

## **TURKEY'S CASPIAN ENERGY QUANDARY**

The Turkish agenda has been understandably dominated in recent months by the grave economic crisis and Turkey's possible role in the United States-led drive for a regime change in Iraq, as well as by the domestic political upheavals that have led to a decision on early elections in November. Consequently, there has been little serious discussion of Turkish energy problems. In fact, until recently, the prevailing mood in Ankara on energy policy was unwaveringly upbeat. Political leaders and officials pointed to Turkey's vibrant economy and projected energy needs as they focused on the important role the country was destined to play in the global energy picture. Parallel to its own growing energy consumption, they argued, Turkey would use its geographic location and strategic influence, along with its ethnic links to the Caspian Sea region oil and gas producers, to provide the answer to the problem of transportation in the exploitation of Caspian energy resources. Thus, as the primary facilitator in the creation of the Eurasian Energy Corridor (EEC), in close cooperation with the United States, Turkey would be transformed into an indispensable energy hub in the transportation of Caspian oil and gas to world markets.

Accordingly, Turkey pushed ahead with long-term agreements to satisfy its estimated energy requirements, as well as the Baku-Tbilisi-Ceyhan (BTC) pipeline project for Caspian oil and the Baku-Tbilisi-Erzurum (BTE) pipeline project for Caspian gas as twin components of the EEC. The unprecedented slump in the Turkish economy, however – it shrank more than 9 percent in 2001 – has forced an unavoidable downward revision of the bloated energy demand projections, and serious questions have inevitably surfaced relating to Turkey's ability to proceed with the planned purchase of Azeri gas through the BTE. Turkish energy rhetoric has long been racing ahead of reality, and, as Turkey prepares for important parliamentary elections and a new government, it is essential to look beyond the exaggerated expectations and miscalculations.

### **THE ENERGY BRIDGE**

In May 1999, then Turkish Energy Minister Ziya Aktas spoke at a CSIS Caspian Energy Project meeting and proudly proclaimed, "Being a natural bridge between Europe and Asia throughout history, Turkey seeks to become an energy bridge of the future between East and West. Based on the facts about Turkey's wider role in the Black Sea and Central Asia, Turkey will remain a major participant in one of the world's greatest energy development projects." The projected Turkish role in the EEC, which had been in development since 1994, was enthusiastically supported by the United States. Both the Clinton and Bush administrations viewed the EEC as crucial in the exploitation and transportation of the region's oil and gas resources to world markets and in strengthening the economic relationship between Turkey and the Caspian oil and gas producers. An additional related goal was preventing a Russian monopoly in transportation while continuing to exclude Iran. The U.S.

backing, which was also designed to shore up U.S.-Turkish cooperation in the post-Cold War era, was first enunciated by then U.S. Ambassador to Turkey, Marc Grossman, in January 1995, and sustained and expanded by his successors in Ankara, as well as by four Senior Advisers for Caspian Basin Energy Diplomacy in Washington. However, it is important to note that Washington's backing for the EEC did not extend to the provision of direct financial support.

U.S.-Turkish cooperation was clearly a factor in obtaining the support of Azerbaijan and Georgia, as well as the even more crucial backing of BPAmoco, the biggest shareholder and operator of the Azerbaijan International Operating Company (AIOC). BPAmoco shifted its policy from open skepticism to full support for the BTC in 1999 and helped sustain the momentum that eventually led to the establishment of the BTC Pipeline Company in August 2002 under its leadership. Although ExxonMobil and Lukoil, two major AIOC shareholders, have not joined, the formation of the new company indicated that the project was poised to move into the construction phase, despite lingering questions relating to volumes and cost, as well as the burden Turkey - which is having problems with existing energy project guarantees - may have to assume.

For their part, Turkish, American, and BPAmoco officials remain confident that the BTC is on track for completion by the end of 2004. David Woodward, the AIOC president, recently argued that the AIOC would have enough oil to fill the 50-million-ton capacity of the pipeline and that additional volumes might be needed only after 2015, when AIOC production is expected to decline. However, without the previously claimed Kazakh volumes, the capacity of BTC will be underutilized for a number of years after its projected completion. Consequently, it might have been advisable to wait until the oil volume had built up to the point where there was an irresistible commercial imperative instead of relying on financially beleaguered Turkey to help make the project attractive to shippers through a fixed long-term transportation fee as well as the cost overrun guarantee for the Turkish portion of the pipeline.

Moreover, even as Turkish energy officials continue to emphasize the apparently imminent decision on the construction of the BTC, they have to confront difficult questions on the future of the projected parallel gas pipeline with its alleged cost savings for the EEC. It is not clear how much of a role the proposed purchase of Azeri gas from the Shah Deniz field, in which BPAmoco is also a major shareholder and operator, played in the Azeri and BPAmoco decision to support the BTC. What is clear, however, is that if Turkey is unable to proceed to the conclusion of a "take or pay agreement" on Shah Deniz gas because its market is "overbooked" by existing gas purchase agreements, or moves ahead in the hope of re-exporting the surplus gas to the well-supplied West European market, the delicate EEC equation is certain to be affected.

## **AVOIDABLE CONTRADICTIONS**

The origins of many of the current problems in Turkish energy policy can be traced back to the brief True Path-Motherland coalition of 1996 that saw the Motherland Party regain control of the Energy Ministry after a gap of four and a half years. The bureaucratic team that was installed managed to retain effective control throughout the next six years, even when the ministerial portfolio was briefly transferred to the Welfare Party and the Democratic Left Party. During this period, the Energy Ministry had the lead on all pipeline issues, which previously had been determined by a pipeline coordinator working in close conjunction with the Foreign Ministry and the Treasury, as well as the Energy Ministry and its affiliated institutions. This authority was used, among other things, to increase Turkey's dependence on Russian gas, most notably through the conclusion of the

controversial Blue Stream project to bring gas through a pipeline under the Black Sea, even as collaboration continued with the United States, Azerbaijan, Georgia, and the AIOC on the EEC.

To be sure, the virtually daily announcements of progress on the extremely popular BTC project were politically invaluable to the Energy Ministry, which was plagued by corruption allegations, particularly after Operation White Energy was launched in January 2001. Many energy bureaucrats were swept up in the investigations, including those relating to alleged improprieties in Blue Stream, and although only a few individuals were eventually sentenced, it is noteworthy that the controversies led to the departures of the Energy Minister and the head of BOTAS, the state-owned Turkish pipeline company.

A few months before his resignation, Energy Minister Cumhuriyet Ersoy was publicly berated by Turkmen President Saparmurat Niyazov over the collapse of the Turkish-Turkmen gas agreement of May 1999 and the Trans-Caspian Pipeline project to carry Turkmen gas to Turkey “in favor of more expensive Russian gas.” Thus, in his typically blunt way, Niyazov helped underline the fundamental ambivalence in Turkish energy policy and the Turkish campaign for the EEC. While promoting the virtues of a non-Russian route for Caspian oil and gas and aggressively opposing Iran coming into the Caspian oil picture for fear of losing volumes from the BTC, Turkey had in fact signed bilateral gas agreements with Tehran as well as Moscow. Even before the Blue Stream deal in December 1997 added a 16-billion-cubic-meters (bcm) commitment to the existing commitments for 14 bcm of Russian gas through Thrace, Ankara had struck a deal in August 1996 for 10 bcm of Iranian gas. Coming on top of long-term agreements on liquefied natural gas (LNG) from Algeria and Nigeria, these deals, which were declared essential to ward off an energy shortage, effectively saturated the Turkish market.

(Source: Republic of Turkey, Ministry of Energy and Natural Resources)

Current Agreements	Maximum Yearly Amount	Date of Agreement	Duration (years)	Status
Russian Federation (via Thrace)	6	February 1986	25	In effect
Algeria (LNG)	4	April 1988	20	In effect
Nigeria (LNG)	1.2	November 1995	22	In effect
Iran	10	August 1996	25	In effect
Russian Federation (via the Black Sea)	16	December 1997	25	Set to begin in late 2002
Turkmenistan	16	May 1999	30	
Russian Federation (via Thrace)	8	February 1998	23	In effect
Azerbaijan	6.6	March 2001	15	Set to begin in 2004
Total (bcm)	67.8			

## EXAGGERATED EXPECTATIONS

The virtual collapse of the agreement with Turkmenistan effectively reduced to 51.8 bcm the amount of gas and LNG Turkey was committed to purchase. However, as Turkey consumed only 14.6 bcm in 2000 and 16.4 bcm last year, even the revised amount appears beyond Turkey's capacity to consume. Not surprisingly, the consumption figures for the last two years were well below official projections, and the first months of 2002 witnessed an even more serious collision with reality. According to the Turkish daily, *Radikal*, Turkey was able to purchase only 80 percent of its commitment in January. This was reported to have declined to 50 percent in February and 40 percent in March. Moreover, as the gas agreements were "take or pay," the newspaper estimated that this amounted to a loss of \$170 million in penalties rising to \$1 billion by the end of 2002. Another newspaper, *Star*, claimed that the production of hydro energy was scaled down in order to reduce the oversupply. The stories prompted vehement denials by energy officials, who claimed that Turkey would not actually have to pay for gas it could not buy until December 31, 2002, even as they reportedly tried without success to renegotiate the deals with Moscow and Tehran.

However, in implicit recognition of their problem with inflated demand projections which were used to justify assurances that the growing Turkish energy market could consume all the gas it was committed to receive - vehemently denied by the State Planning Organization - energy officials quietly reduced the demand projections. By August 2002, the demand for the current year had been lowered from 23.3 bcm to 19 bcm. Similarly the figure for 2003 was lowered from 31.6 bcm to 27.3 bcm, for 2004 from 37.6 bcm to 30.8 bcm and for 2005 from 43.9 bcm to 32.2 bcm. According to the still unrevised estimates for subsequent years, Turkish gas demand is projected to reach 52.1 bcm in 2009 and rise to 82.7 bcm in 2020. Committed purchases, however, are due to rise from 25 bcm in 2002 to 27.9 bcm in 2003, 30.8 bcm in 2004, and 40.5 bcm in 2005, when Azeri gas is scheduled to start reaching the Turkish market. Consequently, barring a miraculous immediate economic recovery and upturn in consumption, Turkey has a very serious oversupply problem.

## ALTERNATIVES WITH COMPLICATIONS

One option being examined to deal with the problem is the creation of underground storage facilities. Refraining from the purchase of additional Azeri gas, which is reportedly cheaper than Blue Stream gas, is apparently not being considered, as this drastic move would obviously undercut the EEC. The current U.S. Caspian Energy Adviser, Steve Mann, recently added his cautionary voice to those of Azeri energy officials on the need for Turkey to "shield and protect Shah Deniz" and to "ensure construction" of the BTE. Consequently, perhaps mindful of the provision in the agreement with Turkmenistan for re-export through Turkey of 14 bcm of Turkmen gas, Turkish officials have turned to this option for Azeri gas, the delivery of which is scheduled to reach 6.6 bcm by 2008. Following the conclusion of an agreement on the re-export of gas to Greece in March, current Energy Minister Zeki Cakan proclaimed that Turkey would be "a transporter as well as a consumer of gas." While the Turkish-Greek pipeline would initially carry only 500 million cubic meters of gas in 2005, Cakan confidently asserted that the amount "would be increased gradually." As Greek consumption could not absorb the excess gas, the surplus would be directed into Western Europe.

Although the project has the blessing of the European Union (EU) along with the United States, there are major obstacles. To begin with, Russia, which has a significant share of the West European market as well as the Turkish market, is unlikely to watch idly as competing gas goes through Turkey

to challenge its lucrative energy relationship with the EU. Moreover, the realization of this option - even if all the necessary and difficult additional agreements on re-export volumes and financing can somehow be concluded - would create the strange spectacle of Russian gas coming to Turkey via Bulgaria while gas went back into Europe through a nearby pipeline via Greece. At the same time, the project requires the assurance of continued good relations between Turkey and Greece, as well as between Turkey and the other EU countries. However, if Turkey is rebuffed by the EU, while the Greek Cypriots are admitted in the name of the entire divided island, relations are likely to worsen considerably.

Another potential pitfall relates to the origin of the gas to be re-exported. While Azeri gas is fine with all concerned, surplus Iranian gas would be a different matter. Although the United States quietly set aside its reservations relating to Turkish consumption of Iranian gas, as Mann has confirmed publicly, the U.S. Congress and the Bush Administration, which has declared Iran to be part of “the axis of evil” in the war against terrorism, are unlikely to tolerate Turkey’s willingness to become a conduit for Iranian gas to Europe. Consequently, Turkey and the United States, which have been jointly opposing swaps through Iran for Caspian oil, may find themselves in sharp disagreement on the possibility of Turkey facilitating the creation of an even more profitable and strategically significant energy link for Iran. The paradox is that Turkey is trying to get out of its current energy mess, which is the direct result of its overpurchase of Russian gas, through the possible re-export of Iranian gas in order to be able to purchase additional Azeri gas. In the confusion it is easy to forget that the EEC was designed to be the alternative to both Russia and Iran in the transportation of Caspian energy resources to markets. Clearly the next Turkish government and the new energy team will have a big job on their hands after the elections.

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