IRAQ: TURKEY'S ENERGY TRUMP CARD

Turkey's impressive economic growth has been fueled by soaring energy consumption which is likely to continue over the years to come. However as Turkey risks to increase its current account deficit by five billion dollars with each ten dollars added to the current price of oil, its import-reliant energy bill is becoming unsustainable. Assessing domestic challenges against emerging regional and international opportunities, this article will argue that Turkey can secure more profitable terms for its fossil fuel imports, providing it reconsiders its foreign policy options. In this context, a politics of engagement with northern and southern Iraq may help Ankara gain greater strategic lever in its relationship with traditional oil and gas suppliers, such as Russia, Iran, and Azerbaijan.

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TURKISH POLICY
QUARTERLY

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For the last ten years, Turkey's economic rise has been accompanied by a balanced foreign policy based on "Kemalist" ideals of peace and security among its neighbors. Its economic growth – occasionally vying with China's for the world's top ranks– has been fueled by an equally soaring energy consumption that is set to continue over the years to come. However, with oil prices breaking the 100 dollars per barrel resistance level, Ankara may soon have to reconsider its foreign relations in order to respond to macroeconomic constraints.

Thanks to its economic progress, Turkey has found the confidence to be more politically assertive, defying Tehran with a decision to deploy an anti-ballistic shield, Israel on the Palestinian blockade and, more recently, Russia on the civil unrest in Syria. But that assertiveness has not been replicated in its ties with energy suppliers as Turkey, aware of its excessive reliance on imported fossil fuels, has been forced to accept onerous terms. However, current developments at regional and international level are likely to sway the balance in Turkey's favor and help it to reduce its energy vulnerability.

Weighing domestic challenges against emerging international opportunities, this article will argue that although Turkey is likely to remain dependent on imported oil and gas in the long run, it can now secure more competitive conditions, providing it becomes equally assertive in its energy relations. That assertiveness should translate in forcing its natural gas suppliers to accept cheaper, flexible rates in line with an emerging pricing trend and using its growing, albeit complex relationship with resource-rich Iraq as a trump card to extract better oil and gas supply terms from Moscow, Tehran, and Baku.

The Domestic Proposition

Analysts have calculated that each ten dollars per barrel increase in oil prices, could add up to five billion dollars to Turkey's already spiraling current account deficit, making its existing energy bill unsustainable in the long term.[1] Given Turkey has to import over 90 percent of its natural gas and oil consumption, and since nearly 50 percent of its electricity generation relies on natural gas, the figures are, no doubt, alarming.

Fully aware of Turkey's soaring electricity demand which is calculated to expand annually by a minimum six percent over the next decade, the Turkish government is now inclined to seek a 20 percent reduction of natural gas in the overall

1 "Turkey's Current Account Deficit: It's the Energy, Stupid", *beyondbrics FT.com*, 16 March 2012.

production mix, introduce nuclear power and increase the share of coal/lignite-fired generation as well as green energy.

This strategy, which is in line with a general diversification trend, is commendable, but by no means flawless. Even as Turkey has taken the bold step to go against a strong anti-atomic international opinion unleashed after the Fukushima disaster last year and pursue its plans to install nuclear generation, the new capacity will prove insufficient. Considering that Turkey adds another 10 - 15GW of nuclear generation over the next ten years, the new capacity will still fall short of the 40 - 45GW that would have to be built over the same period in order to respond to growing consumption.

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There are equally significant question marks hanging over Turkey's plans to increase its lignite-fired generation as it banks on sizable domestic resources to break its overreliance on hydrocarbon imports. Turkey's lignite resources have a low calorific value, which means that important quantities have to be burnt in order to produce a certain amount of power. While the diversification of Turkey's energy mix is crucial to its economy, it should also be assessed against a proposed introduction of a carbon emission scheme that is likely to increase costs, particularly on polluting lignite-fired capacity.

Similarly, Turkey's green energy potential, and in particular hydro production is undoubtedly important to its energy strategy, but the country will have to adopt a realistic approach towards its dependence on solar and wind generation, given their intrinsic unreliable nature and expensive feed-in tariffs paid for this form of energy.

Even if Turkey were to build additional green, nuclear and coal/lignite-fired generation, the new capacity would hardly make up for the shortfall, and the overall costs would be barely cheaper than those paid for imported hydrocarbon resources.

Sitting close to three quarters of the world's natural gas and oil reserves, Turkey is not only a natural outlet for these riches, but it is also a transportation corridor to Europe, the world's second largest natural gas market. Given this proximity, as well as its soaring energy demand that, as already shown, cannot be met simply

at domestic level, Turkey must accept that its reliance on imported hydrocarbon resources cannot change for the foreseeable future. What can change, however, are the terms of its relationship with exporting countries and there are a number of emerging factors that could play out in Turkey's favor.

The International Context

" (...)each ten dollars per barrel increase in oil prices could add up to five billion dollars to Turkey's already spiraling current account deficit."

The discovery and subsequent exploration of large unconventional gas resources in the U.S. and Canada has coincided with the impressive growth of Asian economies, a growth that is overwhelmingly dependent on oil and natural gas consumption. Furthermore, Japan's nuclear shut down after the Fukushima disaster last year, has exacerbated the need for the clean fossil fuel, pushing the country's big trading companies to bet billions of dollars on securing natural gas.[2] Asia's gas binge is not only putting the commodity on course to become the world's fastest growing fuel, but is also set to trigger a shift from traditional oil-indexed prices to comparatively cheaper spot-linked rates. Asian companies have been buying oil-indexed natural gas at a record of 13 dollars per millions of British thermal units (MMBTu) premium to the American spot-linked values. In April however, a number of Japanese companies agreed to buy liquefied natural gas (LNG) at prices linked to U.S. Henry Hub spot levels, hoping to sell natural gas in Japan below the ten dollars/ MMBTu level.[3]

The decoupling of natural gas tariffs from their traditional oil indexation and the emergence of an international market for LNG driven by gas discoveries in North America, East Africa and Australia may have a long-term bearish effect on prices and give consuming countries more leeway when negotiating import contracts. One of the most important winners in this pricing revolution could be Turkey, as it may seek a compromise with Russia's Gazprom, its biggest supplier of natural gas and push for an important spot linkage that would drive down the costs. Although the Russian monopoly remains a staunch defender of oil indexation, the global gas oversupply may force it to admit greater flexibility in accepting a larger spot element in long term supply contracts.

2 "Japan Gas Binge Ties Third-Biggest Economy to one Fuel", *Bloomberg,* 24 May 2012.
3 Ibid.

Another auspicious development for Turkey's energy strategy is the emergence of Iraq as a leading oil and natural gas producer that could earn Ankara, a strategic lever in its future negotiations with traditional suppliers such as Russia, Iran and Azerbaijan. Turkey is already an active player in the Middle East. Its trade value with Iraq has grown to more than six billion dollars per year and the figure is set to increase to 25 billion dollars within the next five years.[4] Turkish Foreign Minister Ahmet Davutoğlu's visit to Erbil, the Iraqi Kurdistan's capital where he opened a consulate in 2010, is highly significant at a time when Turkey's domestic oil consumption is predicted to increase by 32 percent and its natural gas demand is expected to double, to more than 80 billion cubic meters by 2023.

Sitting on approximately 45 billion barrels of oil, and natural gas reserves estimated at anything between three to six trillion cubic meters, enough to replace Turkey's current imports from Russia for the next 50 years, northern Iraq could become the cornerstone of Ankara's energy strategy in the long-run. The fact that there were 600 Turkish companies and 15,000 Turkish citizens living there in 2011, suggests that Turkey has understood that substantial investments and trade exchanges would not only help it to contain separatist Kurdish militancy on its own territory and across the border, but also facilitate access to vast resources that could ensure its long-term energy security.[5]

It is hardly disputable that Turkey faces numerous stumbling blocks in its quest for oil and gas ranging from legal and political disputes between the Kurdish Regional Government (KRG) and the federal administration in Baghdad over hydrocarbon revenues to rising ethnic and religious tensions that may jeopardize a precarious regional stability. On the plus side, however, Turkey, with its vibrant economy and unique geostrategic position is best placed to assist northern and southern Iraq in building their infrastructure and offer them the chance to revive their oil and gas sectors by opening viable transport routes to international markets.

A number of recent developments suggest that Turkey is prepared to engage both Erbil and Baghdad by discussing joint projects that may flesh out a future Turkish-Kurdish-Iraqi axis. Such an axis, largely based on pragmatic goals, would recalibrate the regional political dynamics, reducing the influence of Iran in the Middle East and granting Ankara greater clout in its relations with energy suppliers.

4 "Turkey 2011", *The Oil and Gas Year,* 2011.
5 "Kurdistan Region of Iraq", *The Oil and Gas Year,* 2011.

Gambling on Iraq

At the beginning of May, the Turkish regulator EMRA selected "Siyahkalem", a Turkish engineering and energy company, to import natural gas from Iraqi Kurdistan.[6] The company which has been required to submit proof of firm supply agreement with a counterparty in the Kurdish region intends to import 0.7 billion cubic meters per year from 2014 – a volume that can be scaled up to just over three billion cubic meters per year, within the next ten years. The volumes may be small compared with some of Turkey's existing gas contracts, but they are an indication that the country is determined to penetrate the vast untapped resources of its southern neighbor. Although there is no infrastructure to transport northern Iraqi gas volumes, the current political crisis in Syria as well as the KRG tense relationship with the federal administration in Baghdad may act as catalysts for the construction of a gas pipeline to Turkey.

Equally noteworthy is a remark by KRG's Minister of Natural Resources Ashti Hawrami last year regarding his government's intention to sell natural gas to Turkey not only for domestic consumption, but also for liquefaction and re-export to international markets, a move that would grant Turkey control over the transportation of northern Iraqi gas volumes.

Similarly, the Kirkuk-Ceyhan oil pipeline which pumps under 500,000 barrels of oil per day and could double the volumes by 2015, is currently the sole evacuation route for northern Iraqi crude although plans have been mooted for a second pipeline to run in parallel with the existing infrastructure. As a major oil producer itself, Iran previously argued that the pipeline which was commissioned in 1970 is in need of expensive repair, casting doubts over Iraq's ambitions of becoming a major oil exporter.[7] The interest expressed by super majors ExxonMobil, Chevron or Total in the region indicates that the obsolete transfer equipment and the lack of infrastructure did not deter them from signing "Public Sharing Agreements" (PSA) with KRG for the exploration of oil and gas reserves.

Baghdad's refusal to acknowledge KRG's pipeline projects, fearing Erbil's separatist tendency is no doubt an important obstacle towards Turkey's ambitions to secure important resources from northern Iraq. However, recent news that Turkey's Ministry of Energy had started discussions with its Iraqi counterparts for shipping crude oil from Basra *via* the Kirkuk-Ceyhan pipeline,[8] followed by a subsequent announcement that a Turkish-Kuwaiti venture had signed an exploration deal with

6 "Firm sole candidate to import Iraqi natural gas", *Hürriyet Daily News,* 29 May 2012.
7 "A realistic outlook for Iraq's oil production in 2030", *Middle East Economic Survey,* 3 July 2012.
8 "Turkey, Iraq work on Basra Oil Exports", *Hürriyet Daily News,* 7 July 2012.

Baghdad for oil reserves in southern Iraq, suggest that Ankara is ready to make strategic moves in the region.[9]

"Turkey is prepared to engage both Erbil and Baghdad by discussing joint projects."

The extension of the Kirkuk-Ceyhan pipeline to Basra would not only help to engage southern Iraq and diffuse tensions that may emerge as a result of growing ties between Ankara and Erbil, but would be instrumental in diverting some of southern Iraq's estimated 110 billion barrels of oil from being shipped through the Strait of Hormuz, in case Iran blocks or threatens to block it. Turkey's growing influence in the Shia-dominated region would place it on a collision course with Iran, which may use several tools such as Shiite militant proxies, intra-Kurdish rivalries and strong sectarian links to southern Iraq to challenge Turkish ambitions in the Middle East.[10] Importantly, however, intelligence publisher Stratfor notes that, Turkey can provide the infrastructure and stable export routes that Iran cannot, even if the Shia regime in Baghdad enjoys the support of Tehran.[11]

Flexing the Political Muscle

It is clear that the emergence of a Turkish-Kurdish-Iraqi axis could have a positive impact on Turkey's energy prospects and trigger political ripples throughout the Middle East. However such a scenario depends on a number of factors. Firstly, Turkey must use its economic influence to ensure that joint energy projects materialize. That means Ankara should continue to engage northern and southern Iraq commercially in addition to offering incentives, such as access to water and reduced custom duties on Iraqi exports.

Secondly, the emergence of Iraqi oil and gas supplies on the Turkish and international markets may further isolate Iran which may seek to engage in proxy wars across the region. It would be Turkey's role to mollify Tehran by offering to resurrect projects such as the Iran-Turkey-Europe Natural Gas Pipeline that aims to bring 35 billion cubic meters of gas from Iran's South Pars field to Turkey and further to European markets. At the same time, however, Ankara should force Tehran into granting a discount on the 10 billion cubic meters of natural gas exported to Turkey by insisting on flexible rates to take into consideration, the international prices and the emergence of new supplies in the region.

9 "Baghdad inks exploration deal with Turkey despite new row", *Agence France-Presse, Hürriyet Daily News,* 17 July 2012.
10 "Turkey's Pipeline Diplomacy", *Stratfor,* 12 July 2012.
11 Ibid.

Similar assumptions could apply to Turkey's relationship with Russia at a time when Moscow seeks to build the South Stream pipeline through Turkish waters. Russia's dependence on Turkey for the construction of the line which seeks to bring 63 billion cubic meters of natural gas per year to European markets may grant Ankara further leverage in negotiations with Moscow for its own supplies.

"The emergence of a Turkish-Kurdish-Iraqi axis could have a positive impact on Turkey's energy prospects."

Although Azerbaijan has secured an 80 percent stake in the Trans-Anatolian Gas Pipeline (TANAP), and is determined to control the entire value chain from its Caspian platforms to European downstream assets, it is also aware that the emergence of Iraqi natural gas on Turkish and European markets may reduce its chances of success. TANAP, a joint Turkish-Azeri project was launched last year and is designed to bring an annual six billion cubic meters of Caspian gas to Turkey and another ten billion cubic meters per year to European markets within the next five years. Although Turkey has only a 20 percent share in the project it may up the rhetoric in favor of the rival South Stream project, or in the longer term use the Iraqi "trump card" as a bargaining chip in its negotiations with Baku. The obverse of this scenario is that Turkey's 20 percent stake in TANAP will allow it to control the flow of non-Russian gas through the southern corridor into European markets and therefore gain greater leverage in its relationship with Brussels.

Equally important to note is that, Turkey's political and economic support for the reconstruction of Iraq might enable it to control the flow of Middle Eastern oil into European markets in case they are diverted from the Strait of Hormuz by a blockade.

Conclusion

This article has sought to demonstrate that despite the Turkish government's ambition to reduce its reliance on imported hydrocarbon reserves in a bid to decrease spiraling energy costs, there are still a number of challenges, but also new possibilities –including an ongoing revolution in the international pricing system for the purchase of gas volumes– that would make it more attractive in the long term for Turkey to retain the *status quo*. However, in order to secure competitive terms, Ankara must no longer see itself as a junior partner in its relations with oil and gas suppliers. It must replicate the assertiveness that it has already displayed in

various political circumstances in its energy negotiations and accept that it must engage both northern and southern Iraq in order to gain an important new source of fossil fuels and through it, strategic lever in its relationship with Russia, Iran, and Azerbaijan.

Importantly, Ankara must remain realistic about the prospects of supply disruptions caused along political, religious or ethnic fault lines happening in the future. The political volatility of the region may escalate, threatening its energy security even further. Nevertheless, depending on Ankara's ability to engage both northern and southern Iraq, new sources of oil and gas may emerge, cementing a Turkish-Kurdish-Iraqi axis that could shield Turkey from supply shocks. Such an axis would also form the backbone of new political dynamics and consolidate Turkey's power in the region.