A Complicated Corridor:

Gas to Europe – it's not just economics

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Abstract

As the deadline of the final decision on the selection of the export route of the Southern Gas Corridor to the European market is approaching, all of the involved parties – companies as well national governments - are fervently hoping that their interests will be rewarded by this strategic decision. Rival and conflicting economic and commercial interests on the part of national majors, in the context of political motivations driving gas producers and sellers as well as the energy policies of consumer countries, make the realization of this project extremely complex. The author examines the complex and thorny questions surrounding the signing of the PSA, completed with the aim of counterbalancing Russian dominance in the region and reducing the energy dependence of South East European and Balkan countries on the Russian monopolist. The current situation demonstrates that the issue of controlling the strategic infrastructure along the value chain is becoming increasingly important, and is leading to an implicit rivalry between the partners of the SD II project in acquiring the majority stake in midstream projects.

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The Southern Gas Corridor project, initiated by the EU to decrease dependence on Russian imported gas, is becoming a critical issue as we move toward the final decision-making process on the evacuation route of the Shah Deniz phase II project (SD II). This project is arguably the most dynamic hydrocarbon investment element not only in the Caspian region but also in the wider European area. There two major issues that contribute to its dynamism: rival and conflicting economic and commercial interests on the part of national majors, in the context of and political motivations driving gas producers and sellers as well as the energy policies of consumer countries.

Both of these aspects must be considered in seeking to determine whether the notion of the Southern Corridor shall make a real contribution to energy security, national security, and well-being of both consumer states in the EU and producer countries, or whether it will fray under the influence of intertwined commercial and political interests of the parties, which make the whole picture extremely complicated.

Complex forces

Several features render this mega project distinct from other similar energy projects underway in the European region, including those being pursued by Russia (such as the various streams - Blue, North and South and others). First of all, there are many players that are directly involved: both states and national majors, each with their own interests and conditions that make the project decision-making process extremely difficult and complicated. It is already a case of "too many cooks". A second issue is the strong role played by external actors in setting the regional agenda. It is a combination of the major powers' regional interests and inevitable external cover that sometimes influences decisions made by internal players. These external forces are the EU, the U.S., Russia and Iran.

The wider picture in terms of the delivery of Azerbaijani gas to European markets and Turkey is also changing. All the interested segments of the strategic Project - the Shah Deniz consortium, midstream consortia such as Transanatolian Pipeline (TANAP), Transadriatic Pipeline, Nabucco West, the EU market with its regulations and terms, Turkey as a transit country – are all implicitly or explicitly pursuing their interests, which are often in conflict.

The starting point along the value chain: Shah Deniz and its partners' interests

A production sharing agreement (PSA) between seven oil companies and the Azerbaijani authorities for the Shah Deniz area of the southern

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Caspian was signed in June 1996 and the field went on-stream in December 2006. Statoil and BP are the biggest shareholders, each with a share of 25.5%. BP has been appointed as operator on behalf of the other PSA Partners and Statoil is Chairman of the Shah Deniz Gas Commercial Committee.[1]

When the agreement was signed, SOCAR did not have the technical, financial or staffing capacity to undertake leadership of the projects and/or to own the strategic majority of the share. Instead, prominent, experienced and financially sound companies were invited to invest, operate and provide technical facilities. This partnership exists between Shah Deniz and the state of Azerbaijan, where it is believed that Shah Deniz Full Field Development has the potential to bring huge benefits to the country through direct investment, creation of jobs, gas and condensate revenues, the application of new technologies and the construction of valuable new infrastructure.

1 *BP in Azerbaijan: Sustainability Report http://www.bp.com/liveassets/bp_internet/globalbp/STAGING/global_assets/downloads/A/Azerbaijan_Sustainability_Report_2010.pdf*

The goal was to provide through these partnerships available, affordable, secure and sustainable Azerbaijani energy to Turkey and Europe, and a new Southern Corridor for gas supply from the Caspian to Europe will be established in the process. The Azerbaijani government secured the "smart and wise Partnerships" that are required to successfully establish this project as a new cornerstone of Caspian gas supply to Europe.

On the other hand, each company and country involved in the Shah Deniz Project had political and strategic interests towards not just Azerbaijan but the region as a whole, in addition to commercial interests. In the 1990s, immediately after gaining independence from the USSR, there were a few years when all the post Soviet countries were extremely volatile and vulnerable in the context of various ethnic conflicts and the residual but strong Russian influence. The region-building process as such had not even begun, and therefore South Caucasus was not a "natural" region like the Nordic, Black Sea, Baltic Sea regions; only today can we identify some elements of region-building processes. There are two main reasons that the South Caucasus was not an obvious region, in the sense that the three states did not have natural grounds for cohesion. First of all, a region building process is usually run through a set of common rules and institutions founded with the consensus of local actors. In the early 1990s, there was no sign of this. Secondly, if we take the local perspective, the Caspian region had very low level of regional integration. Formerly all roads had led to Moscow. Even today, the region has not yet reached the status of a regional entity where integration is based not only on a compatibility of interests but also on common institutions.

On the contrary, the rules, norms, and expectations that were in place were promoted by a regional leader: Russia. Russia has always claimed to prefer "regional solutions to regional problems" (including conflicts, although it is unclear how it is possible

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to find a local solution to such conflicts and keep external players out). While this is clearly desirable for Russia – it helps it maintain its hegemony in the vast area it considers "its near abroad" – it is not at all clear if this is what the countries involved actually want. Caspian states, as a result, had as their primary strategy a goal of counterbalancing Russia, which itself is seeking to counterbalance the U.S. (and the West in general).

The inward-oriented policy of Russia at that time was unacceptable to other regional players, especially Azerbaijan. This was a country that had an ongoing territorial conflict with neighboring Armenia; it was also a country that was sufficiently far-sighted to invite all the international majors to the region to open up the first vast oil and then gas resources of the Caspian. Without the external intervention of western countries and international institutions, Azerbaijan simply would not be able to cope with the repercussions of the Nagorno-Karabakh conflict. The Shah Deniz project will enable the country to further strengthen its position and role as a major hydrocarbon exporter in the region, gaining strategic leverage towards other players.

In a political sense, the project would give the country closer security cooperation with the U.S. and NATO, and with the European countries whose majors were investing millions in the Azerbaijani gas field, and the EU as an organization that could be instrumental in containing Russian (and Iranian) regional influences. Also there was a belief in Baku that Russian pressure was aimed at obtaining blocking stakes in Azerbaijan's energy developments for Russian companies.

Furthermore, the project would strengthen the strategic relationship with Turkey, which traditionally Azerbaijan has sought to maintain, by motivating Ankara's participation in Caspian energy projects. Turkey's greater involvement in the projects would make Ankara more assertive on the regional political scene, which would likely be to Azerbaijan's advantage.

Another important political factor is Azerbaijan's clear strategy of using its growing energy potential towards the resolution of the Nagorno-Karabakh conflict. Baku seeks to use energy projects as platforms through which to win political support, not only from the states through which Azerbaijani gas is transited, but also countries where Baku has non-oil partnerships. Yet the country is still uncertain about the selection of the most commercially viable evacuation route to the European market, leaving the door open for further political bargaining.

External actors. The main political interest of the EU and U.S. in the Shah Deniz project is to counterbalance Russian influence in the Caspian region, as well as to reduce Russia's near monopoly in European pipeline gas imports.

On the other hand, the *EU* interests relate to its view of the region as a part of the wider Black Sea region, which includes a Euro-Asian energy corridor linking Euro-Atlantic countries with Central Asian energy supplies. The EU's main interest in the region in geographical terms starts from the Shah Deniz, to secure the transportation of Turkmen gas via Azerbaijan and Turkey and onward to the European markets. Yet the EU is perfectly aware that the Trans-Caspian prospects are dependent upon the internal actors, namely Azerbaijan and Turkmenistan.

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With regard to *U.S.* regional interests, it seems likely that balancing Russia and preventing any alliance with Iran is the key factor. Turkey is the U.S' traditional ally on such issues. Still, the U.S. will be the most decisive actor for Iran, and it is Washington that will decide how long Iran will be subject to international sanctions. Given that the Iranian state oil company holds 10 percent stake at the SDII project, Washington will remain vigilant in respect to the project, Azerbaijan, and the region. This can be also seen in the increasing attention NATO is paying to energy security in the region.

Turkey has its own ambitions of becoming an energy hub not only regionally but also internationally, as an influential bridge between the hydrocarbons-rich East and the West

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with its lucrative markets. Turkey is attempting to win the stakes in the key midstream projects and infrastructures passing through its territory, in order to exert its influence on all the actors within the project. There are a number of political explanations for this. Firstly, Turkey would have leverage against the EU, which is crucial in the context of the prospect of EU accession. Secondly, Turkey wants to gain leverage over the gas price negotiations with Azerbaijan, in order to get 6 bcm of Azerbaijani gas for a favorable price via the Transanatolian pipeline.

Azerbaijan is also interested in benefiting from the Shah Deniz project in order to keep *Georgia* as a close ally and an important regional partner. Azerbaijan has already helped Georgia minimize its oil and gas dependence on Russia. SOCAR controls the port facilities in the Kulevi harbor, a significant portion of Georgia's gasoline retail network and the Baku-Supsa oil pipeline. There is no doubt that Baku is among the country's top foreign investors and its most important commercial partner. The publicly discussed prospect of SOCAR's purchase of the Georgian portion of the gas pipeline connecting Russia and Armenia is another recent example of the Baku-Tbilisi nexus, which may be interpreted as an explicitly political move against Yerevan.

Of the companies involved, most have a mainly commercial interest in the project – with the possible exception of Russian Lukoil and Iranian NICO. Both are acting as national representatives to monitor and protect national interests.

BP, Statoil, Total are mainly interested in expansion into Eurasia with strong support from their governments, and in strengthening their positions as an energy majors. They realize that nowadays, successful economic relations are the most important way of building and sustaining influence.

BOTAS/TPAO - a minor partner with clear representative of Turkish interests, BOTAS has stakes in all decision-making processes. As outlined above, Turkey's main focus is to become an influential East-West bridge for energy exports. It would be strategic for Turkey to privatize BOTAS, to demonstrate that BOTAS endorses the Energy Charter (and EU regulations, as if the accession process ever gets underway, it would be valuable to have EU legislation in place already).

The midstream value chain: **South Caucasus Pipeline & TANAP**

It is sixteen years since the PSA

on Shah Deniz was signed. Many things have changed, including Azerbaijan's rapid economic development, its ambitions, and their aggressive realization, which have all led to its growing pivotal role in the region. SOCAR, the state-controlled national oil major of the country, is an internationally successful energy company with 79,800 employees.[2] Since 1994, SOCAR has signed 25 major production sharing agreements with consortiums of foreign oil companies[3]. Thanks to its wise energy policy and smart management, the company has positioned Azerbaijan as a strategically important energy player in the Black Sea/Caspian region as well as internationally. SOCAR is capable of coordinating production strength, a well-developed service sector and significant scientific and technical potential. Today the company has strong financial assets to invest in various downstream projects, regionally and beyond. Thanks to its vast financial resources, SOCAR is expanding its investment in strategic projects, which will provide long-term cash inflows from a wide range of countries.

Successfully pursuing the energy strategy established in the 1990s, Azerbaijan has already reached its goal of maximum benefit from oil exports, guaranteeing the flow of petrodollars to the country. The government is now investing this money in the development of the non-oil sector. Oil revenues are projected at roughly USD 103 billion over the thirty-year life of the AIOC. Azerbaijan will see 80% of these revenues[4]. With its oil strategy successfully realized, Azerbaijan has begun to pursue its strategic goals related to gas export policy; it is currently the only country in the region exporting gas to international markets (i.e. Turkey), and so the country has been designated as an "enabler of- and contributor to" the Southern Gas Corridor by the EU.

SOCAR is capable of coordinating production strength, a well-developed service sector and significant scientific and technical potential.

In line with this strategy, Azerbaijan is aiming to become an important and strategic gas exporter country for the EU in the long-term. It is now putting significant effort into establishing a presence at every part of the value chain, from the Shah Deniz field to the European end users.

The PSA on the Shah Deniz Second Phase of development is valid till 2036, and the lifetime of the project is 14 years from now[5]. Until then,

2 *SOCAR is one of most successful energy companies of world – Der Spiegel, http://ann.az/en/?p=57600*

3 *http://new.socar.az/socar/en/company/about-socar/discover-socar*

4 *Caspian Oil Windfalls: Who Will Benefit? By Svetlana Tsalik http://caspianrevenuewatch.org/news/publications/051203.pdf*

5 *BP in Azerbaijan: Sustainability Report http://www.bp.com/liveassets/bp_internet/globalbp/STAGING/global_assets/*

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SOCAR will not be able to change the terms of the contract or change the sharing of assets. However, today, with its rapidly growing financial capabilities and strategic position in the project, it is able to acquire more assets along the value chain. This allows it to control the infrastructure through which its gas will be transported to the market, where the company can also have stakes.

At this stage, Azerbaijan would never sell its gas at the Turkish-European border as a net crude exporter. Gas is a strategic commodity, and by using this asset wisely, SOCAR and the country can gain important geostrategic and financial leverage. The issue of controlling the prospective network is becoming increasingly urgent. Thus one can see the implicit rivalry between Shah Deniz partners, especially SOCAR and BP, over control of the strategic infrastructure. This can be deemed the main reason that BP proposed the South East European Pipeline (SEEP), which would have enable the British major to acquire more assets in the midstream project under advantageous terms. Since SEEP has been dropped from consideration by the Shah Deniz consortium[6] BP has now announced that the company is interested in joining the TAP consortium[7] and having its own stake in the project that won the semi-final of the pipeline contest, and might transport the 10 bcm of Azerbaijani gas to the Italian market in the event that the proposal wins the final.

Returning to the starting point of the value chain of the South Caucasus Pipeline (SCP), SOCAR and Azerbaijan would not be satisfied with only a 10 percent stake in the pipeline. The company is now seeking further assets in the midstream and downstream projects in order to maximize revenues and returns, and to secure greater long-term political and strategic influence in the region.

Not satisfied with the 10 percent stake in the South Caspian Pipeline (SCP), SOCAR State Oil Company of Azerbaijan has begun an initiative to expand the SCP. The proposed system would be scalable up to 60 bcm of Azerbaijani gas, and in the future, include Central Asian gas as well.

There are two reasons that such an initiative was suggested. First, the scalable infrastructure is needed to transport Shah Deniz gas after 2017, and the gas from new discoveries will ensure Azerbaijani gas production

downloads/A/Azerbaijan_Sustainability_Report_2010.pdf

6 http://www.offshore-mag.com/articles/2012/07/shah-deniz-partners-select.html

7 http://www.naturalgaseurope.com/bp-tap-pipeline-partnership reaches 50 bcm/pa after 2025[8]. Yet the huge volume of gas that under some scenarios will be shipped from Turkmenistan once the Trans-Caspian pipeline is built is further reason to launch a new scalable pipeline.

Launching the second SCP would be an excellent opportunity for SOCAR to increase its share in the project, and even to become a majority share operator. With a majority stake in the Caucasus section of the whole value chain, Azerbaijan would be able to operate and control part of the strategic project. Baku has the cash, and is sitting on huge gas reserves; thus financing pipelines like SCP and TANAP is something the country is happy to do.

Here, SOCAR and BP's interests are intertwined. BP is mostly interested in small scale, low fixed infrastructure with minimum investment and maximum short-term returns. Azerbaijan, on the other hand, is interested in scalable projects, considering the gas reserves in the fields that are currently under development. BP has already suggested a 42-inch pipeline, 16 bcm of normal capacity, which can be upgraded to 22 bcm maximum with the compressor stations. This capacity is the same as the current SCP pipeline. This type of expansion would not make a sense, considering the possible volumes of gas that can

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be exported from the region in the future.

A 56-inch pipeline with maximum 60 bcm capacity would be wholly consistent with the TANAP pipeline. In this case, the 56-inch pipeline would run until Georgian territory, at which point would be downsized, due to the mountainous terrain. With the help of two compressor stations in Georgia, the pipeline would be scaled to its maximum capacity after being downsized.

SOCAR and BP should first agree on the capacity and size of the pipeline, and second, on the share allocation. BP would not want to relinquish its favorable position in the projects and accept the minority share, letting SOCAR step in as an operator with all the leverage of controlling the infrastructure.

However, it is highly likely that BP would have no other choice than to agree, given its dependence on Azerbaijani oil and gas. Arguably, BP might want something in return from Baku. That might be new licensing, for the new fields along in addition to what it already has in the Shafag-Asiman field.

8 *http://eurasianenergyanalysis.blogspot.com/2012/06/trans-anatolian-gas-pipeline-strongest.html*

Furthermore, BP has repeatedly stated that Azerbaijan is its priority in the region and that it wants to stay as long as possible. Its lack of penetration into Russia, Turkmenistan and Iraq has lead to its local interest. It is entirely logical to expect that BP will demonstrate a cooperative attitude with SOCAR, since both of them are in the same consortium.

On the other hand, with such a big pipeline, it is perfectly reasonable that it would have an unused capacity, which would be not viable from commercial point of view. For that reason the other possibility could be that SOCAR and BP would go for less controversial option of the expansion and instead choose the *looping* of the pipeline. Both Socar and BP would consider building a parallel nearby small capacity pipeline sharing the same right-of-way and other facilities (especially at pumping or compressor stations) in Georgian territory, and increase the capacity of the pipeline with the help of compressors and additional lines when necessary. In this scenario, the question of timing arises. Can the current SCP handle the volumes of the proposed SD production? If not, then when is expansion needed? If it can, then the Shah Deniz project will not want to pay for the expansion.

TANAP – a strategic game changer?

With the expansion of SCP, Azerbaijan would be able to secure its

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interests in controlling the potential volume of gas from the wellhead till the end users over half of the value chain. However, this arrangement would not satisfy the broader goal of becoming an influential gas exporting country. The Azerbaijani government as an owner of the gas would not want to transport its gas via a pipeline that belongs to a consortium that represents the interests of consumer countries, and to be dependent on an infrastructure where gas producer companies interests are not represented. Similarly, the Shah Deniz consortium shareholders would be aligned with such a strategy and support Baku's initiative to build a dedicated, standalone pipeline, which would deliver huge volumes of Azerbaijani, and in the future Central Asian, gas and thus replace Nabucco East in Turkish territory.

The solution that came with announcement of the Transanatolian pipeline on 17 November 2011 was an inevitable game changer for entire Southern Gas Corridor. As expected, the pipeline would replace the entire Nabucco East on Turkish soil, following its replacement on Azerbaijani and Georgian territory via the expansion of SCP.

In a manner ideal for all parties

In a manner ideal for all parties of the Shah Deniz consortium, TANAP would be regulated by the International law rather than Turkish.

of the Shah Deniz consortium, TANAP would be regulated by the International law rather than Turkish. This would mean that the consortium was not dependent on Turkey for legal matters during the operation of the pipeline.

Contrary to what many experts predicted, the legal regulatory framework of the pipeline was not a problematic issue in the TANAP negotiations. It was, however, the main issue for the BOTAS-SOCAR transit agreement, signed on 25 October, 2011 after two years of negotiations. It has been agreed that the IGA/HGA[9] of TANAP will be based on Swiss law.

It was important for SOCAR to include the terms of transporting 6 bcm of gas for export to the Turkish market via TANAP, and both sides have agreed on these terms. Without this 6 bcm of gas, TANAP is not feasible, as its 56-inch and 32 bcm capacity pipeline will not be economically viable with a startup volume of only 10 bcm.

The transit fee will be charged according to the transit agreement between Azerbaijan and Turkey. The other Shah Deniz shareholders joining the Transanatolian pipeline will pay transit fee according to the transit agreement based on non-discriminatory principles.

TANAP is fully supported by both the Azerbaijani and Turkish governments. It is also supported by the UK, the U.S. and the EU, as well as the TAP and even Nabucco consortiums. BP supports both TANAP and BOTAS Grid based on different approaches. The first is a strategically important and scalable pipeline/trunkline. The second is cheap, regulated by IGA and GTA and secured by a Technical Cooperation Agreement signed by Botas, SOCAR and BP. It is thus a win-win situation. SOCAR may also opt for Botas Grid for early gas delivery to Bulgaria-Romania, rather than SDII.

BP supports both TANAP and BOTAS Grid based on different approaches.

TANAP released a Request for Information and the TANAP Consortium started negotiation with potential new shareholders by releasing a Letter of Intent and a technical information document for BP, Statoil and Total for partnership. Total is an upstream company and so far has not invested in any midstream projects except for SCP. But because TOTAL has a 40%

9 *IGA: Intergovernmental Agreement, HGA: Host Government Agreement*

stake in Azerbaijan's Absheron gas field, it would make sense for it to be interested in securing a share in midstream projects such as TANAP. The same is applicable to BP. BP also holds no stakes in midstream projects, except for SCP and BTC, but its investment in the Shafag-Asiman field is provides incentives for BP to have transportation assets.

It is expected that BOTAS would have 5 percent stake, compared with TPAO's 15 percent. The reason BOTAS would have the minimum stake is that the company would be responsible for transportation of 6 bcm of gas for Turkey via TANAP. SOCAR wants to hold at least 50 percent, but securing this will not be an easy task.[10] The reason for this is that the other members of the Shah Deniz Consortium such as Statoil and Total will also be invited to the project, and in this case BP and Statoil prefer the BOTAS transportation Grid, because there are already signed and robust agreements supporting this low-cost option.

However, there is a completely different approach from the consumer side at the other end of the network on the part of the EU. From the European perspective a free market creates actionable alternatives. According to EU third party access law, a single company cannot own assets of more than 50 percent in the upstream, midstream and downstream projects. It is obvious that due to a monopoly rationale the EU will not give third party exemption to the Shah Deniz Consortium shareholders. Regardless of which evacuation route and pipeline is selected – Italian or South East European (TAP or Nabucco West) - the Shah Deniz consortium shareholders, including SOCAR, BP, Statoil etc cannot own more than a 50 percent stake along the value chain. How much SOCAR and BP will own in terms of assets in the supply chain, to sell gas to possible purchasers, will depend on their total stakes at Shah Deniz SCP and TANAP.

Through TANAP, Turkey is aiming to reduce its dependence on Russian and Iranian gas imports in the future with the additional 6 bcm/pa of gas that TANAP would provide.

If even the Shah Deniz consortium shareholder companies will not have direct access to the end users and distribution network in the market, it would still be profitable, indeed lucrative, for them to sell gas to European gas buyer companies. They will not lose anything because the price in the market is still high enough.

TANAP also holds geopolitical implications for the parties. Following the signing of the agreement between Azerbaijan and Turkey, Russia and

10 *Interviews by the author with senior officials from BOTAS and the Azerbaijani Ministry of Energy*

Iran have indicated concerns over the project. Through TANAP, Turkey is aiming to reduce its dependence on Russian and Iranian gas imports in the future with the additional 6 bcm/pa of gas that TANAP would provide. Turkey is anxious about its rocketing demand for gas, and its energy policy is designed to ensure long-term energy security.

Turkey cannot countenance increasing the gas import volume from Russia and Iran, simply based on the economics of it. Iran sells its gas to Turkey for $585 per thousand cubic meters, which increases Turkey's annual natural gas bill by an extra $800 million. The price of a thousand cubic meters of natural gas is currently $400 in international markets. Moreover, much of the problem in the gas trade between Tehran and Ankara derives from a "take or pay" condition in the contract. After the TANAP agreement was signed, Iran increased the gas price for Turkey from $505 to $585,[11] the highest price Turkey pays.

Russia has also reacted to the deal between the two "brother" countries, and has threatened Ankara that it will not supply additional volumes of gas to Turkey in case of winter emergencies if the latter buys from Azerbaijan. Although Turkey has recently secured a discount for Russian gas, and pays $400,[12] this is the average in the context of the European price standard. The cheapest and most commercially attractive price is the $330 that Turkey pays for Azerbaijani gas. Consequently, Ankara is more interested in increasing the gas export volume from Shah Deniz in long run.

Russia has also reacted on the political level. The recent announcement from Ashgabat in June 2012 that it will take the disputed Kyapaz/Serdar field case to the International Court of Justice and, more importantly, will sue the Azerbaijani officials for their statements on the field, is no coincidence. Russia has political and economic leverage over Ashgabat, and it should not be ruled out that Turkmenistan is acting with Russia's silent consent.

SEE or Italian market: the interests of gas consumer companies and Shah Deniz partners

On 29 June 2012, the Shah Deniz consortium announced that it had selected the Nabucco West project to transport Azerbaijani gas to the South East European markets. Since Nabucco East was replaced by SCP and TANAP, the Nabucco consortium had no choice but to suggest a downsized and abridged version of the project – Nabucco West, which would be significantly cheaper than Nabucco XL and Classic. Apart from

11 http://www.byegm.gov.tr/yabanci-bultenler.aspx?d=15.03.2012&pg=2&ahid=50189&act=3

12 http://www.todayszaman.com/news-270575-turkey-eyes-solution-as-iran-insists-on-unfair-gas-price.html

Big and expensive pipelines with spare capacity are lack commercial appeal as this makes the transportation costs much higher.

the strategic and geopolitical concerns of the Shah Deniz consortium in being dependent on the Nabucco consortium along the entire value chain, another equally important reason that Nabucco Classic fell out of favor was the commercial viability of the project.

Big and expensive pipelines *with spare capacity* are lack commercial appeal as this makes the transportation costs much higher. For instance, according to a basic calculation based on a sales price assumption of U.S. $400/mcm in Austrian destination markets in 2020, the netbacks to Shah Deniz associated with SEEP or Nabucco West are around U.S. $260/mcm, while the netback of Nabucco XL or Classic is much lower, at U.S. $125/mcm. Needles to say, the lower infrastructure tariffs mean better margins for the producer.

The project also had problems on the market end. Because there have been no sale and purchase agreements, the lenders could not finance the project and thus the proposal's guaranteed materialization is still on the table. The partners of the Nabucco consortium blame the dynamic inactivity of the EU. Until now, the EU failed to realize the Trans-Caspian pipeline and demonstrate political support to Azerbaijan and Turkmenistan, without which it is impossible to begin the project.

In addition, the financial weakness of Nabucco consortium became clear, rendering the project even more vulnerable. Firstly, the Hungarian Prime Minister Urban announced in May that the energy major MOL is leaving the consortium because it cannot sustain the capital expenditure in the projects[13]. Following that, the most influential partner of the consortium, RWE, announced that is considering whether "the Nabucco project is meeting its commercial interests."[14] That was a strong message to the Energy Commission that the EU must finally demonstrate concrete support for the project, and that RWE was not willing to continue spending millions on capital expenditures once there was no guarantee that at least the downsized Nabucco West would be selected.

The SDII consortium needed an actionable alternative for bargaining, namely SEEP, otherwise Nabucco was unlikely to give them a good price. The capacity of the Nabucco West pipeline with 48-inch pipeline is designed to be 16 bcm, with possible expansion of up to 20-23 bcm/a[15]. It

13 http://www.naturalgaseurope.com/mol-may-sell-nabucco-stakes

14 http://www.reuters.com/article/2012/05/12/rwe-nabucco-idUSL5E8GC26K20120512

15 http://www.platts.com/weblog/oilblog/2012/07/05/nabucco_is_dead.html

would make sense for SOCAR and other Shah Deniz partners to buy a stake in the project. If they do, then it will be directly linked to a transport deal, as there is no point in SD II having a stake without a transport deal.

The other semi-finalist in the pipeline contest is the TAP project, which would deliver Shah Deniz gas to the Italian market. Both markets are different, and have different values. The South Eastern Europe market is a strategic and important market for Azerbaijan as a producer country, as well as for the Shah Deniz consortium, which will be penetrated by 2017 when SDII comes on stream. At present the gas price in the region is 25 percent higher than the spot price in Austria. This is only possible because other forces are interfering in the free flow of energy throughout the region. The SEE and Balkan region buys nearly all of its gas from a single supplier, and lacks a sufficient number of connections to alternative energy sources. As a result, the supplier has the power to set the price through long-term contracts.

Nabucco Classic planned to supply little or no gas to Bulgaria, and no gas to the nearby countries of Albania, Greece, Montenegro, FYROM, Croatia and Bosnia–Herzegovina. Balkan countries may be small markets but the combination of the small markets entails the diversification of demand and guarantees continuous demand and the off-take of gas.

Nabucco West could be a game changer in terms of the strategic imperative of reducing Gazprom's market share through the diversification of supply to Central European countries. In the Balkans, Russia's Gazprom can intervene and block pipeline access to third parties. This is only possible because the Russian monopolist sets the gas price, and also owns many downstream assets in the region via joint ventures. Caspian natural gas could change the situation in this market, and as such, is vital for the region.

However, while analyzing each of the markets of the countries along the Nabucco West pipeline, one can say that the gas demand in these countries is very low, and alone they will not be able to absorb 10 bcm/a, let alone more. The demand for natural gas in *Bulgaria*, for example, is relatively low - only about 3.4 billion cubic meters (bcm) for 2008. Of this, 0.211 bcm was covered by domestic production, while the rest was imported from the only supplier of natural gas to Bulgaria: Russia[16].

Since the gas supply contract between Bulgaria and Russia is due to expire at the end of this year, according to Minister of Economy, Energy and Tourism Delyan Dobrev, the new gas contract will be signed by the end

16 http://www.naturalgas.bg/en/pages/index/page/in_the_country of this summer[17]. The new contract should be signed for at least six years, until 2018, when Shah Deniz gas will come on stream, and in the event that Nabucco West is selected, would provide some 1 bcm of gas to the Bulgarian market. However, the question is how Bulgaria can obtain a guarantee that the SEE evacuation route will be selected by the Shah Deniz consortium and that it will get its 1 bcm/a via Nabucco West. Moreover, gas supply contracts between Bulgaria and Russia are based on oil directives price formation and "take or pay" principles, which consider long-term contracts for at least 10-15 years. Under which conditions would Russian gas monopolist Gazprom agree to sign mid-term contract with Sofia?

Furthermore, Bulgaria can get its 1 bcm/a early gas from SOCAR (not Shah Deniz gas) starting from 2014[18], in order to reduce its dependence on the single supplier that is now importing 96 percent of its gas. In that case, the BOTAS transportation network would be used on Turkish territory.

Romania is the only self-sufficient country in the region, producing approximately 14 bcm of gas per annum. Its annual gas consumption is about 17-18 bcm and its import dependence on Russia is 20-25 percent, or 3 bcm/pa. The market for Shah Deniz gas is not big, however the long-term risk here is not the size of the market but new discoveries on Romania's Black Sea coast. The new discovery by Exxon Mobile and OMV Neptun is estimated to have deposits of 42 to 84 bcm, or three to six times Romania's annual gas consumption[19]. The deposits are not huge, but big enough to enable Romania to become the region's only energy independent country.

The market for Shah Deniz gas is not big, however the long-term risk here is not the size of the market but new discoveries on Romania's Black Sea coast.

The *Hungarian* market appears to be the biggest one along Nabucco West. Hungary imports around 70% of its natural gas consumption from one supplier, Russia. Parallel to its high dependency on imports, Hungary's domestic production of natural gas has been decreasing continuously. The country's annual gas consumption is 29 bcm and its gas import is 26.3 bcm, while the domestic production is 2.6 bcm/pa[20]. As the country is completely reliant on one supplier, similar to other countries in the region, during the

17 http://www.novinite.com/view_news.php?id=138403

18 http://www.naturalgaseurope.com/socar-beh-sign-gas-mou-6117

19 http://www.euractiv.com/energy/gas-discovery-gives-romania-pros-news-511319

20 http://www.ensec.org/index.php?view=article&catid=114%3Acontent0211&id=278%3Athe-road-to-hungarian-energy-security&tmpl=component&print=1&page=&option=com_content&Itemid=374

It is important for SOCAR and the Shah Deniz consortium to have access to the Balkans.

2009 Russia-Ukraine gas dispute, Hungary was one of the most affected EU countries in terms of supply shortfall. This increases the need to improve Hungary's energy security.

Hungary has ambitions to become an energy hub in Central Europe. Hungary's government owned oil major MOL managed to invest and construct strategic gas storage with the capacity of 1.2 bcm/pa and 20 million cubic meters (mcm) daily withdrawal capacity. The new E.On Földgáz Storage owned by E.ON is also contributing to the energy security of the country in case of emergencies. The earlier 3.4 bcm storage capacity was increased to 4.2 bcm, reaching a 55 mcm daily withdrawal capacity[21].

In order to realize its ambitions, Hungary is planning to build a number of cross-border interconnectors along the Hungarian border within the energy networks project (TEN-E). This would allow Hungary to transit additional volume of gas coming from alternative sources, primarily Shah Deniz to the neighboring countries, thereby increasing its significance as a transit country. This includes new interconnectors between Hungary-Romania, Hungary-Croatia, and Hungary-Slovakia. However, only the Hungary-Romania interconnector is currently operational. The second is under construction, and the third one is under construction. The TEN-E also supported a capacity increase in the existing Ukraine-Hungary and Austria-Hungary interconnectors.

It is important for SOCAR and the Shah Deniz consortium to have access to the Balkans, namely Croatia, Slovakia, FYROM, as well as possible access to the Ukrainian market via a country like Hungary rather than the hub of Baumgartner. The reason for this is that the Shah Deniz partners will have direct access to the consumers and end users, while via interconnectors they would have a chance to directly sell the gas to the customers.

However, the big question here is whether the Hungarian government or MOL would be able to finance the building of all the mentioned connection pipelines, considering that the company was not able to maintain capital expenditure of Nabucco, which was only 3 million euro.

One of the main goals of the Shah Deniz partners is to reach the German market through Baumgartner. Despite strong pipeline infrastructure, significant grid extension is necessary to reach the markets of western

21 http://www.ensec.org/index.php?view=article&catid=114%3Acontent0211&id=278%3Athe-road-to-hungarian-energy-security&tmpl=component&print=1&page=&option=com_content&Itemid=374

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Germany from Baumgartner. Routes from Baumgartner to Germany lack capacity, and significant expansion is needed.

The main advantage of the *Italian market* for the Shah Deniz consortium is that the gas price on the market is 20 percent higher than in Western European countries. However, higher gas prices in the Italian market could be a temporary symptom of monopolistic positions. In the future Italy may well diversify energy supply sources, especially gas from Shah Deniz, as it moves toward the full implementation of EU energy packages and a market based on full open and transparent competition.

The other advantage is its solid financial capability. It is still unclear whether Nabucco's finances would make sense in the long-term as TAP's shareholders' composition changes to include major global, European and regional players, which would increase the pipeline's commercial appeal. TAP's financial and commercial merits seem to have secured it a key ally that may eventually tip the scale in its favour vis-à-vis Nabucco West.

According to TAP consortium representatives, the proposal would be well connected to the Italian gas grid to provide freely allocable capacity; the Italian virtual trading point and all Italian exit points can be reached. TAP can reach Baumgartner via TAG (Austrian Italy pipeline from / to Baumgartner) to have the same (limited) opportunities as other projects in the fourth corridor. Also, transit via Switzerland to Germany and France gives added value to TAP's landfall point in Italy.

There also would be swap potential available for 25 bcm/a average flow 12 bcm/pa minimum flow (2011). The total capacity of TAP can be delivered to Baumgartner by using swaps (according to the TAP consortium, 6 bcm guaranteed by physical reverse flow, and additional capacity is likely due to large imports)[22].

Currently no firm capacity from Italy to Germany is available, but typical flow from Germany and France to Italy will allow for a virtual backhaul of approximately 10 bcm/a. Snam Rete Gas and Open Grid Europe offers capacity in adjacent grids in Italy and Germany.

TAP recently signed two Memoranda of Understanding and Cooperation with the Croatian and Bosnian system operators, Plinacro and BH-Gas, who both support the Ionian Adriatic Pipeline (IAP). Starting at a tie-in point to TAP in Albania, the

22 *Interviews of the author with TAP representatives*

IAP aims to deliver gas to northern Albania, Montenegro, Bosnia and Herzegovina, and Croatia[23]. In a fact, if realized, TAP would be able to guarantee access to the Balkans.

It remains a possibility that the Italian market could be oversupplied, given the financial crisis and a projected fall of demand. Furthermore, in the south of the country, there could be an additional volume of 20bcm/y in the event that all LNG and pipeline import projects (i.e. GALSI project) are completed.

The other complexity that might occur is that TAP terminates on the Italian border; as mentioned above, Snam Rete Gas - the Italian TSO would ship the gas further to Northern Italy. All gas buyers and/or shippers will have to deal with Snam. The free pipeline capacity inside the Snam Rete controlled system is under stress, as constraints may appear in the system's ability to transport gas to the northern part of Italy.

Most importantly TAP still lacks the political support of the Greek and Italian governments. The Italian and Greek governments may be ready to support the project if: (a) the TAP consortium includes one Italian and one Greek gas company and (b) if the SD consortium would guarantee that the final decision will be primarily taken on the commercial merits of the projects rather than the geopolitical and political complications of its routing.The project does not have an IGA/HGA between Greece, Albania and Italy.

Conclusion

Complications abound; dozens of analysts generate huge volumes of commentary every day on the topic of the Southern Corridor. But neither words nor position papers produce gas, nor do they build pipelines. Despite all this news flow and support, the SDII project must start immediately and eliminate all its loose ends. It needs to get pipeline construction and sales contracts in place over the coming months. If it waits too long, Iraqi and/or East Mediterranean gas will move in and capture its potential markets. There is no more time for analysis and geopolitical posturing.

23 http://www.trans-adriatic-pipeline.com/why-tap/benefits-for-south-eastern-europe/