

THE GAME-CHANGERS IN WORLD ENERGY: GEOPOLITICAL IMPLICATIONS

The forward march of globalization has paused since the financial crisis, giving way to a more conditional, interventionist, and nationalist model of development. The geopolitical scene is strongly affected by factors related to this trend – such as protectionism, economic and resource nationalism, technological, the rise of new energy producers and consumers, changing pricing mechanism, declining levels of investment, and shifting trade flows toward Asia. With a particular focus on Turkey’s neighborhood and the Southern Corridor, this paper discusses changing dynamics and emerging new risks in the new global energy game, with a view to developing messages for government and business leaders.

Mehmet Ögütçü*



* Mehmet Ögütçü is the Chairman of UK-based Global Resources Partnership and sits on the boards of Genel Energy plc and Yaşar Holding Group as independent non-executive director. Ögütçü has recently assumed the honorary position of the “Special Envoy” for the Energy Charter Secretariat in Brussels. He is also the executive chair of The Bosphorus Energy Club.

Over the past 20 years we have gone through a series of fundamental “game-changing” developments and a “power shift” in almost every sector of our lives, including the economy, geopolitics, security, technology, and values. The financial crisis that spread worldwide in 2008 and its subsequent recession have proven to be the most severe economic downturn since the Great Depression of 1929, causing a major turn towards protectionism and economic and resource nationalism, while transforming the global economy and energy industries.

Set against what seemed like crippled developed countries, emerging market growth kept trade moving, commodities prices afloat, and offered attractive investment opportunities. But in a tougher overall growth environment in which the U.S. economy looks like a better bet and the potential for explosive risk in the Eurozone goes away, concerns over emerging markets and their future will again receive closer attention. Emerging markets will have much more volatility and instability than those of the advanced industrial democracies.

Still, there is a noticeable tilt in influence from West to East with an accelerated shift of power that has been in the making since early 2000.¹ By 2030, no country –the U.S., China, or any other country– will be a hegemonic power. The empowerment of individuals and diffusion of power among states and from states to informal networks will have a dramatic impact, largely reversing the historic rise of the West since 1750, and restoring Asia’s weight in the global economy.

We are on the verge of a great, ongoing energy revolution. The world economy, food production and distribution, water security, geopolitics, and the environment all depend on how this revolution turns out. As the world population grows so does the demand for energy, driving fierce competition for diminishing resources. The world energy map is changing in terms of supplies of hydrocarbon and renewables; expectations are also going to change. That means markets will change as well, and this will have a serious impact on geopolitics.

Let’s make no mistake: this is not the first time that the energy sector has faced uncertainty – recall the oil shocks of the 1970s and 1980s, as well as the depressed energy demand because of the recession that has lingered on too long. Such changes do not of course occur without serious risks, particularly above-the-ground risks, threatening the energy sector seriously in today’s interconnected world. Uncertainties are

1 “The Implications of the global economic power shifting to developing countries,” *Tharawat Magazine*, <http://www.tharawat-magazine.com/en/magazines/20-july-august-september-2011/185-the-implications-of-the-global-economic-power-shifting-to-developing-countries>

particularly dangerous and need to be effectively mitigated in a sector where investments are long-lived and take a long lead-time to pay off.

Geopolitical Realignment and Tensions

The transfer of power from West to East is now widely recognized and is quickly gathering pace. Let's not forget: major shifts of power between states, not to mention regions, occur infrequently and are rarely peaceful. The uneven distribution of energy resources internationally has proven a constant source of friction. Such friction has given rise to significant vulnerabilities, such as those in the Straits of Hormuz, the East China Sea, the Caspian Sea, and the KRG vs. Baghdad, as well as domestic instabilities triggered by the Arab Spring, Nigerian labor strikes, attacks in Algeria, the breach of contract sanctity in Kazakhstan and Russia, and the ongoing Iraqi, Egyptian, and Libyan unrest.²

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Geopolitics has gained the upper-hand once again in world energy as a result of scarce resources, as well as legal and political disputes over how to share the upside of national resources and transportation routes. Each case vividly illustrates how above-the-ground factors could inhibit the development of hydrocarbons. The most explosive ones seem to be the South China Sea and China's "Malacca Dilemma", as well as cross-border gas pipelines from Turkmenistan to Europe and India, and from the Eastern Mediterranean.³ Iran's potential re-entry into the world energy scene as a powerful supplier of crude oil and natural gas will also have serious ramifications for traditional players.

Diplomatic disputes aside, the economics of extraction are also set to play a big role in the development of the disputed areas.⁴ Some countries have a strong urge not to procure energy for its own use, but to dominate the flow of energy to others. In particular, Moscow seeks a monopoly on the transportation of Central Asian/Caspian gas to Europe *via* Gazprom's vast pipeline network; it also wants to tap

2 Mehmet Ögütçü, "Natural gas as the game-changer: implications for, and actions from Turkey," *Today's Zaman*, 23 January 2013, <http://www.todayszaman.com/news-304955-natural-gas-as-the-game-changer-implications-for-and-actions-from-turkey-by-mehmet-ogutcu-.html>

3 Leslie Hook, "China: Risk of conflict over resources in deep water," *Financial Times*, 4 November 2012, <http://www.ft.com/cms/s/0/77434050-1dd1-11e2-8e1d-00144feabdc0.html#axzz2F1u3NBaB>

4 Michael Klare, "Tomgram: Michael Klare, Oil Rules!," *TomDispatch.com*, 15 April 2008, http://www.tomdispatch.com/post/174919/michael_klare_oil_rules_

into Iran's mammoth gas fields, further cementing Russia's control over the trade in natural gas.

Another facet of the new geopolitics of energy is the looming prospect of a scramble for control of the Earth's remaining resource deposits; the Arctic's emerging significance is evidence of this. The Arctic is widely believed to hold the world's sole remaining significant deposit of untapped hydrocarbon reserves. Furthermore, given the rapid thinning of the Arctic shelf due to climate change (easing access to the Arctic's hydrocarbon "riches"), competition over the region is becoming fiercer.⁵

The region is slowly emerging as a geopolitical flashpoint. The stakes are high in the region, with Russia, Canada, the U.S., Norway, and Denmark jostling for what they regard as their sovereign piece of the Arctic pie. True to its petrostate form, Russia is leading the Arctic carve-up, with firm rhetoric proclaiming its ownership of the region. In 2007, Russia confirmed global fears by sending a nuclear powered submarine to plant a Russian flag on the Arctic seabed. This is happening at a time when Gazprom's international and domestic outreach has been severely undercut.

The 2006 Russian-Ukrainian gas "war" highlighted the new rules of the energy game and the new geopolitics of energy in action. The 2008 Georgian War, where Russian troops invaded sovereign territory, highlighting the primacy of Russia's ambitions over international law and how vulnerable energy transit countries could be if Moscow feels its vital national security interests are threatened.

Geopolitical Game in the Middle East and North Africa

Over the past two years, mass protests have challenged regimes in almost every Arab country, but the results thus far have been highly uneven.⁶ In the short-term, the prospect that Egypt or any other country in the Arab world will have a successful transition to democracy remains highly uncertain; the forces unleashed by the Arab Uprisings will continue to create enormous political and geopolitical turbulence for years to come.

Under most plausible scenarios, Syria will be a gaping security hole in the heart of the Levant in the foreseeable future – Western nations will be hard-pressed to heal

5 Elizabeth Buchanan, "The New Geopolitics of Energy: Conflict or Cooperation," *Australian Institute of International Affairs*, <http://www.aiia.asn.au/qa/qa-vol3-issue3/678-the-new-geopolitics-of-energy-conflict-or-cooperation>

6 In Jordan, Morocco, and Oman, for example, modest protests have produced tentative steps toward reform. In sharp contrast, in Syria, a peaceful protest movement has morphed into a nationwide insurgency in response to the brutal repression of Bashar al-Assad's regime. In Bahrain, the Al-Khalifa monarchy has responded to demands for political change by the country's Shiite majority with a stern government crackdown, but the opposition remains active and is increasingly radicalized.

regardless of the level of their intervention. Russia and Iran will remain actors to reckon with. The aftermath of the “Arab Spring” and Washington’s abandonment of longtime proxies such as Egypt’s Hosni Mubarak has left some governments keen to find alternative allies. Even longtime U.S. partners such as Saudi Arabia feel this pull.

Iran has a longstanding ambition to be the regional superpower from the Gulf into the Levant of Syria and Lebanon, and beyond even into Libya – as well as anywhere there are Shiite populations. This ambition brings the Iranians up against both Saudi Arabia and Egypt in particular, carrying home the message that “Iran cannot be ignored and if we do so, we do at our peril.”

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Iran’s nuclear programs are only part of the story and one that many of the Western allies and security partners in the region see as less important than the other Iranian threats they face. The Arab Gulf states, Jordan, and other regional powers are at least as concerned with the build-up of Iranian asymmetric warfare capabilities, Iran’s long-range rocket and missile capabilities, and the prospect of some form of major clash or war in the Gulf.

They are particularly concerned over the near collapse of meaningful U.S. influence in Iraq and the threat Iraq will become an Iranian sphere of influence or a near-permanent source of extremism and Sunni-Shiite tension.⁷ They are also worried about the U.S. resolve and willingness to maintain its forces in the Gulf to help them deter and defend against the other military threats Iran poses.

Since his election, President Rouhani has insisted on the need for improving relations with all the Gulf States and has taken steps in this direction as part of his reform agenda. Skeptics are quick to point out that such statements are mere courtesy and that Iran is controlled by radicals who still believe in exporting the revolution in one form or another.

They fear that the U.S. might reach an agreement with Iran over its nuclear weapons that will sacrifice their security and leave them open to Iranian threats and

⁷ Anthony H. Cordesman, “The Gulf and Middle East Strategic Partnership: The Other Side of the Iran Negotiations,” *Center for Strategic and International Studies*, 22 October 2013, <http://csis.org/publication/gulf-and-middle-east-strategic-partnerships-other-side-iran-negotiations>

intimidation. They, and nations like Israel and Turkey, are equally concerned that the U.S. has failed to take any meaningful stand against the role Iran is playing in Syria, its ties to the Hezbollah, and its role in supporting Shiite dissidents in Bahrain, Saudi Arabia, and Yemen.

Some of their fears and concerns are exaggerated, but the new strategy the U.S. announced in January 2012 recognized the reality that they are critical security partners at a time of already limited capabilities of British and French power projection forces, and gave Middle East security the same priority as the rebalancing of U.S. forces from Europe to Asia.

Contrary to popular belief, the U.S. is not heavily dependent on the Persian Gulf for oil and has never been so. The region currently supplies fewer than 10 percent of U.S. oil demand, and never in history has the number surpassed 15 percent. In fact, most U.S. imports come from the Western Hemisphere. The U.S. is therefore much more dependent on the fluctuation of prices that may have roots in the Middle East than the oil itself. Oil being a fungible commodity with a global price, spells of political instability in the region have global consequences, regardless of the physical exposure of certain countries to MENA crude.⁸

Even if the U.S. were to become self-sufficient in oil, that self-sufficiency does not yield low prices.⁹ Any suggestion that U.S. foreign policy is “all about oil” ignores the complexity and multitude of U.S. interests. Geography, Cold War legacies, superpower requisites, Israel, terrorism, arms sales, religion, nuclear proliferation, and democracy promotion are some of the equally important factors guiding U.S. thinking on the region.

Beijing’s economic, political, and diplomatic clout, however, is growing fast. China’s Ministry of Commerce said China-Arab nation trade now reaches 222 billion dollars a year, 12 times its 2002 level. This outstrips U.S.-Middle East trade, valued at 193 billion dollars in 2011.¹⁰ In the longer term, China may need to step up its naval presence in the region. Presently, U.S. military forces serve the dual role of providing both internal and external stability for Gulf Cooperation Council (GCC) regimes.

Signs are in favor of heightened confrontation rather than collaboration, particularly over resources, as the imbalance between supply and demand widens. Furthermore,

8 For instance, between mid-February and April 2011, the war in Libya caused oil prices to spike by 25 dollars per barrel for the U.S. despite the fact that it imported no oil from Libya.

9 “Balance of Power Shifts in Changing World of Oil,” *Financial Times*, 5 November 2012, <http://www.ft.com/cms/cbaf549c-26e8-11e2-9295-00144feabdc0.pdf>

10 “FT Special Report: Energy,” *Financial Times*, 5 November 2012,

<http://news.yahoo.com/turkey-missile-deal-shows-chinas-growing-mideast-clout-063424309--finance.html>

resource-holders want to alter the balance of interests with international extraction companies to maximize their gains through the so-called “resource nationalism”.¹¹

Is Russia on the Losing End?

Thanks to the shale gas “revolution”, the U.S. will be replacing Russia as the world’s natural gas superpower by 2015. Russia holds the world’s largest proven reserves of natural gas, most of which wait to be explored, and continually alternates with Saudi Arabia as the top oil producer.¹² The country supplies a third of Europe’s oil and natural gas and is starting to export more to the energy-hungry East Asian markets. The energy sector is far more than a commercial asset for Moscow; it has been one of the pillars of Russia’s national security and stabilization and increasing strength for more than a century.

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Currently, energy revenues make up half of the Russian government’s budget. This capital influx was and continues to be instrumental in helping Russia build the military and industrial basis needed to maintain its status as a regional –if not global– power. However, as Russian governments became dependent on energy, revenues also became a large vulnerability.

The energy sector also contributes to Russia’s ability to expand its influence to its immediate neighbors.¹³ Moscow’s use of energy as leverage in the buffer states differs from country to country and ranges from controlling regional energy production (as it previously did in the Azerbaijani and Kazakh oil fields) to subsidizing cheap energy supplies to the countries and controlling the energy transport infrastructure. Russia has used similar strategies to shape relationships beyond the former Soviet states.

As things stand, Gazprom’s unparalleled prosperity and dominant market position in Europe have been seriously upset by the “shale energy revolution” and emergence of new suppliers/competitors both within Russia (e.g. Novatek and Rosneft)

¹¹ Ögütçü (2013).

¹² “The Past, Present and Future of Russian Energy Strategy,” *Stratfor Global Intelligence*, 12 February 2013, <http://www.stratfor.com/weekly/past-present-and-future-russian-energy-strategy>

¹³ *Stratfor Global Intelligence* (2013).

and outside. Its domestic competitors give Gazprom a hard time. The share of gas supplied by independent producers has increased to 25 percent.

Novatek (Russia's largest independent producer of natural gas) has put an end to Gazprom's monopoly on gas exports by signing a 10-year contract with Germany's EnBW Group worth 6 billion euros.¹⁴ Rosneft too is a significant new power to reckon with for Gazprom. Russia has also lost a great deal of its influence in Central Asia or the "near abroad" to China.¹⁵

A set of EU-wide policies, including the Third Energy Package, has begun giving EU member nations the political and legal tools to mitigate Gazprom's dominance in their respective natural gas supply chains.¹⁶ This common framework also allows European nations to present a more unified front in challenging certain business practices they believe are monopolistic – the latest example being the EU Commission probe into Gazprom's pricing strategy in Central Europe.

New gas extraction set to begin in Azerbaijan, Turkmenistan, Australia, Tanzania, and East Mediterranean may further aggravate the Gazprom's monopoly on gas, driving prices downward and changing geopolitical dynamics.¹⁷

Europe and the Future of the Southern Corridor

Europe is seemingly missing out on the natural gas boom that is transforming energy use in the U.S. and Asia. Due to low levels of support among politicians and the public, a European boom in shale gas extraction remains unlikely in the near future.¹⁸ Based upon public opinion dilemmas, Bulgaria and France have already banned exploratory drilling that employs controversial hydraulic fracturing technology. In Poland, an advocate of shale gas in Europe, a similarly perplexing situation has surfaced, in which ExxonMobil recently declared an end to exploratory work due to insufficient commercial quantities.¹⁹

14 Alexander Kilyakov, "Gazprom May Lose its Position," *Russia Beyond the Headline*, 27 December 2012, http://mobile.rbth.ru/articles/2012/12/27/gazprom_may_lose_its_position_21523.html

15 Dmitry Gorenburg, "Russia and China vie for influence in Central Asia," *Valdai Discussion Club*, 15 March 2013, <http://valdaiclub.com/blogs/56260.html>

16 This, coupled with the EU-funded efforts to physically interconnect the natural gas grids of EU members in Central Europe, has made it increasingly difficult for Russia to use natural gas pricing as a foreign policy tool. This is a major change in the way Moscow has dealt with the region for the past decade, when it rewarded closer ties with Russia with low gas prices (as with Belarus) and increased rates for those who defied it (the Baltics).

17 Öğütçü (2013).

18 Öğütçü (2013).

19 Jozef Badida, "The Golden Age of Natural Gas in Europe? (Perspectives on the European Gas Industry)," *ua-energy.org*, http://ua-energy.org/upload/files/Jozef_Badida_Golden_Age_of_Natural_Gas_in_Europe.pdf

More than half of Europe's supply of fuel is bought through long-term contracts linked to the price of oil, and that will remain the case until 2014. Even after a wave of renegotiations, most prices for gas from Gazprom, which meets about a third of the EU's needs through contracts tied to oil, were reduced no more than 10 percent.²⁰ Disputes remain with RWE, Germany's second-largest utility, and the Polish gas company PGNiG.

In Europe, gas costs three times as much as in the U.S., cutting competitiveness for industrial users such as Germany's BASF, the world's largest chemical maker, which intends to relocate some of its facilities to the U.S.²¹ If not correctly handled, boosting renewables could result in increased dependence on imported technologies and equipment. Without a sustainable energy mix that includes different forms of energy, the European economy will be less competitive, industry will move abroad, and jobs will inevitably be lost.

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Development of a Southern Corridor to link the Caspian to Europe with oil and natural gas pipelines was an early element of a Western strategy to reduce dependence on Russia. The first stage was achieved with the completion of the Baku-Tbilisi-Ceyhan oil pipeline from Azerbaijan to a Turkish Mediterranean port and the South Caucasus Gas Pipeline from Azerbaijan to Turkey. The next stage of Southern Corridor development is to use expanded production of natural gas in Azerbaijan as a supply anchor.

The Southern Corridor was to contribute to a target of securing new gas for 10-20 percent of demand in the EU by 2020, totalling 45-90 bcm year. Trans-Adriatic Pipeline (TAP) has a projected initial capacity of just 10 bcm, potentially rising to 20 bcm, and the earliest it could be operational is 2019. Therefore, if all goes well from here on, the EU has the opportunity to open up by 2020, 10 bcm annually, two

²⁰ The planned construction of LNG export terminals in Australia and the U.S. in 2015 should lead to an increase in the security of supplies to Europe but the overall positive effect on European prices is questionable as LNG is more expensive than pipeline gas. LNG prices must fall if it is to be affordable for buyers in the EU, India and China; a price of 9 dollars to 11 dollars per MMBtu. Also see: Öğütçü (2013).

²¹ “China's Chemical Industry: The new forces driving change,” KPMG, September 2011, <http://www.kpmg.de/docs/China-Chemical-Industry-201109.pdf>

percent of Europe's gas needs (calculated on the basis of the IEA's WEO Current Policy Scenario forecast for EU demand in 2020). It would, therefore, be more accurate to call this a medium-sized link rather than an actual corridor. It would be three times smaller than the Yamal-Europe pipeline running from Russia through Belarus and Poland, and five times smaller than the current capacity of Nord Stream.²²

Turkey's rapidly growing domestic energy demand has been a central dynamic to the Southern Corridor. In particular, its willingness to allow transit of significant amounts of natural gas to Europe, even when its own domestic market could easily consume the gas, has bolstered the prospects for the Southern Corridor. Azerbaijan is the pivotal supplier for the Southern Corridor and is positioned to be a long-term transit hub for potential trans-Caspian supplies from Turkmenistan and Kazakhstan.

The Southern Corridor was planned to contribute to energy diversification by opening up access to vast new gas supplies from the Caspian and the Middle East, whilst also bringing an end to Russian dominance in Central and South-Eastern Europe, which have been disproportionately dependent on Gazprom. With only one supplier, depressed European demand, and other alternatives available, it is nonsense to speak of a genuine "corridor".

From the U.S. perspective, this Corridor would further isolate Iran, assist in cultivating partners in the Caucasus and Central Asia and bolster their sovereign independence, and perhaps most importantly, curtail Russia's energy leverage over European NATO allies.²³ Among EU countries, Austria, Bulgaria, the Czech Republic, Estonia, Finland, Latvia, Lithuania, Poland, and Slovakia all depend on Russia for over 60 percent of their gas imports; EU aspirants such as Moldova, Turkey, and Ukraine rely on Russia for over 65 percent of their imports.

Some critics may argue that the Southern Corridor should be a lower priority: U.S. shale gas and global LNG trade are producing more market liquidity, thus tending to lower prices and improve Europe's negotiating position with Russia. Russia's Gazprom has been forced to change its domestic strategy, including abandoning its flagship Stockman project in the Arctic, and has had to contend with plummeting market value and a new EU antitrust investigation. These trends may or may not last, but their existence today gives an unprecedented opportunity to advance broad natural gas diversification and break Russia's control over European gas markets.

²² Agata Loskot-Strachota and Janek Lasocki, "End of Nabucco – End of Southern Gas Corridor," *Energy Post*, 27 June 2013, <http://www.energypost.eu/end-of-nabucco-end-of-southern-gas-corridor/>

²³ "Energy and security from the Caspian to Europe, a minority staff report prepared for the use of the committee on foreign relations United States Senate," *U.S. Government Printing Office*, 12 December 2012, <http://www.gpo.gov/fdsys/pkg/CPRT-112SPRT77221/pdf/CPRT-112SPRT77221.pdf>

Beyond Shah Deniz II gas, securing additional supplies for the Southern Corridor is crucial. Turkmenistan's conventional natural gas supply, the world's fourth largest, has high potential for being joined to the Southern Corridor by constructing a Trans-Caspian Pipeline. However, a combination of inscrutable leadership, geopolitical pressure by Russia, and an investment climate unfriendly to energy majors has hampered progress, and the window for Turkmenistan's participation in the Southern Corridor may be closing.

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Key Messages

- The coercive manipulation of energy supplies, competition over energy sources, the tendency of political instability among energy producing countries, attacks on supply infrastructure, competition for market dominance, accidents, and natural disasters are all adding significant risks to global energy security. Increased competition over energy resources may also lead to the formation of security compacts to enable an equitable distribution of oil and gas between major powers.
- Current political factors, such as the Iranian ambition to dominate the region, U.S. policy towards the New Middle East, and the ambiguous outcomes of the Arab Spring, have served as pressing incentives for the rulers of the Gulf to abandon their own separate interests and adopt political and economic reforms that lead to real development and integration and maintain a safe future for GCC nationals and for rulers.
- Beijing pressing ahead with its own unconventional resources is also a major factor. Piece all that together, and the biggest Eurasian loser from new energy gains is Russia. Moscow's "grand Asian designs" look more like primitive blueprints with weak foundations. Unless Russia's willing to sell large volumes of energy set at Beijing prices, Moscow's inherent arbitrage potential will go wanting. China plays the unconventional game to perfection.
- There are several changes in the energy resources map that could play a role in reshaping MENA geopolitics. Among them are the discovery of vast natural

gas reserves in the Eastern Mediterranean and the KRG, and the construction of new energy corridors to circumvent the Strait of Hormuz. However, the boost in U.S. oil production is not one of them. The Middle East will continue to exhibit chronic instability due to the rise of militant Islam, weapons of mass destruction proliferation, and the acute and deep-rooted rivalry between Sunnis and Shiites.

- To fulfill the potential of the Southern Corridor it would need to channel gas from new sources in the Middle East (currently talk is of Iraq but originally the goal was Iran), across the Caspian (Turkmenistan) and the Eastern Mediterranean (where Turkey, Cyprus, and Israel have recently begun exploration for new gas sources).
- Fully aware of these global and regional game-changers in energy, investment, and geopolitics, both government and corporate leaders must adapt their countries' and organisations' governance structures and strategic policies to capture the opportunities and mitigate the risks.