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**The EU-Turkey Energy
Relations After the 2014
Ukraine Crisis. Enhancing the
Partnership in a Rapidly
Changing Environment**

By **Simone Tagliapietra**, Fondazione
Eni Enrico Mattei and Istanbul Policy
Center

Energy: Resources and Markets Series

Editor: Giuseppe Sammarco

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Summary

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Keywords: EU-Turkey Energy Relations, EU Energy Security, Southern Gas Corridor

JEL Classification: Q40, Q42, Q48

This paper represents the fifth outcome of FEEM's research project "The rise of Turkey and the new Mediterranean. Challenges and opportunities for energy cooperation in a region in transition". This project analyses how energy could represent a major tool to strengthen the economic, political and social integration in the enlarged Euro-Mediterranean region. The project focuses particularly on Turkey, a country considered as crucial for both the EU energy security and for the regional balance of power in the aftermath of the so-called "Arab Spring"

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The rise of Turkey and the new Mediterranean
Research programme

THE EU-TURKEY ENERGY RELATIONS AFTER THE 2014 UKRAINE CRISIS
Enhancing the partnership in a rapidly changing environment

by

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The EU-Turkey energy relations: the pivotal role of the Southern Gas Corridor

Over the last two decades energy has emerged as an increasingly important component of the overall cooperation scheme being built between the European Union (EU) and Turkey. In particular, over the years the EU-Turkey energy relations have progressively focused on a specific segment of energy markets: natural gas.

This focus on natural gas has been mainly based on Turkey's strategic geographical location at the crossroads of major natural gas-rich regions such the Caspian and the Middle East on the one hand, and a major natural gas-consuming region, Europe, on the other hand. This peculiar position has paved the way for the emergence of a vision on which Turkey would eventually play the role of key transit country of future natural gas flows from Azerbaijan, Turkmenistan, Iraq and Iran to Europe¹.

The rise and fall of Nabucco

This vision was first translated into an infrastructure project in 2002, when a five-company consortium composed by OMV of Austria, MOL Group of Hungary, Bulgargaz of Bulgaria, Transgaz of Romania and BOTAŞ of Turkey² agreed to cooperate on the development of Nabucco, a projected 3,800 kilometers (km) long pipeline with a capacity of 31 billion cubic metres per year (bcm/year) designed to carry natural gas extracted in Azerbaijan, Turkmenistan, Iraq, Iran and Egypt to Southeast and Central Europe via Turkey³. The project immediately got an unprecedented political support from Turkey, the EU and the United States (US).

For Turkey the project represented a unique opportunity to realize its long-term strategic objective of becoming a key energy corridor between hydrocarbon rich countries in the East and energy importing European markets in the West.

For the EU the project represented a major opportunity to diversify its natural gas supplies away from Russia. For this reason Nabucco not only got the financial support of the EU⁴ but also became the flagship project of the Southern Gas Corridor, an initiative for the natural gas supply from Caspian and Middle Eastern regions to Europe launched in 2008 by the European Commission (EC)⁵ as a response to the energy

¹ For a detailed discussion of the potential role of Turkey as a regional natural gas hub please refer to: Tagliapietra, S. (2014), *Turkey as a Regional Natural Gas Hub: Myth or Reality?*, Nota di Lavoro n. 2.2014, Fondazione Eni Enrico Mattei.

² The consortium was successively extended to RWE of Germany in 2008.

³ Natural gas flows from these producing countries would have reached the Turkish border as follow: via the South Caucasus Pipeline in the case of Azerbaijan; via Iran or the planned Trans-Caspian Pipeline in the case of Turkmenistan; via the planned extension of the Arab Gas Pipeline in the case of Iraq; via the Arab Gas Pipeline in the case of Egypt.

⁴ The European Commission awarded a grant in the amount of 50 percent of the estimated total eligible cost of the feasibility study including market analysis, and technical, economic and financial studies.

⁵ European Commission, *Second Strategic Energy Review – An EU Energy Security and Solidarity Action Plan*. COM(2008) 781 final, 13 November 2008. The document recognized in the Southern Gas Corridor one of the EU's highest energy security priorities, outlying the need of a joint work between the EC, EU Member States and the countries concerned (Azerbaijan and Turkmenistan, Iraq and Mashreq countries) with the objective of rapidly securing firm commitments for the supply of natural gas and the construction of the pipelines necessary for all stages of its development.

security concerns emerged in the EU after the first Russian-Ukrainian-European natural gas crisis occurred in January 2006⁶.

For the US the project represented an important geopolitical asset to reduce the EU natural gas dependency on Russia, exactly as the Baku-Tbilisi-Ceyhan pipeline served in the 1990s to reduce the EU oil dependency on Russia⁷.

Strong of the political backing of Turkey, the EU and the US, the Nabucco project gradually advanced with the signature of the joint venture agreement between the five companies initially involved in the consortium in 2005⁸, with the signature of a declaration calling for the acceleration of the Nabucco project by the EC and energy ministers from Austria, Hungary, Romania, Bulgaria and Turkey in 2006⁹, with the signature of the first contract to supply natural gas from Azerbaijan in 2008¹⁰, with the signature of the intergovernmental agreement between the five transit countries in 2009¹¹ and, finally, with the signature of the project support agreements between the Nabucco consortium and each of the five transit countries in 2011¹².

Notwithstanding the strong political commitment of the five transit countries and the unprecedented political support of the EU and the US, the Nabucco project ultimately failed, mainly because of commercial and financial reasons. As Hafner (2012) pointed out: «The Nabucco project has died because of the market uncertainties: a very large scale pipeline project combined with a hugely uncertain demand outlook and the potential competition of South Stream. Moreover, the project promoters were mainly mid-size companies who have to rely on project finance and bank loans, and the banks ask for guarantees and long term ship or pay contracts which the market today cannot deliver.»¹³ Furthermore, another major element of uncertainty for the Nabucco project was related to the fact that -with the only exception of Azerbaijan- all the potential suppliers were facing major difficulties to materialize their willingness to evacuate natural gas to Europe via Turkey.

⁶ In January 2006, after a long-lasting disagreement on natural gas prices, Russia cut off supplies to Ukraine for 3 days, Ukraine diverted volumes destined to Europe, and as a consequence natural gas supply to some Central European countries fell briefly. A second Russian-Ukrainian-European natural gas crisis occurred in 2009, when the transit of Russian gas through Ukraine was completely halted for two weeks, a fact that generated a severe humanitarian crisis in several Central and Eastern European countries. For a detailed discussion of these two natural gas crises refer to: Stern, J. (2006), *The Russian-Ukrainian gas crisis of January 2006*, Oxford Institute for Energy Studies; and to: Pirani, S., Stern, J. and Yafimava, K. (2009), *The Russo-Ukrainian Gas Dispute of January 2009: A Comprehensive Assessment*, OIES paper: NG27, Oxford Institute for Energy Studies.

⁷ “U.S. throws weight behind EU’s Nabucco pipeline”, in *Reuters*, 22 February 2008.

⁸ “Nabucco Partners Sign Joint Venture Agreement”, in *Middle East Economic Survey*, 11 July 2005.

⁹ “EU Commission, Ministers Agree To Accelerate Nabucco Gas Project”, in *Middle East Economic Survey*, 3 July 2006.

¹⁰ “Azeri Energy Minister Announces Readiness To Join Nabucco Project”, in *Middle East Economic Survey*, 8 September 2008.

¹¹ “Nabucco Partners Sign Intergovernmental Agreement”, in *Middle East Economic Survey*, 20 July 2009.

¹² “Nabucco Legally Finalized as Transit States Sign Project Support Agreements”, in *Novinite*, 8 June 2011.

¹³ Hafner, M. (2012), *Russian Strategy on Infrastructure and Gas Flows to Europe*, POLINARES Working Paper n. 73, p. 41.

The Southern Gas Corridor beyond Nabucco: TANAP and TAP

Taking into account the insurmountable commercial and financial barriers that the Nabucco project was facing, Azerbaijan -clearly the natural gas producing country most interested on the development of the Southern Gas Corridor¹⁴- completely reshaped the Southern Gas Corridor game in 2011 by rapidly conceptualizing its own infrastructure project to evacuate future natural gas flows from Shah Deniz Phase II to Turkey: the Trans-Anatolian Pipeline (TANAP).

TANAP, a projected 2,000 km-long natural gas pipeline with a capacity of 16 bcm/year, has been designed to supply 6 bcm/year to Turkey by 2018 and 10 bcm/year to Europe by 2019. On the contrary of Nabucco, TANAP was not born as a multilateral project but rather as a bilateral project between Azerbaijan and Turkey. The initial act of the project -occurred in December 2011- was the signature of a Memorandum of Understanding (MoU) between Azerbaijan and Turkey establishing a consortium to build and operate the pipeline¹⁵. This initial step was then followed by the signature of a binding intergovernmental agreement on TANAP made by Azerbaijan's President Aliyev and Turkey's Prime Minister Erdoğan in June 2012¹⁶. Of course this bilateral relation was not symmetric, but rather unbalanced in favour of Azerbaijan. In fact, the State Oil Company of Azerbaijan (SOCAR) was initially set to hold an 80 percent stake in the project, leaving only the remaining 20 percent to the Turkish partners (15 percent to BOTAS and 5 percent to TPAO). This figure has changed over time, to a more balanced structure entailing a share of 58 percent for SOCAR, 25 percent for BOTAS, 5 percent for TPAO and 12 percent for British Petroleum¹⁷. Notwithstanding this realignment of shares, SOCAR is set to continue to retain a controlling 51% of TANAP and operatorship of the line in the future. In fact, TANAP is crucially important for the Azeri state owned company, as it will have a key role in the delivery of natural gas from its Shah Deniz field further down the supply chain to Europe, rather than selling at its border.

Among other factors, a key element of strength of the TANAP project relates to its financing: because of the considerable oil revenues provided by the exports through the Baku-Tbilisi-Ceyhan pipeline, Azerbaijan is able to directly ensure the financing of the infrastructure. In fact, the cost of TANAP is estimated about USD 7-10 billion¹⁸, an amount that Azerbaijan could easily finance just by making use of its sovereign wealth fund, the State Oil Fund, which currently retains about USD 34 billion in assets under management¹⁹.

The entrance of TANAP into the Southern Gas Corridor race in December 2011 gave the "coup de grace" to the already moribund Nabucco project. For this reason the

¹⁴ Not only because of the investments already made on its Shah Deniz natural gas field, but also because of the need to reach a final investment decision for Shah Deniz Phase II (a decision that finally arrived on December 17, 2013).

¹⁵ "Turkey and Azerbaijan Sign MoU for TANAP Pipeline", in *Middle East Economic Survey*, 9 January 2012.

¹⁶ "TANAP Project, the Silk Road of Energy, Has Been Signed", <http://www.tanap.com>, 26 June 2012.

¹⁷ "Turkish Companies Increase Their Shares in TANAP Up To 30%", Azeri News Agency, 2 June 2014.

¹⁸ "BP Agrees to Join Tanap Gas Pipeline Project by Taking 12% Stake", in *Bloomberg*, 23 January 2013.

¹⁹ Sovereign Wealth Fund Institute.

Nabucco consortium tried to reinvent itself in 2012, by proposing a new -and smaller- version of the project: Nabucco West²⁰. This pipeline was designed to carry the TANAP 10 bcm/year destined to Europe from the Turkish-European border to Austria via Bulgaria, Romania and Hungary. This project -again supported by the EU²¹- ultimately failed like its predecessor, as the Shah Deniz consortium selected in June 2013 the Trans Adriatic Pipeline (TAP) to provide the missing link between TANAP and the European market²². TAP, a projected 800 km-long natural gas pipeline with an initial capacity of 10 bcm/year, will thus carry the TANAP natural gas destined to Europe from the Turkish-Greek border to Italy through Albania and the Adriatic Sea by 2019²³.

The current shape of the Southern Gas Corridor: a half-empty glass?

The historical evolution of the Southern Gas Corridor, and particularly the rise and fall of Nabucco, clearly exemplifies how the original idea of a multilateral and large-scale project based on a variety of natural gas supply sources, turned out to be a bilateral and medium-scale project with only one supply source, Azerbaijan. This evolution does not completely fulfill neither the interest of the EU nor the interest of Turkey, not only because of the different market structure (both in terms of volumes and supply sources) but also because of the different legal structure of the two projects.

In fact, Nabucco was a project completely under EU law; this signifies that the pipeline was to be regulated by rules such as third party access and unbundling throughout its entire length. The intergovernmental agreement signed by the five transit countries in 2009 provided a legal framework for 50 years, confirming that 50 percent of the pipeline's capacity was to be reserved for the shareholders of the project and the remaining 50 percent was to be offered to third-party shippers on the basis of a regulatory transit regime under EU law²⁴.

The situation of TANAP is clearly very different. In fact, considering that Turkey has not yet adopted the EU energy *acquis* on its legislation, Azerbaijan -with a major stake in the project- will practically have the control of the pipeline and of the natural gas

²⁰ "Nabucco-West: Abridged Pipeline Project Officially Submitted to Shah Deniz Consortium", in *Eurasia Daily Monitor*, Vol. 9, Issue 98, 23 May 2012.

²¹ European Commission, *Commissioner Oettinger welcomes decision on "Nabucco West" pipeline*, Press Release, 28 June 2012. The Nabucco West project was also supported by British Petroleum (BP), the operator of Shah Deniz Phase II. In fact, in order to support Nabucco West, in June 2012 BP ceased the development of its South East Europe Pipeline (SEEP), a project launched in September 2011 to carry the TANAP 10 bcm/year destined to Europe from the Turkish-European border to Austria.

²² "Shah Deniz consortium chooses TAP to carry Azeri gas to Europe", in *Reuters*, 28 June 2013. Nabucco West also had the support of British Petroleum. In September 2011 British Petroleum also proposed a pipeline project, the so-called South East Europe Pipeline (SEEP), to carry the TANAP 10 bcm/year destined to Europe from the Turkish-European border to Austria. Albeit designed by the operator of Shah Deniz Phase II.

²³ The TAP project was announced in 2003 by Swiss energy company EGL Group. The feasibility study was concluded in March 2006. Two options were investigated: a northern route through Bulgaria, Republic of Macedonia and Albania, and a southern route through Greece and Albania, which finally was considered to be more feasible.

²⁴ "Nabucco: Delivering Diversification to the European Gas Market", in *Natural Gas Europe*, 23 May 2013.

transit through it. Moreover, considering both Turkey's reluctance to enter the Energy Community and the difficulties related to the opening of the energy chapter of Turkey's EU accession process, this situation will unlikely change in the foreseeable future. Albeit Azerbaijan could eventually have an interest in having some volumes of non-Azeri natural gas into TANAP temporarily in the short term (in order to make the project more bankable), it will unlikely have the interest of doing so in the longer term, as the development of Shah Deniz and other fields will continue and additional volumes of Azeri natural gas will thus be ready to be evacuated to Turkey and the EU via TANAP.

The Southern Gas Corridor: pivot or Achilles' heel of EU-Turkey energy relations?

The developments of the Southern Gas Corridor just described ultimately call into question the EU-Turkey energy relations. In particular, a major question is whether the Southern Gas Corridor would have evolved from being a pivotal element of the EU-Turkey energy relations to becoming their Achilles' heel. In fact, the odyssey of Nabucco and the emergence of TANAP have ultimately outlined a progressive divergence in the way the EU and Turkey perceived not only the Southern Gas Corridor but also their energy relations.

As previously discussed, after years of cooperation with the EU on Nabucco, in 2011 Turkey rapidly decided to change its approach and turn to Azerbaijan to speed-up the development of the Southern Gas Corridor. This choice clearly reflected the fact that «the primary aim of Turkey is to realize its own energy security»²⁵, but it also reflected a genuine discontent of Turkey towards the EU due to the continuous procrastination of the accession negotiations in general and to the vagueness of the EU about the opening of the accession process's energy chapter in particular²⁶.

This divergence represents a serious risk not only for the EU-Turkey energy relations, but also for the strategic interests of the two players individually. A coherent and coordinated approach on the Southern Gas Corridor would indeed allow the two players to pursue their respective interests in a much more effective way. First of all, by dealing together with natural gas producing countries the EU and Turkey could well enhance their bargaining power. Secondly, a coherent approach on the infrastructural development could allow the overcoming of a number of political and commercial barriers, respectively through the enhancement of their political and diplomatic leverage and the achievement of economies of scale.

The experience of Nabucco certainly left a negative legacy in Turkey as far as the energy cooperation with the EU is concerned. However, strategically speaking it is necessary to find a way to revive the EU-Turkey energy relations -and notably the EU-Turkey natural gas relations- particularly considering that the market and political environment on which Nabucco was conceptualized is rapidly changing and that some of the major barriers to the development of Nabucco could now be vanishing.

²⁵ Republic of Turkey Ministry of Foreign Affairs, *Turkey's Energy Strategy*, available online.

²⁶ For a detailed discussion of this point please refer to: Korany, D. and Sartori, N. (2013), *EU-Turkish Energy Relations in the Context of the EU Accession Negotiations: Focus on Natural Gas*, Global Turkey in Europe, Istituto Affari Internazionali.

Boosting the EU-Turkey energy relations in a rapidly changing environment

Since the time of the Nabucco' odyssey a lot has changed in the regional market and political environment. First of all, new major natural gas reserves have been discovered in the Kurdistan Region of Iraq (KRI) and in offshore Israel. Secondly, an unprecedented political standoff between the Western world and Russia has materialized with the 2014 Ukraine crisis, paving the way for a serious reconsideration at the EU level of the economic relations between Europe and Russia. Let's have a closer look at these recent developments before to analyse their potential impact on the EU-Turkey energy relations.

The rise of the Kurdistan Region of Iraq as a world-class natural gas province

Iraq's natural gas scenario is radically changing because of the enormous natural gas reserves being discovered in the country's semi-autonomous Kurdistan Region. With natural gas reserves estimated between 3 and 6 trillion cubic metres (tcm)²⁷, this northern region is actually paving the way for the emergence of Iraq as world-class natural gas province (just to provide a quick comparison, Azerbaijan owns 1.3 tcm of natural gas reserves)²⁸. With this consistent amount of natural gas reserves, the KRI could easily satisfy its own domestic natural gas demand and also export significant volumes of natural gas to Turkey and the EU.

In the short term, the key barrier to a quick development of KRI natural gas resources is of course represented by the unstable political situation emerged in the country with the rapid escalation of violence started in June 2014. However, this situation might well turn out to be geo-politically beneficial for the KRI, either in terms of more autonomy from Baghdad and in territorial terms. In addition to this unforeseeable escalation of events, a long-lasting dispute on state sovereignty between the KRG in Erbil and the Iraqi Federal Government in Baghdad continues to remain on the table. In a nutshell, Baghdad and Erbil are at odds over the KRG's desire for autonomy and the central government's desire for sovereignty and control²⁹. This debate translates into the energy sector as well, as the governments in Baghdad and Erbil have been unable to resolve their differences over the federal hydrocarbon law. This dispute generates significant political risk and is already creating a number of problems with regard to oil export to Turkey. The US, which enjoys close diplomatic ties with both Baghdad and Ankara, has been pressing all parties to reach an agreement and is known to oppose Erbil's unilateralist energy plans.

These recent developments represent a key element for the future prospects of the Southern Gas Corridor, as the KRI -after Azerbaijan- is the only natural gas producing player that could turn in the medium term its availability of natural gas resources into deliverability. In fact, the other countries usually seen as potential suppliers for the

²⁷ Official estimation of the Kurdistan Regional Government.

²⁸ British Petroleum, *Statistical Review of World Energy*, June 2013.

²⁹ For a wider discussion on Iraq's internal divisions please refer to: Elliott, S. and Beryl, L. (2012), *Natural Gas Development in Kurdistan: A Financial Assessment*, Belfer Center for Science and International Affairs, Harvard University.

Southern Gas Corridor -Turkmenistan and Iran- seem to be very far from being able to eventually supply the Corridor.

Turkmenistan has established a special natural gas relationship with China, and this trend is likely to consolidate further in the future. However, given its world-class natural gas reserves, the country could well be able to supply natural gas to Turkey and to the EU -in addition to the major volumes targeting the Chinese market- but a major barrier will likely make such a development unfeasible: the infrastructural problem related to the divergences existing between Russia, Iran, and Turkmenistan on the legal status of the Caspian Sea, and therefore on the construction of the Trans-Caspian Pipeline. In order to try to bypass this problem, in 2010 Eni proposed to Azerbaijan and Turkmenistan a compressed natural gas (CNG) project that would permit the transport and transit of considerable volumes of Turkmen gas across the Caspian Sea to the coast of Azerbaijan, from where it would be transported through an overland pipeline to other destinations. At the time, this project was halted by Azerbaijan, as it did not want Turkmen gas to compete with its resources being developed. Such a project could be revived in the future if Azerbaijan would temporarily need additional volumes to fill the TANAP pipeline, while waiting for additional production in Shah Deniz. However, this solution will likely be very costly and very limited in both time and volumes. For this reason, the aspiration of the EU to bring major volumes of Turkmen natural gas into the Southern Gas Corridor would probably need to be revised, at least until the dispute over the legal status of the Caspian Sea will finally be resolved³⁰.

Iran is the perennial “elephant in the room” of the international gas trade, a country that could, one day, become a major game changer of world’s gas markets, but whose potential still remains fundamentally untapped due to a number of geopolitical and commercial reasons. The main reason for the current under-exploitation of Iran’s natural gas resources is clearly linked to the difficult political relations that have evolved over the last decades with the West. However, after years of frustration and impasse in negotiations between Iran and six world powers (P5+1), an interim Iranian nuclear deal was finally reached in Geneva on November 24, 2013. This occurrence certainly represents just a first step toward a truly complete resolution of the Iranian nuclear issue, but it could be seen as a positive sign for the future. If this recent positive development will have effective follow-up steps, great opportunities could open up in Iran, including on the natural gas sector. However, considering the geographical location of Iran’s natural gas reserves (mainly concentrated in the Southern part of the country, in the offshore Persian Gulf), such a development will likely first interest the global LNG market before interesting the European market via pipeline. Furthermore, the first international pipeline that the country will likely develop will not target the EU market, but the Asian market. In fact, Iran is already working on a pipeline to Pakistan, in order to export its natural gas not only to this country but also to India. Moreover, Chinese interest in Iran’s natural gas reserves is also very strong, and Iranian natural gas exports to China will likely take place in the future as well. For these reasons it seems

³⁰ For a detailed discussion of Turkmenistan’s natural gas market please refer to: Pirani, S. (2012), *Central Asian and Caspian Gas Production and the Constraints on Export*, OIES Paper: NG 69, Oxford Institute for Energy Studies.

that in the medium-term Iran would hardly fit into the Southern Gas Corridor concept, as it will first target the global LNG market and Asian markets via pipeline³¹.

The emergence of Israel as natural gas exporting country

The energy landscape of the Eastern Mediterranean region is rapidly changing and Israel is the key driver of this recent development. Offshore exploration in the waters of the Eastern Mediterranean region started in the early 1970's and sporadically continued during the 1980's and the 1990's. Exploration activity in the offshore Eastern Mediterranean experienced a significant renaissance since 1999-2000, when five modest natural gas fields were discovered at a shallow depth west of the coastal town of Ashqelon and the Gaza Strip. These discoveries speeded up exploration efforts and promoted the acquisition of geophysical data throughout the entire Eastern Mediterranean area, particularly in the Levant basin. The real turning point in terms of natural gas discoveries came in 2009, when Noble Energy announced the discovery of the Tamar field (250 bcm) in offshore Israel. After this first major discovery, Noble Energy announced other two major findings in the Levant Basin: the Leviathan field (535 bcm) in offshore Israel (2010) and the Aphrodite field (140 bcm) in offshore Cyprus (2011).

Owning the largest natural gas reserves in the offshore Eastern Mediterranean, Israel has a pivotal role in the emerging regional natural gas architecture. In other words, a large-scale development of Eastern Mediterranean natural gas seems to be very difficult without a strong commitment of Israel to export a substantial part of its gas resources.

After a long-lasting debate, in 2013 the Israeli government decided to keep 540 bcm of natural gas for the domestic market over a 25-year period, leaving only 360 bcm or 40% of projected supply for export. This development has enhanced the discussion on Israel's natural gas export options. In fact, many options are currently on the table, even if none of them is yet a frontrunner: a) Construction of a pipeline to Turkey (via Lebanon and Syria or via the Republic of Cyprus EEZ); b) Construction of a pipeline to Jordan and to the Palestinian Territories; c) Utilization of the existing pipeline from Ashkelon to Egypt -reversing the flow- and then utilization of the Egyptian LNG plant in Idku; d) Construction of a submarine pipeline from the Leviathan field to the Egyptian LNG plant in Idku; e) Construction of an onshore LNG plant on Israel's Mediterranean coast; f) Construction of a LNG plant on the Israeli shore of the Gulf of Aqaba; g) Development of a FLNG plant in the Israeli offshore Mediterranean; h) Development of a compressed natural gas (CNG) solution; i) Construction of a pipeline to Cyprus and construction of a joint Israeli-Cypriot LNG plant in Vasilikos³².

³¹ For a detailed discussion of the future prospects of Iran's natural gas market please refer to: Tagliapietra, S. (2014), *Iran after the (potential) nuclear deal. What's next for the country's natural gas market?*, Nota di Lavoro n. 31.2014, Fondazione Eni Enrico Mattei.

³² For a comprehensive discussion of the Eastern Mediterranean natural gas developments please refer to: Tagliapietra, S. (2013), *Towards a New Eastern Mediterranean Energy Corridor? Natural Gas Developments Between Market Opportunities and Political Risks*, Nota di Lavoro n. 12.2013, Fondazione Eni Enrico Mattei.

The 2014 Ukraine crisis and the unprecedented EU-Russia political standoff

The dawn of the 2014 Ukraine crisis dates back to November 21, 2013, the day on which Ukraine's President Viktor Yanukovich rejected the Ukraine-EU Association Agreement and the related Deep and Comprehensive Free Trade Agreement, two measures of economic and trade incentives offered by the EU to Ukraine within the framework of the Eastern partnership, an initiative aimed at strengthening cooperation with countries in the former USSR and implicitly containing the influence of Russia in the region. On the same day, thousands of people gathered to Independence Square in central Kiev to take part in a rally against the choices of Yanukovich and in favor of greater integration with the EU.

From that moment on the Euromaidan (literally Eurosquare) protests never stopped, finally leading to the deposition of President Yanukovich on February 22 and to the establishment of a pro-European government on February 27. In the aftermath of this regime change, pro-Russian forces began to gradually take control of the Crimean peninsula. In the meantime, a referendum on the status of Crimea was held on March 16, resulting in a 96% vote in favor of the option to join Russia as a federal subject. The legitimacy of the referendum was immediately rejected by the EU, the US and Canada, while Russia instantly recognized the result. On March 18 Russia and Crimea signed a treaty of accession of the Republic of Crimea and Sevastopol into the Russian Federation.

Following these events, the EU and the US imposed sanctions on a number of Russian and Ukrainian officials involved in Russia's annexation of the Crimean peninsula. Furthermore, the European Commission decided on March 10 to postpone talks with Russia over the legal status of the planned South Stream pipeline and full capacity utilization of the existing Nord Stream line. Both issues required a compromise to move forward, but this appeared unlikely and for this reason EU Energy Commissioner Guenther Oettinger declared that he will not advance talks about pipelines such as South Stream for the time being³³. The European Commission has also delayed a decision on exempting the Opal pipeline from Germany to the Czech Republic from the EU's third-party access rules. This means the 55 bcm/year Nord Stream pipeline, built under the Baltic Sea to supply Russian gas to Europe, will have to continue running below full capacity³⁴. South Stream, a projected pipeline aimed at delivering 63 bcm/year of Russian gas to Europe under the Black Sea, represents -together with Nord Stream- the cornerstone of Russia's strategy to evacuate natural gas to Europe bypassing Ukraine. A serious delay of the project will thus turn out to be a major damage for Russia, both under the political and commercial points of view.

The EU heads of state and government gathered in Brussels on March 20-21 for an EU Council mainly devoted to an in depth discussion on the situation in Ukraine and of course a major focus was devoted to energy. In fact, the EU Council concluded that «efforts to reduce Europe's high gas energy dependency rates should be intensified,

³³ "EU Postpones Talks on Russian Gas Pipelines", in *Energy Intelligence*, 13 March 2014.

³⁴ Although Nord Stream had been construed before the Third Energy Package was introduced, the commission has so far refused to exempt Opal from the third-party access demands required by the new rules. As a result, Gazprom has been able to use only 50% of Opal's 36 Bcm/yr capacity, leaving Nord Stream underutilized.

especially for the most dependent Member States»³⁵. The EU leaders also tasked the European Commission to elaborate a plan for reducing energy dependence from Russia, to be discussed at the EU summit of June 26-27. According to the conclusions of the EU Council: «The plan should reflect the fact that the EU needs to accelerate further diversification of its energy supply, increase its bargaining power and energy efficiency, continue to develop renewable and other indigenous energy sources and coordinate the development of the infrastructure to support this diversification in a sustainable manner, including through the development of interconnections. Such interconnections should also include the Iberian peninsula and the Mediterranean area. Where relevant, interconnections should also be developed with third countries. Member States will show solidarity in case of sudden disruptions of energy supply in one or several Member States. In addition, further action should be taken to support the development of the Southern Corridor, including further spur routes through Eastern Europe, to examine ways to facilitate natural gas exports from North America to the EU and consider how this may best be reflected in TTIP, and increase the transparency of Intergovernmental Agreements in the field of energy»³⁶.

The European Commission published its plan for reducing energy dependence from Russia on May, 26 with the Communication “European Energy Security Strategy”³⁷. With this document the European Commission outlines once more the need to reinforce the EU’s energy security, particularly in terms of natural gas supplies. The strategy proposed is structured on eight key pillars aimed at promoting closer cooperation among Member States in light of the principle of solidarity, while respecting national energy choices: «i) Immediate actions aimed at increasing the EU’s capacity to overcome a major disruption during the winter 2014/2015; ii) Strengthening emergency/solidarity mechanisms including coordination of risk assessment and contingency plans; iii) Moderating energy demand; iv) Building a well-functioning and fully integrated internal market; v) Increasing energy production in the EU; vi) Further developing energy technologies; vii) Diversifying external supplies and related infrastructure; viii) Improving coordination of national energy policies and speaking with one voice in external energy policy»³⁸.

As far as the diversification of external natural gas supplies is concerned, the strategy designed by the European Commission outlines that «beyond strengthening our [EU] relationship with existing suppliers, a EU policy goal should also be to open the way for new sources. The establishment of the Southern Corridor and the identified projects of common interest is an important element in this respect, as it prepares the ground for supplies from the Caspian region and beyond. Pursuing an active trade agenda in this region is crucial to ensure market access but also for the development of critical infrastructure, the viability of which depends on access to sufficient export volumes. In a first phase it is expected that by 2020 10 bcm/y of natural gas produced in Azerbaijan will reach the European market through the southern Gas Corridor. Moreover, this new

³⁵ European Council, *Conclusions*, EUCO 7/1/14 REV1, 29/21 March 2014, p. 10.

³⁶ *Ibidem*, p. 10.

³⁷ European Commission, *European Energy Security Strategy*, COM(2014) 330 final, 28 May 2014. This official document is accompanied by a major study on the state of the European energy security: European Commission, *In depth study of European Energy Security*, SWD(2014) 330 final, 28 May 2014.

³⁸ European Commission, *European Energy Security Strategy*, op. cit., p. 3.

pipeline connection is vital in providing a connection to the Middle East. The currently envisaged infrastructure in Turkey could accommodate up to 25 bcm/y for the European market. In the longer term perspective, other countries such as Turkmenistan, Iraq and Iran, if conditions are met to lift the sanctions regime, could also significantly contribute to the enlargement of the Southern Gas Corridor. A coherent and targeted Foreign policy vis-à-vis these countries will be crucial. Furthermore, the EU should engage in intensified political and trade dialogue with Northern African and Eastern Mediterranean partners, in particular with a view to creating a Mediterranean gas hub in the South of Europe.»³⁹

This strategy designed by the European Commission was discussed in the European Council of June 26-27, 2014 and a formal political decision from the European Council is expected by the end of 2014.

Without entering the discussion on the pro and cons of the EU strategy to diversify its natural gas supplies away from Russia, let's try to understand what might be the potential impact of the recent discoveries of natural gas in the KRI and in offshore Israel on the one hand, and of the 2014 Ukraine crisis on the other hand, on the EU-Turkey energy relations.

The potential impact of these new developments on the EU-Turkey energy relations

Albeit apparently far from each other, the recent discoveries of natural gas in the KRI and in offshore Israel, and the 2014 Ukraine crisis, are two developments potentially interconnected, as they can eventually converge to reshape the EU-Turkey energy relations. In fact, if in the aftermath of the Ukraine crisis the EU will seriously pursue a strategy of progressive diversification of its natural gas supplies away from Russia, it will likely focus on enhancing the internal energy market (i.e. through natural gas interconnections), on developing the European LNG market (this time with a particular reference on the potential imports from the US) and on further diversifying the EU natural gas supply portfolio. In particular, as the “European Energy Security Strategy” of the European Commission seems to suggest, the EU will likely try to further enhance the development of the Southern Gas Corridor.

Of course this strategy will likely not have the impossible target of reducing by 100 percent the EU dependence on Russian gas, but it will certainly target a substantial reduction not only for its direct impact in terms of energy security but also for its indirect impact concerning the related gain of bargaining power in the next round of re-negotiation of Russian contracts. If so, this strategy will not be very different from the one adopted by the EU in 2008 with the Communication “Second Strategic Energy Review - An EU Energy Security and Solidarity Action Plan”⁴⁰, the one launching the Southern Gas Corridor. However, as far as the Southern Gas Corridor is concerned, this time the situation could well turn out to be different from 2008, exactly for the two reasons described above: the availability of major natural gas reserves in the KRI and in offshore Israel on the supply side and the potential absence of competition -at least for a

³⁹ European Commission, *European Energy Security Strategy*, op. cit., p. 16.

⁴⁰ European Commission, *Second Strategic Energy Review – An EU Energy Security and Solidarity Action Plan* (COM(2008) 781 final), 13 November 2008.

certain period of time- from South Stream on the demand side as a result of the 2014 Ukraine crisis.

Notwithstanding these positive elements for the Southern Gas Corridor, this time a new element should be taken into consideration by the EU: the role of Turkey. In fact, a collaborative approach from Turkey should not be taken for granted. As mentioned before, Nabucco did not leave a positive legacy in Turkey as far as the energy cooperation with the EU is concerned and it paved the way for a new form of bilateral energy diplomacy between Turkey and natural gas producing countries. Azerbaijan certainly represents the clearest example of this dynamic, but another, more recent example, of this dynamic could be found in the relation between Turkey and the KRI itself. In fact, in November 2013 the Government of Turkey and the KRG signed a Gas Sales Agreement (GSA) governing the export of natural gas from the KRI to Turkey. The GSA calls for an initial 4 bcm/year of natural gas exports from 2017, rising to 10 bcm/year by 2020 and the option of increasing to 20 bcm/year thereafter; volumes that Turkey will of course use for its domestic market, considering that its natural gas demand is likely to grow from 45 bcm/year in 2012 to 70 bcm/year in 2030⁴¹.

The risk that the Southern Gas Corridor is facing is thus the one of another policy fragmentation between EU and Turkey. A fragmentation that could potentially generate rivalries between the two players, paving the way for the derail of the EU-Turkey energy relations. This occurrence will be detrimental to the interests of the EU and Turkey themselves, and will also provide more bargaining power to natural gas producing countries. This is the reason why a new EU-Turkey Natural Gas Initiative seems to be urgently needed, for the benefit of both the two players.

The urgent need for a new EU-Turkey Natural Gas Initiative

As an overall trend, a new EU-Turkey Natural Gas Initiative might be based on a win-win cooperation scheme able to engage the two players in a sustainable way. The prospect of becoming a natural gas hub will not be sufficient to seriously engage Turkey in such a cooperation project, as it already demonstrated that its first energy policy priority is to secure its own energy supplies. The EU might acknowledge this policy priority of Turkey and design accordingly a natural gas cooperation scheme able to match both the security of natural gas supplies of the EU and Turkey at one fell swoop.

In particular, a new EU-Turkey Natural Gas Initiative could be developed on the basis of the following key axes:

- **Energy diplomacy to unlock the Kurdistan Region of Iraq's gas supplies.** In addition to the overall unstable situation generated by the recent escalation of events started in June 2014 (which could -as mentioned before- ultimately turn out to be geopolitically beneficial for the KRI), the main obstacle to the development of the KRI's natural gas reserves is represented by the dispute between the KRG in Erbil and the Iraqi Federal Government in Baghdad about the federal hydrocarbon law and the related issue of revenue sharing. Turkey has little diplomatic leverage in contributing to the

⁴¹ Gulmira Rzayeva (2014), *Natural Gas in the Turkish Domestic Energy Market. Policies and Challenges*, OIES Paper: NG 82, Oxford Institute for Energy Studies.

resolution of this dispute. For this reason, the first (longer-term) target of the Initiative might be the creation of a joint diplomatic task force between the EU, Turkey and the US, to mediate between the governments of Erbil and Baghdad in order to achieve a quick resolution of the dispute.

- **Energy diplomacy to allow Israeli gas exports to Turkey.** As previously described, since 2010 the Eastern Mediterranean has emerged as a potential world-class natural gas province. In particular, Israel plays a major role in this field, as it owns the largest natural gas reserves. As far as Israel's natural gas export projects are concerned, ten options are currently under evaluation, between pipelines, liquefied natural gas (LNG) and floating liquefied natural gas (FLNG) solutions. A pipeline connecting Israel with Turkey is often presented as the most commercially viable export option. Turcas Petrol, a Turkish company, in September 2013 formally proposed a pipeline connecting the Israeli Leviathan field with the southern shore of Turkey with a capacity of 16 bcm/year. This volume, equivalent to the one of TANAP, would of course be split between the Turkish market (i.e. 6 bcm/year) and the EU market (i.e. 10 bcm/year). However, considering that this pipeline would need to pass through waters which lie within the Republic of Cyprus's Exclusive Economic Zone (EEZ), this project is today politically unfeasible. Turkey does not have any diplomatic leverage to enhance this situation. For this reason, a second (shorter-term) target of the Initiative might consist of an engagement of the EU in convincing its Member State to allow the transit of the pipeline through its EEZ independently from a full resolution of the long-lasting Cyprus dispute, in order to allow the evacuation of Israeli natural gas to the EU and Turkey.

- **Market reforms to facilitate energy infrastructure investments.** Looking at the future, Turkey will need enormous investments on energy infrastructure, most notably on electricity and gas infrastructure. According to the Investment Support and Promotion Agency of Turkey (ISPAT), Turkey's energy investment requirements amount to USD 120 billion by 2023⁴². International investors will need to find a favourable investment climate in order to jump into this market and also for this reason Turkey will need to advance the liberalization of its electricity and natural gas markets and to enhance the governance of the energy market. A solid EU-Turkey energy cooperation will be the only way for Turkey to carry out the reforms necessary to accomplish these targets. For this reasons the third target of the Initiative might be the reform of Turkey's energy market. The EU has already played an important role in the first steps of the liberalization of Turkey's electricity market; further steps will need to be taken to conclude this reform and to carry out also the one of natural gas market. Such a process will be highly beneficial for Turkey, as it will ultimately favour the inflow of foreign capital into the country's energy infrastructure sector. Moreover, the liberalization process will likely have an immediate positive effect on the competition within the country's energy market, an effect that will not only favour the country's households but also the industrial competitiveness of Turkey. Such a development would be highly beneficial also for the public finances of Turkey, considering greatest economic weakness of the country: the current account deficit. This element, which currently places Turkey among the most fragile and vulnerable emerging economies, is mainly due to the country's energy bill. A competitive energy market could well lower

⁴² Investment Support and Promotion Agency of Turkey official website: <http://www.invest.gov.tr>

the prices, ultimately contributing to ease the country's current account deficit as well. Furthermore, this process would be very beneficial not only for Turkey but also for EU, as part of these energy infrastructure investments will likely target the reinforcement of Turkey's natural gas grid, the infrastructure through which part of additional supplies from KRI and Israel could eventually flow towards the Turkey-EU border.

To conclude, a new EU-Turkey Natural Gas Initiative structured in the way just presented could provide a sustainable contribution to the EU on its quest to diversify natural gas supplies. If immediately pursued, this strategy could well add to the current planned volume of 10 bcm/year from Azerbaijan by 2019 another 10 bcm/year from KRI and an additional 10 bcm/year from Israel by 2020. On this scenario, the Southern Gas Corridor would thus be practically tripled, to a supply level (30 bcm/year) equal to the one currently covered by Qatar, the fourth natural gas supplier of the EU after Russia, Norway and Algeria. Among other things, a new EU-Turkey Natural Gas Initiative could also well turn out to be a catalyst for the EU-Turkey energy relations. In fact, the cooperation between the two players in the energy field is currently experiencing a deep impasse⁴³. Turkey's EU accession process is stagnating and the energy chapter seems to be far from being opened. Moreover, Turkey refused to become a member of the Energy Community, thus excluding the only alternative of energy cooperation outside the EU accession process. A new EU-Turkey Natural Gas Initiative could thus represent a new way to (re-)build trust between the EU and Turkey, the fundamental prerequisite not only for the energy cooperation between the two players, but also for the overall EU-Turkey political, economic and social relations.

⁴³ Among others, see: Tocci, N. and Bechev, D. (2013), "Will Turkey Find its Place in Post-Crisis Europe?", in *Global Turkey in Europe: Political, Economic, and Foreign Policy Dimensions of Turkey's Evolving Relationship with the EU*, IAI Research Paper, Istituto Affari Internazionali; Blockmans, S. (2014), *EU-Turkey Relations: Turning vicious circles into virtuous ones*, CEPS Policy Brief No. 317, Center for European Policy Studies.

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