Nabucco's window of opportunity

The psychological effect of the Russian-Ukrainian gas dispute on Europe and difficulties in relations between Russia and Turkmenistan are giving a new boost to Nabucco. But the EU's gas pipeline hopes are being undermined by competing projects from European companies and the Caspian states' growing realisation that they may secure a better deal if they do not commit to any pipeline just yet. For the proponents of Nabucco, the time to act is now.

by Nazrin Mehdiyeva

Contrary to conventional wisdom, Russia's policy of diversifying away from Ukraine is not new. It became apparent in 1996, when after several severe interruptions of gas supplies to Turkey via the then only existing 'western' route through Ukraine, Gazprom announced the construction of the Blue Stream pipeline. This line presently carries Russian gas under the Black Sea to Turkey. The main rationale behind its construction was to ensure the safety of supplies to the Turkish market.

Russia's determination to diversify away from all transit states grew over time to encompass Belarus and Poland. But in 1999, Belarus was still considered reliable. Gazprom therefore planned for the construction of two new lines to transport "new" gas from the Yamal peninsula to Europe. The first – Yamal-Europe I – was completed in the early 2000s. The second was never built in part due to delays in developing Yamal. Another plan to bypass Ukraine involved the creation of a link between Poland and Slovakia. The plan envisaged raising the capacity of the existing Yamal-Europe line and constructing a parallel one, with perhaps a parallel link to the Slovakian network. Russia and Slovakia came to an agreement, but Poland had objections and the plan never got off the ground. Had it been realised, it is likely that Russia would have never opted for expensive pipelines under the Baltic Sea. The difficulties with Poland and uneasy relations with Belarus, led Moscow to decide that it was safest to avoid transit states altogether. Gazprom subsequently rejected the Amber project – from Torzhok in Russia across the Baltic states to Poland and Germany – which Warsaw proposed as an alternative to Nord Stream.

Caspian policymakers tend to overestimate their importance for European gas supplies

Remarkably, a similar strategy of diversification has been applied to oil. In 1997, Moscow approved the creation of the Baltic Pipeline System to Primorsk (near Vyborg in Russia where Nord Stream originates). The main motivation here was the rising cost of transit paid by Russia to the Baltic states. The project was completed in 2001. Following a dispute with Belarus in December 2006, Russia approved the construction of the BPS II, on which work has started, although doubts persist as to whether it will have enough oil to fill it.

Nabucco pipeline conference, Budapest, January 2009. Photo: OMV

Gas wars

Moscow's August 2008 war in Georgia, and the Kremlin's belief that Kiev offered military support to Georgia, are behind the Kremlin's determination not to yield to Ukraine's demands of lower gas prices. Speaking on national television, President Dmitry Medvedev warned that Russia would "never forget" Ukraine's military involvement and would "factor it into" its policy towards Ukraine.

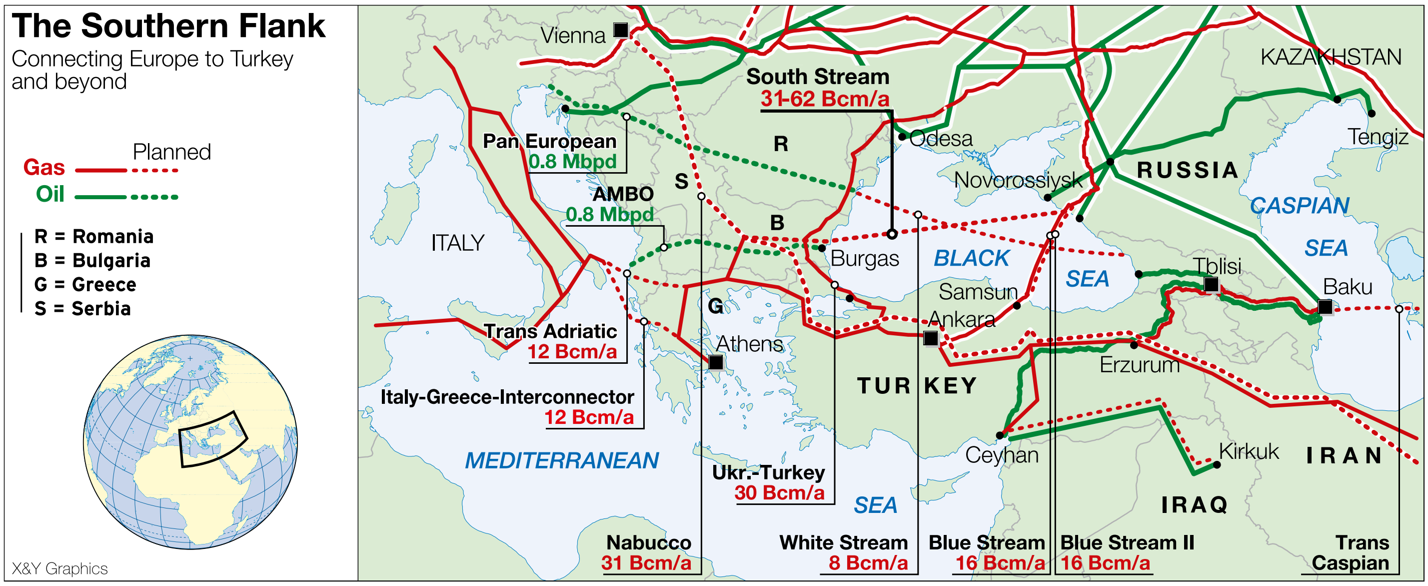
The Kremlin's rigid position coincided with Gazprom's wishes of raising prices to Ukraine. Thus, the 2009 dispute was allowed to deteriorate beyond the point of what had been previously considered acceptable in order to make Europe feel the consequences of a serious supply disruption, which – it was hoped – would force the EU as well as European countries to intervene. An elaborate and well prepared public relations campaign was launched to explain the Russian position to Europe. Yet by January 2009, demands reflected emotions rather than what Moscow realistically expected to obtain from Kiev. Because of their excessive nature and the humanitarian emergency that the supply disruptions caused in the Balkans, Russia's position towards Ukraine generated little support in the West.

The crisis has had a strong impact on the EU psyche. It has caused heavy damage to Russia's reputation as a reliable supplier and intensified efforts to create not just new routes to Europe, but to find new, non-Russian sources of gas.

On Europe's side, the idea of bypassing Russia is also not new. It started in the early 1990s, with the Baku-Supsa and Baku-Tbilisi-Ceyhan (BTC) oil pipelines. A gas pipeline that for most part runs parallel to BTC was subsequently constructed to Erzurum in Turkey, with an intention to use it as a key section of the future Nabucco line that will run from the Turkish border to Baumgarten in Austria.

Currently, questions as to whether Nabucco is a purely political project abound. Numerical modelling undertaken by Pöyry Energy Consulting shows that even under its Central Scenario, a situation is likely to develop whereby the depletion of the main super-giant fields in West Siberia is not matched with a timely development of Russia's next gas province – Yamal. Upstream development is likely to suffer as a result of Russia's determination to pursue investment in expensive bypass pipelines. When demand in Europe and Russia resumes, Gazprom could struggle to grow production sufficiently quickly.

Turkmen gas, which until now has been used to plug holes in times of deficit in Russian gas production will be available in far lesser volumes once the 30 billion m^3 (bcm) per year pipeline from Central Asia to China becomes fully operational in 2011. If the diversion of significant volumes to China is not matched with increased investment in the large South Yolotan-



Osman and Yashlar fields, then Russia's panacea of compensating for production shortages with imports of Turkmen gas will no longer apply.

Vulnerability

Russia has recently expressed interest in buying up all the gas from the development of the second phase of Azerbaijan's Shah Deniz field. However, the problems experienced by Turkmenistan in exporting gas to Russia following a pipeline explosion on April 9 highlight the vulnerability of the Caspian supplier states in relying on one export route. It appears probable that the explosion had been precipitated by Russia, which was unwilling to buy unneeded volumes of Turkmen gas at the high price agreed in December 2008. Even after the line was repaired, exports did not resume, as Moscow offered Ashgabat to reduce either the price or the volume (by 80%). This vulnerability has deep consequences for the socio-economic and, ultimately, political stability of the Caspian states, which depend on hydrocarbon revenues. The absence of existing bypass outlets constrains upstream investment, as companies are uncertain they will find an outlet for their gas. One indication of this came with Azerbaijan's announced delay in launching Phase II of Shah Deniz until 2016, as a result of the difficulties in negotiations with Turkey.

Thus, incentives for building Nabucco are two-fold. On the part of consumer states, the likely shortages in Russian gas production as a result of high demand in Russia and Europe during periods of high economic growth, provide the economic rationale for Nabucco. This is reinforced by political considerations highlighted during the Russian-Ukrainian dispute of 2009. On the part of producer states, the diversification of routes will result not only in more reliable gas flows to markets but also enhanced investment in production, which in turn, will increase exports and revenues.

And yet, despite this convergence of interests between consumers and producers, Nabucco is still lacking the commitment to obtain financing. On the surface, this is down to the supplier states' lack of firm commitments. Azerbaijan can provide the baseload for the pipeline, but gas from Shah Deniz will be insufficient to fill the 31 bcm/annum line. Baku's recent orientation towards Russia, explained partly by Turkish rapprochement with Armenia, now makes the availability of even the initially projected volumes uncertain. Turkmenistan's participation is key; yet, the country's new leadership has engaged in a complicated manoeuvring game between Russia and the West.

Competition

And Nabucco is threatened from another side as well. It is not the only project vying for Caspian gas. It competes with at least two other projects initiated within the EU that stand a good chance of being implemented. The first is ITGI (Interconnector Turkey-Greece-Italy), which has Italy's Edison and Greece's Depa as partners. The second is the Trans-Adriatic pipeline (TAP), a joint venture between Swiss EGL and Norwegian StatoilHydro.

ITGI has a planned offshore section, known as the Poseidon project. If constructed, the pipeline will have capacity of 8 bcm/annum. Edison and Depa hope to fill it with gas from Phase II of Shah Deniz and will need at least 5 bcm to make the project viable. Nabucco will need about 8 bcm to justify start of construction and 15 bcm to reach break-even. In two separate agreements, Azerbaijan has indicated its readiness to supply gas to Edison and Depa. However, earlier this year, Baku announced that it failed to reach an agreement with Turkey on the transit of additional volumes to Greece.

TAP would take gas from Greece to Italy across Albania. The project is promoted by EGL, but until recently, there existed vast uncertainty over the sources of supply. In March 2008, EGL and the National Iranian Gas Export Company signed an agreement for the supply of up to 5.5 bcm of gas through the existing Iran-Turkey link for a 25-year period. Furthermore, at around the same time, EGL and StatoilHydro established a joint-venture to develop TAP, which has given the pipeline a significant boost because StatoilHydro owns a 25.5% stake in the Shah Deniz field and will now seek to develop this pipeline as an outlet for Caspian gas.

Then there is a third potential competitor to Nabucco – White Stream, which was first proposed by Ukraine in 2005, in response to the difficulties this country was having with Russia. This project has the least chance of being realised. Until recently, its route remained undecided, with two main options considered, the first to link Georgia with Ukraine and Romania; and the second to link Georgia directly with Romania, with a longer sub-sea section. Although White Stream has slim chances of securing the necessary volumes of gas, the representatives of the London-based GUEU-White Stream Pipeline Company have been active in lobbying Azerbaijan to send new volumes from Shah Deniz gas via this pipeline. Their efforts have been matched by endeavours from the companies interested in the construction of ITGI, TAP and Nabucco.

Clearly all these pipelines cannot be filled with gas from Azerbaijan alone. Enter Turkmenistan. This country has received even greater attention than Azerbaijan, especially in comparison with the scant international exposure it had under late President Saparmurat Niyazov. Its potential role in providing the gas to enable the implementation of all of these projects was enhanced recently when the results were announced of an international audit conducted by Gaffney, Cline & Associates. This audit confirmed the existence of large reserves in the fields of South Yolotan-Osman and Yashlar. Even at the lower estimate of 4,000 bcm, the super-giant South Yolotan-Osman field is larger than Russia's Shtokman field. The top-end estimate for the field could be as high as 14,000 bcm, as much as the total proven reserves of countries like Nigeria or Algeria. South Yolotan-Osman is not without its difficulties: it is, for example, expected to contain high levels of sulphur, but its development is likely to be far less technologically challenging than the launching of the Shtokman field in the Barents Sea.

The Russian policy of diversifying away from Ukraine is not new

Increased international attention has affected self-perceptions of Caspian producer states, which now feel in high demand. In fact, their policy-making circles tend to overestimate their importance for European gas supplies. Caught in the present flurry of diplomatic activity, they frequently overlook the fact that Europe has access to LNG as well as potentially greater volumes of pipeline gas from Africa and the Middle East. For the Caspian states, playing the manoeuvring game for too long and failing to capitalise on the existing opportunity of building outlets to Europe will limit their export markets. They will then be constrained to selling gas to Russia and Iran, which themselves have enormous reserves, and China, whose willingness and ability to pay a price comparable to what exporters could fetch on the European market, remains an open question.

Time to act

The opportunities for Nabucco – or other outlets for Caspian gas, such as ITGI and TAP – will not always be there. When Russia launches the first Yamal field of Bovanenkovo, production from that field alone will grow to 115 bcm/annum within three years. Bringing online the neighbouring Kharasavei and Kruzenshtern fields will be simpler because the Yamal-Ukhta pipelines will have already been put in place. A successful launching of Shtokman will bring very significant new volumes of gas to the market, particularly if Russia decides not to liquefy the bulk of output but to send it via pipelines to Europe.

The psychological effect of the Russian-Ukrainian crisis of 2009 will also fade over time. Of course, interruptions of supply remain a real possibility up until the construction of Nord Stream. However, once the first of the two 27.5 bcm/annum pipelines becomes operational, Kiev's leverage over Moscow will be significantly reduced, resulting in more reliable exports to Europe. If Russia continues to implement the policy of diversification consistently, as it has done over the past decade, the second line of Nord Stream and the construction of South Stream will wipe out Ukraine's bargaining position altogether.

In brief, the two factors that are currently driving Nabucco – the probable gas shortages in Russian gas supplies and Europe's political incentive to receive gas via other sources – will lose much of their momentum by 2014-15 and may disappear altogether by 2020, when Russia makes inroads into establishing its eastern gas fields as significant sources of new gas. The time to act is now. ■

Who is Nazrin Mehdiyeva?

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