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THE BATTLE FOR EUROPE'S SOUTHERN GAS CORRIDOR: NABUCCO V. SOUTH STREAM

Stephen Buryk



The Grand Bazaar

Inside the arched lanes of the Grand Bazaar in Istanbul, Turkey, a tourist can find almost any souvenir he or she desires, from aromatic Ceylon tea to intricately engraved camel bone boxes. However, the most striking feature of the bazaar is not its voluminous stores of exotic goods, but the voracious haggling underway in each and every merchant's booth. Everything is negotiable; offers and counteroffers flow freely from the mouths of the participants at dizzying speeds.

To an outsider, this process looks daunting and chaotic. The vendor asks outrageous prices for his wares, while the customer waffles back and forth, acting (truthfully or not) as if the item in question is neither special nor unique. The practice seems pointless, an all-out battle of wits over a transaction that should be quick and painless. However, this seemingly overblown exchange is actually completely rational and efficient. It is in the merchant's best

interest to charge the tourist exactly what the tourist is willing to pay, and he will attempt to do so. In return, the customer can work as hard as possible to buy his prized souvenir for the lowest price the merchant is willing to accept, even if he has to feign walking away to get it. In the end, the item the buyer desires will be exchanged for a price agreeable to the vendor — both are better off from the transaction.

The logic of the Grand Bazaar is not limited to that which is for sale within its arched walls; it can also be applied to many other transactions, including the competition between two long-haul natural gas pipelines vying to be built on Turkish soil. Turkey, straddling a land bridge between Europe and Asia, plans to rent a geopolitically valuable strip of the Anatolian peninsula that is in the perfect location to transport gas to Western Europe without crossing traditional, but problematic, Eastern European transit routes. The two parties interested in Turkey's route are Russia and the European Union; each is looking out for its own gas diversification interests

and offering Turkey substantial but different rewards for the use of its valuable territory.

Adding another customer to the bargaining process changes the terms of the transaction. Turkey is in a position of power. Instead of two parties negotiating over the terms of a deal advantageous to both, one customer will undoubtedly leave Turkey's stall empty-handed. With a souvenir, this event may make for a bad afternoon. But with an economic input as vital as natural gas, losing to the other party could result in uncertainty of gas supply for the EU or an erosion of political leverage for the Kremlin. Because of the undesirability of both outcomes, the bargaining for Turkey's route has been protracted and heated, with each party maneuvering to secure the best possible deal for its constituents.

Watching the volatile process itself yields little insight into its probable outcome; in bargaining it is often not advantageous to be sincere in one's actions. However, it is not impossible to predict with which buyer Turkey will ultimately strike a deal. In an auction with rapidly changing terms, some basic rules stay static. The offer put forth by the EU differs greatly from that of Russia. Each buyer is offering a package of economic and political benefits, both stated and implied. With pipelines, there is more at stake than just transit revenues. Natural gas pipelines contain a vital input for economic welfare that transporters are usually able to tap into for the security and development of their own economies. In addition, pipelines forge strong political and economic ties between the countries building them.

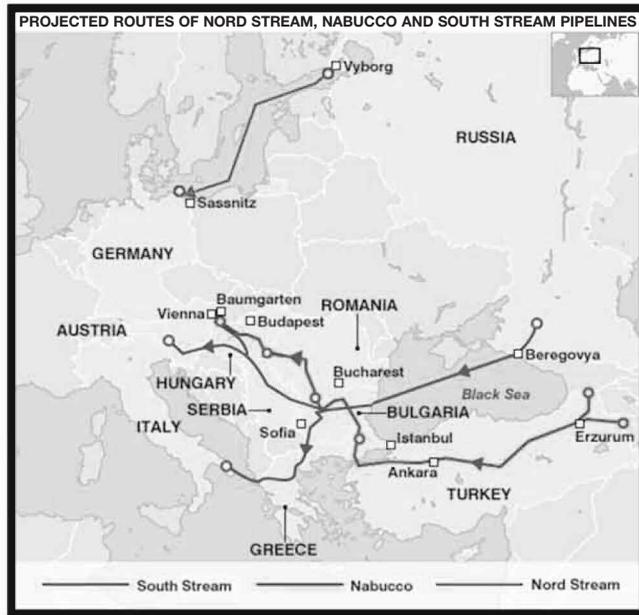
Turkey must weigh the benefits and costs of each offer, as each implies a very different direction for the up-and-coming energy hub. In the end, the offer Turkey chooses must coincide with its interests as a country. In terms of the auction, which offer is worth more to Turkey? Weighing all monetary and political revenues and costs, Turkish leaders will make their choice based on whether the economic and political benefits of each group's offer coincide with Turkey's most important goals. The purpose of this article is to compare Turkey's options and, based on this analysis, predict the outcome of the competition between the two southern bypass pipelines currently being considered, the EU's Nabucco and Russia's South Stream.

Breaking the Eurasian Gas Monopoly

In order to understand Turkey's current situation, it is imperative to comprehend why Russia and the EU are shopping for a bypass in the first place. For the Nabucco pipeline, which is backed by a consortium of private and state-owned energy companies including Turkey's BOTAS, Austria's OMV Gas, and Germany's RWE-AS, bypassing monopolized Russian and Ukrainian routes is the key motivation. ("Shareholders") As shown in Figure 1, the pipeline will directly connect consumers in western, central, and eastern Europe with supplier countries in central Asia, the Caucasus, and the Middle East. Starting on the Georgian-Turkish border and ending in Baumgarten, Austria, the pipeline is expected to pump 31 billion cubic meters (bcm) of gas a year a distance of 3,300 km, and is estimated to cost 7.9 billion euros. The first phase of the project was expected to be completed by 2012, but construction has been delayed. ("Project Description / Pipeline Route")

If completed, the Nabucco pipeline will make Turkey the conduit for one-tenth of Europe's natural gas supply. (Lucas, p. 176) More importantly, Nabucco's gas would originate in a variety of countries and pass through a pipeline that is not wholly owned and operated by OAO Gazprom, the Russian state-owned natural gas monopoly. These two facts are important for the EU because of the unique characteristics of natural gas and its exchange on world markets. Unlike oil, fruit, vegetables, consumer electronics, and other goods that regularly trade between states, natural gas is not solid or liquid at room temperature. This seemingly innocuous fact limits the options for transporting this economic input to two: pipeline and liquefaction (LNG). Due to LNG's prohibitive costs, pipelines are the dominant way gas is transported from supplier to consumer. (Goldman, p. 82) Gas transport is further concentrated because pipeline construction is a very capital-intensive activity that is subject to large economies of scale and geographical constraints. Similarly, natural gas deposits are not distributed evenly across the globe; they are concentrated only in places that have the proper geologic formations to capture the gas as it forms from organic material. This concentra-

Figure 1
Proposed Pipeline Routes



Source: "Europe's Energy Portal."

tion of routes and supply creates considerable market power for the companies and countries that own them, leading to higher prices for an input vital to economic welfare.

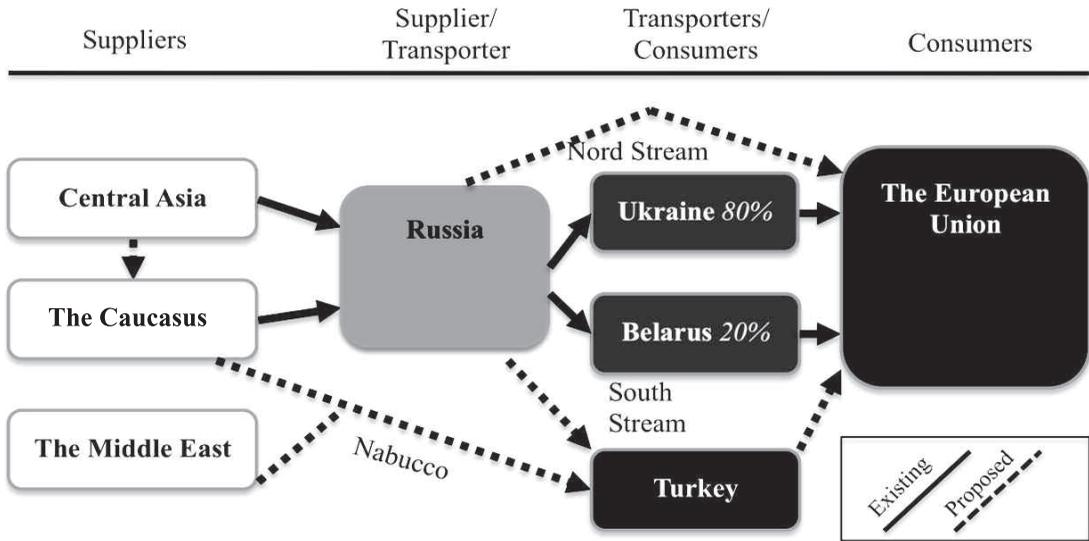
High prices, however, are not the only issue downstream customers must fear. When economic terms like supplier and transporter are replaced with the term sovereign state, a political component is added to the equation. States do not always act in an economically rational manner. Upstream monopolists can choose to view trade simply as a means of economic enrichment in the liberal spirit, or they can easily adopt a more mercantilist view of trade, whereby countries actively use the exchange of goods to create gains in relative political power. Russia's gas relations with the eastern European countries in its immediate vicinity clearly illustrate the injection of political ambitions into gas trade. Ukraine, a country that recently underwent a democratic revolution and elected a Western-leaning government, pays much higher prices for gas than most of its neighbors while being under continuous pressure from Gazprom to rene-

gotiate its gas price to the European norm. (Chow and Elkind, pp. 82–84) Because of Ukraine's vital position in the trade of gas from east to west (80 percent of Russia's European deliveries are transported through it), this pressure has led to two embargoes of gas to Western Europe. The first was in the beginning of 2006, roughly a year after the revolution. The second began on the first day of 2009 following a heated dispute over contract terms. ("Energetic Squabbles")

The European Union is dependent upon this unstable transportation system for a sizeable chunk of its natural gas. Russia, endowed with the world's largest natural gas reserves, currently supplies 40 percent of the EU's energy imports. (*Quarterly Report . . .*, p. 18) This number, however, is a deceiving aggregate. Dependency increases as one moves east across the continent, hitting 100 percent in some central and eastern European countries and all of the Baltic nations. ("Country Analysis Briefs: Russia," p. 11) This heavy reliance, coupled with the current rocky relationship between Russia and Ukraine, creates a nightmare for Euro-

Figure 2

Eurasian Natural Gas Trade Routes



Source: Author's graphic based on information from *Eurasia Daily Monitor*.

pean decision makers trying to ensure that the important commodity continues to flow.

In this geopolitical setting, one can see the EU's logic behind supporting the Nabucco pipeline project. First, Nabucco will allow the EU to receive gas from more transit routes and sources and will "break up" a monopolized market and turn it into an oligopoly. This action will ultimately lead to lower prices due to decreased market power for formerly monopolist suppliers and transporters. In addition to price effects, alternative routes of travel for gas will increase the EU's energy security by tapping an independent alternate supply base and transportation route, allowing the EU to receive gas during times of supply disruption, whether they be technical or political. Finally, by showing its cohesiveness on energy issues, the EU will gain relative power over its upstream partners by showing that diversification is a viable and achievable option. This show of unity will make Russia and Ukraine much more likely to refrain from injecting political ambitions into gas deals in the future, due to the fear of further erosion of their primacy as supplier and transporter. (Lucas, p. 176)

However, the EU will not achieve its diversification goals without a challenge. Russia is very keen to keep the status quo of dependency,

and is even trying to modify the current system for its own advantage. It was no surprise when Russia announced the construction of its own southern bypass route in an attempt to effectively kill Nabucco. This pipeline, dubbed the South Stream, would be built by Russia's Gazprom and Italy's ENI. It would transport up to 63 bcm of Russian and Central Asian natural gas through the Black Sea (in Turkey's exclusive economic zone) to Bulgaria and further to Italy and Austria. ("Gas Pipeline Route;" "Facts and Figures") There are two main goals for this pipeline: first, to bypass Ukraine and allow Russia to use its gas for political ends without fear of spooking the EU into a more cohesive push toward diversification; second, to strike first and make the Nabucco project unprofitable, preserving the Russian monopoly and blocking the EU's attempt at diversification that does not involve Russia. (Lucas, pp. 177-78)

Supply and Demand

In order to determine which pipeline will ultimately be built, one must understand the supply and demand constraints under which these projects operate. Although the Turkish government insists that the two pipelines are

“complementary, not rival, efforts,” the current consensus is that there are only enough resources and customers to support one southern bypass pipeline, at least in the near term. (“Nabucco Still the Top . . .”) Mikhail Korchemkin of East European Gas Analysis drove this point home in a recent analysis of Gazprom’s pipeline volumes and the EU’s future demand. Because the combined volume of South and Nord Stream (Russia’s proposed northern bypass) would be more than enough to satisfy EU demand through 2020, he concludes that Nabucco cannot even begin to be economically feasible until 2025. (Korchemkin) Therefore, at least in the short term, a decision for Nabucco is necessarily a decision against South Stream and vice versa.

As illustrated in Figure 2, Nabucco’s gas supply will come primarily from central Asia, the Caucasus, and eventually the Middle East. Nabucco, unlike South Stream, currently has specific gas reserves pledged to the project from Azerbaijan, while Turkmenistan, Kazakhstan, Egypt, and Iraq have pledged their support in the future. (Kardas, “Nabucco Intergovernmental Agreement . . .”) Potential Nabucco suppliers have much to gain from shipping gas through non-Russian pipelines. Currently Russia generates considerable revenues by exploiting its advantageous position as one of the few (and largest) gas transportation links between central Asia and Europe by buying gas at low prices in central Asia and reselling it on lucrative European markets. Large gas producers in central Asia, whose economies are geared toward the extraction and export of gas and oil, must accept much lower than European prices for their precious exports. In addition, the Kremlin has not been the most amicable transporter. In April 2009, politically charged price negotiations between Turkmenistan and Russia ultimately led to an explosion that ripped through the main export pipeline connecting the two countries. (Grib) Shipments began again in January 2010 (Socor, “Russia Resuming Gas Imports . . .”), but Turkmenistan has repeatedly shown its displeasure, severing ties with Moscow on other deals and pledging its gas to Nabucco. (Socor, “Turkmenistan Delays . . .”) Nabucco offers these economically one-dimensional states the very real benefit of receiving prices closer to the European norm. In contrast,

South Stream would preserve Russia’s monopoly over transit routes for central Asian gas and thus its grip on prices. It has no dedicated supply base, but will most likely draw on the reserves dedicated to Nabucco from Azerbaijan and Turkmenistan, in addition to Russian exports currently flowing through Ukraine. (Socor, “No Gas Sources Foreseen . . .”)

As far as demand for gas is concerned, the main determinant of each pipeline’s success is the European Union’s solidarity on energy security. In the last few decades the EU has shown remarkable unity on such issues as the free movement of goods and capital, but it has had a less-cohesive track record on forging a coherent energy security policy. Russia’s usual tactic of dealing with the EU is one of divide and conquer, offering preferential bilateral deals to individual EU countries that may be rational for one but detrimental collectively. Nabucco would undoubtedly reflect solidarity by the members of the European Union, the culmination of a growing realization that diversification is an important issue for the security of Europe. Successive Ukrainian gas crises in 2006 and 2009 and the current tumultuous contract negotiations between Ukrainian and Russian leaders have driven the point home. (Kupchinsky) Although the individual states of the EU are still susceptible to Russia’s divide-and-conquer tactics, these factors combined have brought solidarity on diversification to the forefront of the EU’s agenda. This point was articulated by Ferran Tarradellas Espuny, the spokesman for energy of the European Commission, in a recent interview with the respected Russian business daily *Kommersant*, where he explained explicitly that “South Stream is not a priority, for the EU Nabucco is much more important.” (Gabuev)

Turkey’s Choice

Supply is ample enough for one Southern bypass. The European Union has diversification on the agenda. What matters now is forging a specific political and territorial connection between the two ends of the hypothetical pipeline. Thus Turkey, or more specifically its geopolitically valuable land corridor, becomes the linchpin — the most important link in the EU’s (and Russia’s) prospective gas transit

route. (Lucas, p. 176) As would be expected from the vendor of any highly-sought-after item, Turkey is currently playing both projects' proponents against each other in the hopes of driving up the price for its valuable property. Both projects are moving along without any regard to the technical and economic constraints the pipelines face in being built. In the near term, there can be only one.

The Nabucco intergovernmental agreement, a 50-year legal framework that will become the base for future negotiations, was signed in Ankara on July 13, 2009. The participants in the event indicate its importance: the prime ministers of Austria, Bulgaria, Hungary, Iraq, Romania, and Turkey attended, along with the President of Georgia (Mikheil Saakashvili), the EU Commission's President (Jose Manuel Barroso), the EU Energy Commissioner (Adris Pielbags), and the U.S. special envoy for Eurasian energy (Richard Morningstar). The high-level participants agreed on a framework for signing future project agreements (five in all over the next five years) with the ultimate goal of completing the construction of the delayed pipeline by 2014. The Azeris reaffirmed their pledge to supply gas to the project, and the Iraqi Prime Minister announced that 17 bcm would be available for Nabucco by 2017. Financing was discussed, and the expectation is that it will be secured shortly. (Kardas, "Nabucco Intergovernmental . . .")

This successful meeting prompted the Russian newspaper *Kommersant* to run an article proclaiming "Nabucco is inevitable." (Zygar) However, the euphoria did not last long for the Nabucco partners. On August 6, 2009, Turkey signed a less potent, non-binding agreement pledging its support for the South Stream pipeline. The proposed pipeline grew in size from its last conception, dwarfing Nabucco at 63 bcm a year of gas throughput, although once again no gas has been specifically earmarked to run through the enlarged pipeline.¹ Cost estimates for the pipeline's construction were given but seem artificially low, especially since securing financing for the project will not be an easy task. Russia was deeply affected by the

global economic downturn, and government revenues are low. The meeting had one important outcome: it finalized South Stream's position as a direct competitor to Nabucco by putting into writing a previously informal agreement for the pipeline to run through Turkey's exclusive economic zone. (Socor, "Putin Entices . . .") The partners also agreed to order seismic and survey analysis for the proposed route. The Turkish government authorized the studies to commence in a meeting in Milan on October 19, 2009. (Socor, "Samsun-Ceyhan Pipeline . . .")

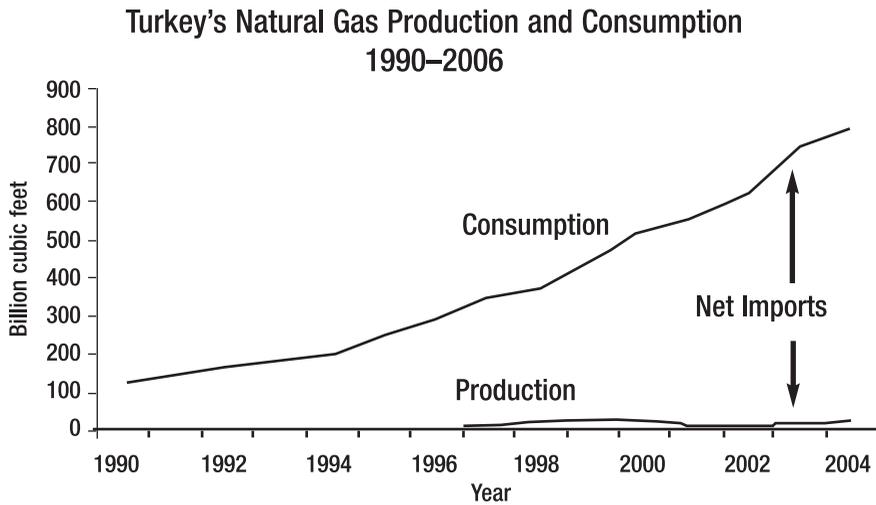
Comparing the meetings concerning the two pipelines, it is very clear that South Stream is not as far along as the Nabucco project. Concrete cost estimates, financing pledges, and set-aside gas make Nabucco the clear front-runner at this point. However, South Stream is still a viable alternative if Nabucco were to fall through. And just because one project is ahead of the other in the preliminary stages of planning, it does not mean it will move from the drawing board to construction. It is definitely in Turkey's interest to use all possible tactics to make it seem as if both Russia and the EU are viable partners, even though only one deal can be struck. For this reason, examining the rhetoric of the international meetings yields little insight into which pipeline will actually be constructed. But there is a better option. While all the parties continue to maneuver, two things remain concrete: Turkey's strategic interests and the broad implications of the two different offers. Identifying the offer that coincides most completely with Turkey's interests will separate bluffs and other false maneuverings from the most likely outcome of the competition.

Many important interests will affect Turkey's ultimate decision, which could be the determining factor in the Nabucco-South Stream competition if the EU can get its act together. The country no doubt sees the strategic advantage of becoming an energy transportation hub during a time of constrained world supply. The most superficial of the benefits of being an energy transporter is monetary gain from pipeline transportation fees. Under the Nabucco project, the payment will be based on the distance the pipe travels over a respective country's territory. Turkey, the largest landmass over which the pipe travels, will receive 60 percent of transportation revenues, totaling

¹The pipe's planned volumes were previously 31 (the same as Nabucco's) and 47 bcm respectively. (Socor, "No Gas Sources . . .")

Figure 3

Turkey's Gas Imports



Source: "Country Analysis Briefs: Turkey," p. 5.

450 million euros a year, along with funds for infrastructure development. (Kardas, "Nabucco Intergovernmental . . .") South Stream, on the other hand, currently has no set framework for the determination of transit revenues. The Russians are tough and sometimes belligerent bargainers, as illustrated by the contract negotiations between Russia and its pesky transit country neighbor Ukraine. The transparent, easy-to-understand tariff formula offered by the EU is a major departure from the current Russian norm.

Although tariff revenues are important, the security of Turkey's energy supply definitely trumps short-term economic gain as a factor in deciding which buyer's bid to choose. Turkey's gas supply is extremely insecure — the commodity accounts for 29 percent of the country's energy consumption, and the country is highly dependent on imports, the majority of which (almost 70 percent) come from Russia. ("Country Analysis Briefs: Turkey," p. 1; "Putin Signs Energy . . .") As Figure 3 shows, the gap between production and consumption will only continue to widen as Turkey's young population grows and its economy continues to develop. Thus, it is imperative for Turkey to ensure that its gas supply continues to flow uninterrupted.

With this knowledge in mind, it is understandable that the biggest issue for Turkey is the

amount of gas it is allowed to withdraw from the pipeline for its own use. The current framework of the Nabucco Consortium states that 50 percent of the pipeline's gas is to be reserved for its shareholders while the other half will be auctioned to outside companies. (Kardas, "Nabucco Intergovernmental . . .") The Turkish government pushed hard to be able to take 15 percent of the amount allotted to the partners. This issue was a major sticking point in the bargaining process — Turkey's BOTAŞ claimed the 15 percent "take away" was still being negotiated, while EU officials continuously contended the amount was too large and off the table. (Kardas, "Turkish-Azeri Talks . . .") The very public disagreement seems to be over. Turkey's Secretary of State for Energy Taner Yildiz recently suggested that Turkey obtained other security guarantees, like the ability to bid for the surplus gas and the construction of a multidirectional pipeline to ship excess gas from Europe back to Turkey.² (Kardas, "Nabucco Intergovernmental . . .") In comparison, South Stream again offers Turkey little in the way of

²In times of gas surplus in the EU, which are common because long-term deals rarely correctly estimate the exact amount of gas needed by a country, Turkey would be able to buy the excess gas by shipping it in the reverse direction from the EU to Turkey. Most pipelines only flow one way, making this transaction impossible.

concrete benefits. Turkey is not part of the joint-stock company, and thus there is no obligation for the partners to allow Turkey to receive any gas at all. As in the case of the transportation fees, the details must be sorted out later, once South Stream is further along in its development and the Turks have committed themselves to working with Russia. (Socor, "Putin Entices . . .")

In its quest to become an international energy hub, Turkey's interests transcend those of money and security. Completing the Nabucco pipeline to bypass monopolized Russian routes is a preeminent goal of the European Union, a club that Turkey has been attempting to join since October 2005.³ The Nabucco project highlights the EU's strategic need to include Turkey to achieve vital energy security goals. (Tekin and Williams, pp. 350–52) The EU was created to achieve goals that could not be attained by individual states acting alone. By this line of reasoning, Turkey's inclusion into the Union is a rational next step in the EU's evolution. The Turks' accession will ensure that Europe has a safe and secure conduit to receive diversified gas shipments, breaking Russia's hold over the EU's energy imports. The joint statement released from the "Turkey and the EU: Together for a European Energy Policy" conference in Istanbul on June 5, 2007, echoes this reasoning, stating explicitly that "Turkey is of strategic importance for the security of energy supplies to the EU." (*Joint Conference Statement*) On top of forging shared interests, the process of integrating its energy markets with the EU will undoubtedly bring the EU and Turkey closer together physically — investments must be coordinated and bureaucratic infrastructure must be standardized. (Tekin and Williams,

³Turkey's accession process was expected to be swift. However, powerful members of the EU have shown their displeasure at the possibility of Turkish accession. Some qualms are reasonable: substantial differences in wage levels and unresolved issues over the contested island of Cyprus. Others border on racism, claiming the Turks are not European and thus cannot be part of the Union. ("Turkey's Circular Worries") Turkey's accession process has been stagnant for some time.

p. 352) In contrast, the South Stream pipeline will undeniably create more connections between Russia and Turkey. Russia, with its own development troubles, has little to offer in regard to bureaucratic reform or high tech investment. Indeed, the current push in the country is to combat corruption in the government and develop a more diversified economy. (Medvedev)

The Highest Bidder

It is clear that Turkey has nothing to lose from driving a hard bargain for its geopolitically valuable gas transportation corridor. Both bidders have a great desire to secure the route for their respective projects. Turkey has expertly played both sides against each other, making it clear to the EU that Nabucco is not inevitable but a choice. It can easily side with Russia, the powerful hydrocarbon exporter, and still achieve some of its strategic goals. In the end, however, Turkey must pick a side, or a very important opportunity for the country will be squandered. To determine which bidder will ultimately win, one must examine what each interested party is willing to trade for its prize. The European Union offers a transparent mechanism for Turkey to generate hard currency, an excellent diversification option for a country with pressing energy security concerns, and enhanced chances for membership in a club Turkey has wanted to join for over a decade. Russia, on the other hand, offers Turkey the promise of big transit profits and gas volume, all to be negotiated down the line, when Turkey will no longer have the luxury of playing off buyers against each other. In the current climate of gas charged political conflict, Turkey's choice is a simple one. Nabucco will be built. It offers the Turks an undeniable opportunity to make their country of vital importance to the EU in addition to securing diversified gas supplies for the development of the young, dynamic country. Strategic, tangible interests will trump illusory future gains, bringing together a buyer and seller who have much to offer each other.

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