climate policies, the US is on course to meet its emissions reductions targets. Emissions in the major European countries (Germany in particular) are now rising.

2. US foreign policy – gradual withdrawal

US involvement in the Middle East is not solely caused by, or restricted to, its oil and gas interests. But it is very hard to imagine the sheer scale of involvement had oil never been discovered there. US foreign policy in the Middle East reflects its historical vital economic interests in keeping the Straights of Hormuz open and ensuring political stability in the major countries, especially Saudi Arabia.

The US has other interests beyond oil – notably 7 million Israelis. More generally, after the fall of the Ottoman Empire at the end of the First World War, the great games between the world superpowers have been played out in this region – from Nasser’s Egypt and the Suez crisis through to today’s deadly conflict in Syria.

Since the Iranian Revolution at the end of the 1970s, the US has had a torrid time in the Middle East. It was pushed out of Iran, it watched Iraq and Iran fight their war to a stalemate, it had its presence reduced in Saudi Arabia because of religious objections to “infidel” western soldiers, it had to intervene to stop Saddam Hussein taking control of Kuwait and threatening Saudi Arabia, it faced a Middle Eastern inspired terrorist threat from Al Qaeda across the region including Lebanon and in the terrible events of 9/11 in the US, it fought in Afghanistan, and then it took on Iraq.

With such a history, it is not surprising that the US has started to retreat from its role as the Middle Eastern policeman. Whilst not yet isolationist, it is hard to avoid concluding that the US has lost its appetite for further conflicts and has opted for a back seat. This new caution has already been reflected in the Libyan conflict, where the US supported
Britain and France, but was not directly involved, in the hesitancy over Egypt and then the unwillingness to intervene in Syria.

All of these shifts away from intervention would probably have occurred without shale oil and gas. But the prospect of energy independence has given the US many more degrees of freedom, and it is to be envisaged that this process towards a more isolationist foreign policy will probably continue for some time. Oil and gas physical security of supply is now less of a vital national interest and the US’s interest is increasingly a more general desire to maintain orderly world markets.

A prime beneficiary of the US military presence in keeping the sea lanes open is China, which will take more and more of the Middle Eastern oil that once would have gone to the US. This growing Chinese presence may limit US enthusiasm to allow it to free ride on US military forces. Already a “pivot” to the Far East has been indicated for US naval strategy, and the heightening tensions around the South China Seas are increasingly drawing in the US. Japan and the Philippines both benefit from US military protection, and both are increasingly threatened by Chinese territorial claims, backed up by China’s expanding military forces.

The Arab Spring proved difficult for the US government to first understand and then respond to. Would the US stand on the side of democracy and human rights – as in Egypt, when the Muslim Brotherhood won the presidential election – or would the US stand by autocratic regimes such as Saudi Arabia? Saudi Arabia practices politics in ways that could hardly contrast more strongly with the US constitution and its liberal values. Religious repression combined with an absolute monarchy is not compatible with the US attempts to promote democracy in Iraq and Afghanistan, whilst the repression of women is obviously at odds with these values.

In the event that Saudi’s internal security forces were unable to quell internal revolt, it is hard to see how the US could explain the rationale for supporting the incumbent regime against a possible democratically driven revolution. A decade or two ago the US would have had to weigh up the consequences to its economy of failing to act. Now the economic impact would be via the rest of the world economy and especially the negative impacts on China, since US energy dependency on Saudi Arabia is much less.

Even the indirect economic effects may be less than they seem. The US does not trade that much of its economy: most trade is internal between its states. With half that trade in energy, its importance will be further diminished. That does not mean that trade – and the state of the world economy – does not matter to the US, but it does mean that it matters more to Europe and to China.

There is then, perhaps for the first time since the 1950s, the possibility that the US would not regard the propping up of the Saudi regime as a vital national interest, and that therefore the Saudis will need to turn elsewhere for their political underpinning. China is the obvious candidate, and it is likely to fill at least a part of the vacuum as the very large importer of its oil and gas.

3. Iran

For Saudi Arabia, its exposure has just got a whole lot worse. In the face of Saudi (and Israeli) hostility, the US has for months been seeking a reset for the relationship between itself and Iran, which has now borne its initial fruit in the six month holding agreement in Geneva. This provides the basis for a further attempt at a comprehensive rapprochement between Iran, the US and Europe.

Go back before the current geopolitical tectonic plates got set at the end of the 1970s, and prior to that Iran was very much a British and US ally. It was the British who developed the Anglo-Iranian oil company (the forerunner of BP) and, with the 1950s short-lived revolution aside, the Shah was very much in the US camp. In the 1970s, the British considered building a number of nuclear power stations in Iran, and the US provided military and diplomatic protection for the Shah’s regime.
The Iranian Revolution was one of those seismic historic shocks that take a long time to comprehend. It is too early to tell how history will report the Iranian Revolution. We do not yet know whether the Iranian Revolution will have resulted in over 30 years of isolation, followed by a return to normal relations, or will permanently create a theocratic state hostile to both the west and to the Sunnis.

The US-driven embargo on Iranian oil has had a significant impact. It is a smart sanction. Oil production has been cut to around 2.5 mb/d, back to its low in the 1989 during the Iran/Iraq war. It has had to turn to China, India, Japan and South Korea with the US withdrawal from the market, and these countries are all feeling the impact of the US sanctions policies. There is little doubt that the sanctions, combined with internal policies, have helped to bring the Iranian economy to its knees.

Should the thaw turn out to be permanent and if the sanctions were all withdrawn in due course, what would the consequences be? The most obvious ones would be to change the power balance in the Middle East dramatically. The Shias would no longer be the outsiders. Iran and southern Iraq would become much more cooperative with the west, and this would open up big opportunities for economic development.

At the core would be the increase in oil and gas production, and a greater role for international companies in investing in the rehabilitation of existing fields, the development of new resources, and the infrastructure to bring the oil and gas to the world market. The current outputs in Iran and Iraq are both at a low ebb. Both are capable of producing 5 mbd by the end of this decade, and both could eventually build up to as much as 10 mbd. That would mean that there would then be 5 countries at or around 10 mbd – the US, Russia, Saudi Arabia, Iran and Iraq.

As this new output is added (if it is), the question is what would happen to world prices, and the reaction of the other major oil producers. The conventional assumption is that the demand for oil will keep going up, driven by China, India and other developing countries, and that this increase in demand will more than compensate for the increases in output and the low demand growth in the US and Europe. But will it?

As the time horizon pushes out, other factors come into play. The shale oil and gas revolutions are only in their infancies. There is Argentina, China, Algeria, Russia, Ukraine and many other possible locations. Then there are lots of conventional supplies still to come, notably in the Arctic, and East Africa. Technology might dramatically improve the depletion potential of existing wells. A 1% greater depletion of existing wells makes a big difference to world supply. Imagine if the new technologies pushed this to 10%.

Gas may cut into oil markets, particularly in transport. This might be direct substitution, as for example in US trucks, or indirectly via electricity, and eventually electric cars and transport systems. Further still in the future are new electricity generation technologies, notably the prospects for next generation solar. Opening up the light spectrum might massively improve solar efficiency, whilst more materials like graphene and new production techniques like 3D printing may be game changing.

Faced with increased oil and gas production in the near term, and substitution await for oil in the medium to longer term, regimes like Saudi Arabia may conclude that the oil in the ground may not be worth as much in a generation's time. In such circumstances, and faced with the need to keep up revenues to buy off their young and growing populations through public works, they might decide to produce more rather than less. A sharp fall in oil prices cannot be ruled out. At minimum the conventional wisdom of ever-rising prices should be looked at with some skepticism.

4. **Turkey**

It might be thought that shale is a US matter, and the changing relations between the US and Iran is a Middle Eastern political and military issue, with limited implications for Turkey. This is very unlikely to be true. The combination of abundant energy in the US and the thawing of the Iran relationship directly impacts on Turkey. Iran and Iraq are its neighbours, Iran and Saudi Arabia are on opposing sides in Syria, and the Europeans need access to Middle Eastern oil and gas.
Turkey is in the key geographical location and the changing Middle East offers it enormous opportunities. It lies on the northern routes to the European markets. Europeans have relied greatly on the US military and security umbrella to secure its oil and gas supply route from the Gulf. Europe’s supplies from North Africa have been disrupted, especially in respect of Libya.

In gas, the recent failure to promote the Nabucco pipeline has shown the weakness of European diplomatic and economic power. The Russians have effectively seen off the Nabucco pipeline, they have pressurized Ukraine and they have attracted in European companies to the Nord Stream and now the South Stream pipelines. The result is that Europe relies on LNG gas (including Qatar) and Russian pipeline gas for its energy security, eased somewhat by supplies from Norway.

The logic behind Nabucco has not gone away. Whereas it was mainly discussed in respect of Caspian gas supplies, the pipeline opened up the possibility of supplies from northern Iraq and from Iran. Both these options may become much more attractive if the Iranian thaw takes place. Europe could work with Turkey to ensure Iranian gas and Iraqi oil flow north as well as south.

5. Conclusions

The geopolitics of oil and gas are going through one of those once-in-a-generation transitions. The game has changed dramatically. The US position is transformed, and its coming degree of energy independence changes its diplomatic room for maneuver. Add in the thaw of US-Iranian relations, and the Middle East may be moving towards a period of profound political realignment, and potentially higher production.

The consequences of these changes will take a decade or so to play out. But it is already clear that Turkey will both be greatly affected by the changes and have enormous opportunities to benefit as a result. Turkey has the potential to be one of the great energy transit countries of the world. To achieve this outcome will depend not only on politics and economic strategy, but also on the development of the necessary infrastructure. That in turn will require large-scale investment, international agreements on transit and bring with it large scale economic growth and revenue potential.

It is “too early to tell” how this all plays out in anything but outline. But we already know the terrain and the fault lines.
Rivalry in the Eastern Mediterranean: The Turkish Dimension

by Mehmet Öğütçu

Political Context
The discovery of large gas reserves in the eastern Mediterranean in sea areas off the coasts of Israel and Cyprus posed a major challenge to Turkey both in terms of its relations with countries in the region and of its energy policy priorities. These discoveries occurred at a time, 2009-2012, when Turkey’s relations with Israel had sharply deteriorated and when renewed efforts to find a comprehensive solution to the Cyprus problem, under United Nations auspices, failed to produce a breakthrough. At the same time, Turkey’s European Union accession process ran into further obstacles. Turkey’s proclaimed foreign policy goal of “zero problems with neighbors” achieved some early political and commercial successes and led to closer relations with a number of Balkan and Middle Eastern countries but overall did not produce expected results, in part because of the turbulence following the uprisings in Arab states and the disappearance of a number of Ankara’s longstanding interlocutors in the region.2

Turkey’s Energy Policy
Turkey aims to meet growing domestic demand for energy, spurred by economic growth, by developing a multitude of energy routes, in particular the “Southern Corridor” as a transit route for gas from Central Asia, the southern Caucasus, and the Middle East. This is intended to ensure that sufficient supplies reach Turkey itself for its own consumption and that the country becomes an “energy hub” for Europe.3 The government’s main priority is to secure adequate uninterrupted energy supplies for its own citizens and industries at affordable prices. Turkey is expected to use 48-50 billion cubic meters (bcm) of natural gas this year and around 70 bcm by 2020, making it one of the largest natural gas consumers in the world. To strengthen energy security, Turkey seeks to diversify its sources of energy,

1 For an analysis of these resources, see the accompanying papers by Brenda Shaffer, “Oil and Natural Gas Resources in the Eastern Mediterranean: Prospects for Energy Markets and Regional Developments,” and Simon Henderson, “The Case of Israel,” German Marshall Fund, June 2012. See also

2 As eastern Mediterranean’s water temperature rises, Turkey should lead an OSCE-type initiative in the Middle East, Mehmet Öğütçu, Today’s Zaman, June 7, 2012, http://www.todayzaman.com/newsDetail_getNewsById.action?newsId=258386

Turkey insists that the benefits of hydrocarbon production in sea areas off the coast of Cyprus should benefit both communities on the island.

In response to the start of drilling in September 2011 by the U.S. company Noble Energy in Cyprus’s “block 12,” which abuts the large Leviathan field discovered in Israeli waters in 2010, Turkey threatened to send naval vessels into the area and ratified a continental shelf delimitation agreement with northern Cyprus. In November 2011, Turkey concluded a contract with Shell, covering sea areas off the coast of Antalya on Turkey’s Mediterranean coast. This agreement may have been designed, in part, to lock the company into cooperation with Turkey rather than Cyprus. No commercially significant gas finds off the Mediterranean coast of Turkey have yet been found.

In April 2012, Turkey authorized the Turkish Petroleum Company (TPAO) to begin exploration for gas in six sea areas within the EEZ claimed by Cyprus, drawing protests from Nicosia. In May 2012, Cyprus launched a second tender for exploration rights in 11 blocks within its EEZ; Turkey objected to the move and indicated that it would blacklist the companies involved. The same month, Turkey sent jet planes to intercept an unidentified Israeli aircraft, which it claimed had made an incursion into northern Cyprus airspace. Israel uses warplanes and pilotless drones, as well as naval craft, to patrol its offshore natural gas fields. These developments illustrate the risk of escalation arising from rival claims in the eastern Mediterranean.

A New Alignment in the Mediterranean?
Against this background, Israel and Cyprus have stepped up their own cooperation. There has been a series of high level visits over the past year, culminating with the visit of Israel’s Prime Minister Benyamin Netanyahu to the island in February 2012. Israel and Cyprus have signed agree-

---

4 TPAO and Shell signed a Joint Operating Agreement covering offshore Antalya licenses AR/ TPO-XV/4154, AR/TPO-XV/4319 and AR/TPO-XV/4320, on November 23, 2011.
ments on defense cooperation, allowing Israel Defense Force combat planes and ships to utilize Cypriot airspace and territorial waters to protect Cypriot offshore natural gas fields.

In both Israel and Cyprus, there is great interest in the possibility of further developing cooperation in the production and marketing of offshore gas. Among the scenarios put forward are the possibility of exporting gas from the offshore fields of both countries to Europe through a pipeline to connect Cyprus and Crete. Other schemes favor the use of future gas supplies to generate electricity that would be exported to Europe by a new undersea cable to Greece. Such ideas, however, run far ahead of the current stage of exploration and production, and presuppose large investments in infrastructure as well as the will to cooperate. For the moment, the Israeli authorities seem unwilling to transfer responsibility for processing gas from Israel’s offshore fields for electricity generated by the gas to another country.

For Ankara, the development of security and energy cooperation between Israel, Cyprus, and Greece is scarcely welcome. Beyond its different legal claims, Ankara looks askance at the prospect of closer cooperation among three countries that it views, to different degrees, as antagonists. While the notion of a new alignment between Israel, Cyprus, and Greece, with tacit support from Moscow, runs ahead of the realities on the ground, it is a prospect that cuts across a number of the objectives of Turkish foreign and energy policy outlined above. It could also complicate Ankara’s relations with Moscow.

These developments have occurred against the background of general instability in the region following the Arab Spring, the deterioration in Turkish-Israeli relations, the reignition of the Kurdish problem, the escalating Syrian crisis,9 and the euro crisis. The disputes over resources have arisen at a critical time when Turkey has begun flexing its muscles as a regional power. Thus disputes in the eastern Mediterranean are not only about energy discoveries and how countries in the region share them; they form part of a multi-dimensional crisis, linked to conflicting sovereign and political claims among prominent actors.9 Overall deeper lines of division in the eastern Mediterranean between Egypt, Israel, Lebanon, Cyprus, and Turkey would put in jeopardy decades of alliances that have been the cornerstone of regional stability.10

Turkey’s announcement that it would step up its patrols in international waters in the eastern Mediterranean has caused uneasiness in almost all littoral countries including Cyprus, Israel, Lebanon, Egypt, and Syria. The recent competition over the region’s natural resources is fuelled by long-lasting political and religious quarrels including the Arab-Israeli conflict and Turkish-Greek hostility.11 Traditional alliances are being replaced by new partnerships in line with changing perceptions of national interests in each country.

Relations with the United States
The latest gas discoveries in the eastern Mediterranean occurred at a time of change in Turkey’s relations with the United States. After a difficult period, beginning with the breakdown of military cooperation over Iraq in 2003, there has been a marked rapprochement in recent years between the Obama administration and the Turkish governments led by Prime Minister Recep Tayyip Erdoğan. This rapprochement is founded on a number of considerations: close traditional links, their relationship as NATO allies and trading partners, cooperation against terrorism, Turkey’s willingness to host radar facilities as part of NATO’s missile shield, Turkey’s efforts to play a moderating role in North Africa and the Middle East following the uprisings there, Turkey’s front line position in absorbing shocks from Syria, and Prime Minister Erdoğan’s calls, after

8 The upheaval in Syria is now having broader ramifications in a region where major powers are engaged in a wider struggle to redefine their traditional role, and former allies Turkey and Israel are jostling for influence in the eastern Mediterranean in the hope of controlling newly discovered energy resources.
initial hesitation, for the departure of President Bashar Hafez al-Assad.

Prime Minister Erdoğan has today become President Obama’s chief interlocutor with the Muslim world. This development is particularly striking as Turkey’s diplomatic relations with Israel have been reduced to second secretary level amid continuing recriminations, following Operation Cast Lead in Gaza in 2008-2009 and, above all, the Gaza flotilla incident, and as Turkey continues to oppose sanctions against Iran.

The United States is keen to shift responsibilities for maintaining stability to regional powers including Turkey and seeks to prevent further clashes between its two allies, Turkey and Israel. The United States supports the EU’s efforts to diversify Europe’s sources of energy and to reduce dependence on Russia and the Gulf. The export of part of the newly discovered gas reserves in the eastern Mediterranean to Europe, when they come on stream in sufficient quantity, would help achieve this goal. As one U.S. diplomat has observed: ”There are multiple pots of gold out there in the eastern Mediterranean. If equitable solutions are found, everybody, all of the countries and their citizens will gain; and if not, nobody is going to reap the whole benefits and a lot of that gold might just sit out there for a long time.”

Policymakers in Ankara are sensitive to U.S. concerns that brankmanship in the region should be avoided and that efforts should be made to tone down hostile rhetoric. Considering the historical importance of Israel for the United States, the intensity of the U.S.-Israeli political and strategic partnership, and earlier setbacks in U.S.-Turkey relations in recent years, Turkey is cautious about not crossing the threshold beyond which the United States would be forced to choose between it and Israel.

The United States would like to keep the door open to regional approaches to energy cooperation in the eastern Mediterranean involving Turkey, when political circumstances permit. This has encouraged Turkish ministers to speak up in favor of cooperation schemes, with the major proviso that acute political problems, and notably the

The United States is keen to shift responsibilities for maintaining stability to regional powers including Turkey and seeks to prevent further clashes between its two allies, Turkey and Israel.

“apology” standoff with Israel arising from the flotilla incident, be solved first.

The Role of Russia

The discovery of gas resources by Israel and Cyprus may well affect Turkey’s relations with Russia. The Russian government has backed the right of Cyprus to develop the gas fields in its EEZ. In turn, Cyprus has labeled Moscow “a shield against any threats by Turkey.” Moscow has long been on good terms with Cyprus, which is an important channel for portfolio and foreign direct investments in Russia. Novatek, Russia’s second largest gas producer after Gazprom, (which is a minority shareholder in Novatek) was among the companies bidding for exploration licenses in Cyprus’s second tender, which closed in May 2012.

Policymakers in Moscow have no interest in seeing eastern Mediterranean gas, however modest the quantities initially available, and whatever the uncertainties about export prospects, become a potential competitor to Russian gas on European markets. Russia’s maximal goal is to aggregate Cypriot and Israeli offshore gas volumes for transport and reselling via Gazprom on European and international markets. Gazprom recently concluded a preliminary (non-binding) agreement to purchase liquefied gas from Israel’s Leviathan project. These moves form part of a strategy to encourage a global move from oil to gas, thus outflanking Saudi Arabia.

12 http://www.todayszaman.com/newsDetail_getNewsById.action?load=detay&newsid=258386 grows=258386
13 U.S. special envoy for Eurasian energy, Ambassador Richard Morningstar, speaking at the Investment Energy Summit hosted by The Economist in Athens in May 2012
16 Gazprom is also one of the bidders for DEPA, the gas transmission pipelines in mainland Greece. If successful in that bid, Gazprom will strive to increase its intake of Cypriot and Israeli offshore gas, transport it (probably in liquefied form) to mainland Greece, and use DEPA pipelines to re-sell it on European markets.
Turkey’s involvement with Gazprom is such that it would be difficult to blacklist it for cooperating with Cyprus or Israel. At the same time, any show of force by Turkey against Cyprus, when a new round of drilling begins, could leave Ankara and Moscow at odds.

These developments may well affect the close ties between Turkey and Russia that formed part of the “zero problems with neighbors” policy and were even described by some Turkish observers as a “strategic partnership.” This relationship served as a demonstration to those in Europe who were opposed to Turkey’s EU accession process that Ankara had other important options in its external relations. Nonetheless, Russia’s close relations with Israel, Cyprus, and Greece, reflecting the presence of Russian population groups, the involvement of Russian companies in their economies, and, some would add, certain religious affinities, have posed a dilemma for Ankara. It is to be hoped that Turkey’s wish to avoid a confrontation with Russia, together with counsels of prudence from Washington, will discourage further brinkmanship.

Implications

The changing balance of power, the moving alliances between regional actors, the clash of interests among them and the new dynamics of natural gas have created additional risks of conflict in the eastern Mediterranean region. Under these circumstances, Ankara’s immediate priority should be to avoid harsh rhetoric and recourse to military means to express its disapproval of Israeli and Cypriot initiatives in the eastern Mediterranean. As Alon Ben-Meir argues, one of the criteria to test Turkey’s leadership competence is “its capacity to balance its relations with the powers in its diverse neighbourhood without trading one bilateral relation for the other.” Accordingly, Turkey needs to employ soft power with a view to shaping the regional environment along non-confrontational, and where possible, co-operative lines.

Ankara should nurture its close relations with Moscow and Washington in order to persuade Cyprus and Israel to exercise a similar degree of restraint. Given the current preoccupation of the international community with the situations in Syria and Iran, Ankara should ensure that nothing occurs in the eastern Mediterranean that could divert attention from efforts to tackle the crisis in Syria and the Iranian nuclear question.

Without prejudice to an eventual comprehensive solution of the Cyprus problem, Ankara could consider the possibility of moving towards limited interim agreements with Cyprus. Such agreements could provide for arbitration by the International Court of Justice or another body of delimitation disputes. An interim agreement could be sought on the transport of gas from Cyprus’s EEZ to Turkey, partly for sale to Turkey and partly for export to Europe through the Southern Corridor, when this becomes operational. As a confidence-building measure, Cyprus could be invited to further consider the proposal for the establishment of an escrow account to receive gas revenues, to benefit both the Greek Cypriot and the Turkish Cypriot communities.

In the absence of mutually agreed maritime boundaries, the possibility of joint development of offshore energy resources, or at least a more coordinated approach, should be considered without prejudice to respective positions on long-standing political problems. As a further step, the possibility of cooperation between Turkey, Israel, and Cyprus on exploration, production, and transport of gas from the eastern Mediterranean could be explored by third parties.

Considering the current standoff between Turkey and Cyprus, and bitter recriminations over the Gaza flotilla incident, such suggestions may appear unrealistic. However all three parties concerned have an interest in overcoming present difficulties, especially in light of far more pressing problems in the region. The Turkish energy minister, Taner...
Yildiz, has been quoted as saying: “We could easily develop projects for drilling for gas in the eastern Mediterranean including Cyprus and Israel, but they have killed nine of our brothers. Neither oil nor gas is more important than the life of one of our brothers.” While this shows the depth of feeling in Turkey over the Mavi Marmara flotilla affair, it also shows a certain openness to new forms of cooperation when present difficulties have been overcome.

In the short run, Cyprus, Israel, and Turkey need to avoid harsh language and, in particular, to avoid military incidents at sea or in the air that carry the risk of escalation. It is particularly important that the Cyprus EU presidency, beginning on July 1, should not be the occasion for renewed recriminations. Cyprus itself faces a major challenge in handling the responsibilities of the presidency in the midst of the sovereign debt crisis, to which it is particularly exposed. Turkey has shown signs in recent months of taking a low-key approach to the Cyprus presidency. This should be encouraged by the EU and the United States. Turkish representatives have themselves pointed out that Turkey’s most important interactions with the EU are through the European Commission, the European Parliament, the High Representative of the Union for Foreign and Security Affairs, and the European Council President rather than the six-month rotating presidency. Measured steps to de-escalate recent tensions can reduce risks of incidents and improve the investment climate. This should bring closer the day when citizens throughout the region will enjoy the benefits of its newly discovered hydrocarbon wealth.

---

About the Author
Mehmet Öğütçü, Chairman, Global Resources Corporation, U.K., is a former Turkish diplomat who has worked with the IEA, OECD, and British Gas. The views expressed in this paper do not necessarily reflect those of any organization he is associated with. The author is grateful to Melis Öğütçü of Kings’ College, University of London, for research support.

About GMF
The German Marshall Fund of the United States (GMF) is a nonpartisan American public policy and grantmaking institution dedicated to promoting better understanding and cooperation between North America and Europe on transatlantic and global issues. GMF does this by supporting individuals and institutions working in the transatlantic sphere, by convening leaders and members of the policy and business communities, by contributing research and analysis on transatlantic topics, and by providing exchange opportunities to foster renewed commitment to the transatlantic relationship. In addition, GMF supports a number of initiatives to strengthen democracies. Founded in 1972 through a gift from Germany as a permanent memorial to Marshall Plan assistance, GMF maintains a strong presence on both sides of the Atlantic. In addition to its headquarters in Washington, DC, GMF has six offices in Europe: Berlin, Paris, Brussels, Belgrade, Ankara, and Bucharest. GMF also has smaller representations in Bratislava, Turin, and Stockholm.

---
