Welcome to the snake pit

The relations between the countries of the Eastern Mediterranean are, to say the least, a tad complex. Centuries of invasions, occupations, liberations and alliances have carved a map that is both ill-defined and often disputed. In recent years, the major gas discoveries under the sea floor and the prospect of more to follow have added new intricacies and calculations to the region's geo-political hodgepodge.

The countries at the table of the Levantine hydrocarbon bonanza are at different stages of exploration and production, and the dynamics being forged between the major players encompass a cocktail of saber rattling and fraternal embracing. The fact that the lines demarcating ownership of the sea floor and what lies underneath have not all been agreed upon further complicates the unfolding play.

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Why Lebanon's oil and gas may not solve the electricity crisis

"You're always going to have problems when there are discoveries before the maritime borders have been agreed upon, and then you have regional disputes such as Turkey and Cyprus or Lebanon and Israel," says Walid Khadduri, the energy and geopolitical risk editor at *The Middle East Economic Survey*.

Cypriot sprint hampered by Turkey

At the nexus of the Levantine basin is the island of Cyprus, whose territorial waters border those of Lebanon, Turkey, Syria, Greece, Israel and Egypt. In late 2011, the discovery of somewhere between 85 and 250 billion cubic meters (bcm) of natural gas, and potentially additional oil, in the Cypriot Aphrodite field marked a major step forward for the island's hydrocarbon sector, and they are now pushing ahead toward production and further exploration. But as Greek Cypriots have progressed with exploration, Turkey has raised the alarm on behalf of the northern, Turkish portion of the island, crying foul and seeking to hold back Nicosia's endeavors.

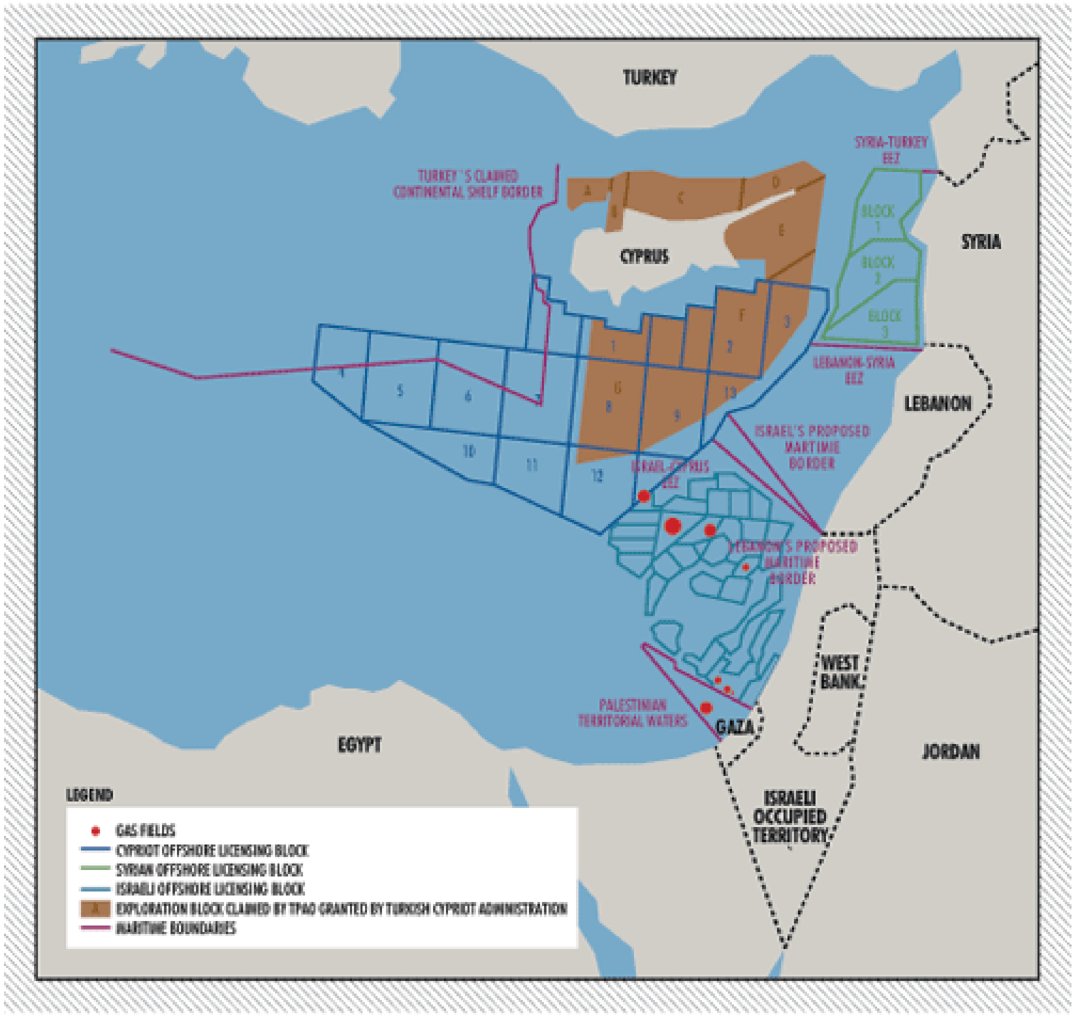
"Turkey can make a lot of noise and flex their muscles but I don't think they will be able to delay Cyprus' progress as their train is very much on track," says Bassam Fattouh, director of the Oil and the Middle East Program at the Oxford Institute for Energy Studies. Ankara has repeatedly called for a freeze on Cyprus' hydrocarbon activities and responded to the first drillings in Cypriot waters by sending warships into the island's exclusive economic zone (EEZ).

Turkey has, from two fronts, argued that certain blocks within the Cypriot EEZ are still contested and therefore not game for exploration. In response to the Greek-Cypriot government's advancement into the second offshore licensing round in February 2012, the Turkish Republic of Northern Cyprus (TRNC) awarded a concession to Turkish Petroleum (TPAO) for the exploration of hydrocarbons in areas that overlap with seven of the 12 oil and gas research blocks in the Republic of Cyprus' EEZ to the east and south of the island. The move by the Turkish authorities is based on a weak legal argument that has elicited little serious response from global players. This is primarily due to the fact that their claim is premised on the continental shelf rights of the TRNC, which is not recognized by the international community.

Turkey has also claimed that five of the Cypriot oil and gas research blocks on the western flank of the island infringe upon their continental shelf. Not only have they warned international oil companies (IOCs) against "unauthorized oil/natural gas exploration and exploitation" in these areas but they have also granted TPAO exploration and production licenses in their own blocks within these contested areas.

It seems that Ankara's blustering has done little to deter investors. Bids were made for three of the disputed blocks in the west in the second licensing round, and whether the lack of interest in the other two is due to political instability is far from certain.

HUNTING BLOCKS



Source: Oxford Institute For Energy Studies

"For blocks that received no bids, it is possible this could be linked, for certain companies, to Ankara's threats, including the threat of exclusion from energy investments in Turkey," says Anastasios Giamouridis of Poyry Management Consulting UK Limited. "However, there is always the chance that these and other IOCs simply did not identify a good fit with their own upstream or midstream strategies; or even sufficient prospectivity in the region."

While Turkey may fume at Cyprus' progress, their hands are tied by a lack of support; The European Union, the United States and Russia all back the Greek Cypriots and many of the major IOCs have participated in the tender rounds. With Ankara diplomatically isolated on this issue and with military threats amounting to little more than, well, threats, Turkey is employing what economic weight it can to lean on prospective companies to dissuade them from working with Nicosia.

In the fall of 2011, Prime Minister Recep Tayyip Erdogan cautioned IOCs that they would be excluded from Turkish energy projects if they invested in Cyprus upstream. This is not an insignificant commercial threat to prospective companies considering Turkey's growing downstream market and the existing investments by leading IOCs such as Shell, BP and GDF Suez. What is more, Turkey is making moves towards its own upstream activities in offshore exploration and production in the Black Sea and the Eastern Mediterranean.

Israeli collaboration

While Cyprus faces hostility to the north, it has been fostering a much more amicable relationship with Israel to the east, which has had its own recent windfalls in offshore gas discoveries. In 1999 around 32 bcm were discovered in the Noa and Mari-B fields, which are Israel's only productive gas fields to date and currently provide for some 60 percent of the country's domestic natural gas demand. However, it was two major finds in 2009 and 2010 that really changed

Israel's energy prospects: The Tamar field, estimated to hold some 274 bcm, and Leviathan, which is around twice the size at 460 to 566 bcm.

Cyprus and Israel are several years ahead of Lebanon, Turkey or Syria in terms of their offshore programs so it is little surprise that they are forging greater cooperation in the this domain. "Lebanon has been preempted by Israel and Cyprus," says Khadduri. A telling sign of the growing affiliation between the two countries was Israel's response to Turkey dispatching its navy and air forces when Cyprus started drilling activities in block 12, which ultimately led to the Aphrodite discovery. Then-Deputy Foreign Minister of Israel, Danny Ayalon, said during a trip to Athens, "If anyone tries to challenge these drillings, we will meet those challenges," in a clear rebuff to Turkey.

Strategic geo-political motives, such as a counter to Turkish pressure on Cyprus or a friend in an unfriendly neighborhood for Israel, are of course a significant part of the reason for Israel and Cyprus forging stronger ties. However, it is at the commercial level that the two countries have the greatest compulsion to build foundations for future cooperation. "The main question, and it is both technical and political, is will there be joint monetization?" asserts Giamouridis. While scores of articles have been written about the different proposals for cooperation between Israel and Cyprus with regards to getting their gas to market, nothing has yet been set in stone.

In March 2012, Israel, Greece and Cyprus failed to put pen to paper on a previously agreed memorandum of understanding (MOU) on joint cooperation on energy matters, despite the fact that it had been left intentionally vague. "Any deal to build a pipeline between Cyprus and Greece is unlikely to be commercially viable and the MOU did not meet the security concerns of the parties involved, especially Israel, which would like to keep control of its infrastructure," says the Oxford Institute for Energy Studies' Fattouh. "Also, Greece and Cyprus would have to consider their fragile relations with their Arab neighbors, which would be strained by a closer alliance with Israel."

Profits of partnership

There are several proposals on the table for cooperation between Cyprus and Israel for the unitization and monetization of their resources. While such joint projects may offer political and commercial benefits to both countries, they also hinge on a number of uncertain factors and could carry significant risks. Considering the long-term binding nature of these agreements, it is understandable why there is some trepidation.

One proposal under serious consideration is an approximately 1,100 kilometer-long pipeline between Cyprus and Crete that would continue on to Greece, from where it would connect to southeast Europe. The potential benefits to both Israel and Cyprus include access to a market with relatively high gas import prices, increased political leverage within Europe and economies of scale. Also, the scheme is complementary to existing and planned infrastructure developments in the region, such as the Trans Adriatic Pipeline; a pipeline linking Turkey, Greece and Italy; and another between Greece and Bulgaria.

However, the commercial feasibility of this project is still far from assured, and a number of political and technical uncertainties are also curbing enthusiasm.

Being tied into one market presents a risk on numerous levels. In the current market, southeast European buyers tend to purchase their gas through relatively long-term oil-indexed pricing mechanisms, which suit suppliers handsomely. However, by the time Cypriot and Israeli gas would be entering the market there is a chance that the markets will have liberalized and moved towards the model prevalent in Western Europe, where buyers are tending toward short-term hub-indexed prices.

If the pipe plans do not come to fruition, then the most credible alternative is to export via liquefied natural gas (LNG). Again there are strong commercial and political arguments for cooperation between Israel and Cyprus. Different Cypriot officials have announced on a number of occasions that they envisage LNG as the most likely monetization option.

Having Israel on board to develop liquefaction infrastructure would be commercially advantageous for Cyprus because it would allow the two states to achieve economies of scale. What is more, the commercial viability of the Aphrodite field alone is still unassured, but increased gas supply from Israel could increase profitability of an LNG plant in Cyprus. This would allow progress without having to wait an extra three to four years for gas reserves to materialize from Cyprus' second tender round.

From an Israeli perspective, the motivations would also have a commercial dimension, but perhaps an even greater security calculation. "Every country wants to liquefy its own gas. Why would Israel take [its gas] to Cyprus?" says Khadduri. "This is for security reasons. They are worried missiles from Lebanon could attack their plants."

A political plug in the pipeline

Israel's internal politics are perhaps one of the major obstacles to successful cooperation between Israel and Cyprus for the monetization of their gas reserves. Israeli politicians and strategists have always sought energy independence and now that they are unearthing their own resources there is a reluctance to sell off their bounty. However, it is primarily through energy exports that investors reap rewards and so Israel will be compelled to strike a deal if IOCs are going to be brought, and kept, on board.

In October 2011, an inter-ministerial board, the Tzemach Committee, was tasked with fashioning a strategy on how Israel's gas will be used. In August 2012, the committee recommended the export of up to 500 bcm of natural gas. It also advised that half of any field containing more than 200 bcm should be reserved for domestic use.

Three month's later Charles Davidson, chief executive officer for Noble Energy Inc — the main investor in the consortium behind Israel's major gas finds — warned, "[the committee's recommendations] need to be finalized by the government. It's a critical component. We can't make any decisions about how to go forward on any of these projects until we know what [exports] are going to be allowed."

"There are definitely tensions," says Oxford's Fattouh. "The gas companies are saying that the only way that they can explore and exploit the resources is if they are allowed monetization, and that will be through exports. Of course some circles within the government are resistant to any exportation of Israeli gas supplies. Eventually they will have to reach some kind of compromise."

Lebanon awakens

While Cyprus and Israel have been making considerable progress, Lebanon has by and large been inactive and watching on from the sidelines. However, now that Lebanon's first tender round is in the offing and the legislative and administrative groundwork has at least partially been laid, a new dynamic will move from the theoretical to the actual.

In terms of joint monetization of its hydrocarbon resources, Lebanon is highly unlikely to partake in any project based in Cyprus if there is any Israeli involvement. "Lebanon could not export via any shared Cypriot and Israeli infrastructure," says Khadduri. "Lebanon is in a state of war with Israel, of course this could not be accepted."

If and when Lebanon finally becomes a producer with export potential, and that is highly unlikely before 2020, its main two options to export gas will be as LNG from its own shores or overland via the Arab Gas Pipeline.

The main issue regarding Lebanon's entrance onto the hydrocarbon scene in the Eastern Mediterranean is the as-yet unresolved dispute over 850 square kilometers of overlap between the Lebanese and Israeli EEZs.

In the short term, at least, the dispute is unlikely to provide any major problems, yet it remains a thorn that will one day need to be torn out.

It has been the Americans, in the form of Deputy Assistant Secretary for Energy Diplomacy Amos Hochsteinat and, until recently, the Head of Lebanese Affairs for the State Department, Frederic Hof, that have been the main interlocutors, but with no concrete success.

"It seems the idea is to give two thirds to Lebanon and one third to Israel," says Khadduri. "[Parliamentary Speaker Nabih] Berri is with this, behind closed doors at least. The one who is against this is [Free Patriotic Movement leader Michel] Aoun. 'Why?' you may ask. Well, you explain Lebanese politics to me."

As Lebanon launches its first tender round, it can avoid blocks that fall under the disputed zone, but eventually it will be in the commercial interests of both Israel and Lebanon to explore in this zone.

"A conflict could arise if they don't agree on the disputed zone and one side started using it without the agreement of the other. It would be suicidal for either side's industry to aggravate this," calculates Khadduri.

Time will tell which Lebanese politician, if any, will be able to pull off the compromise that will be required for these 850 square kilometers to become fair game for the IOCs.

In the past the Minister of Energy of Water Gebran Bassil has vehemently rejected the idea of any concession, but perhaps tellingly, at the last industry conference in Lebanon, no mention was made by the minister or his representatives on the EEZ. A public shift in stance from Bassil or Aoun is unlikely, especially in the pre-election period, but perhaps the cooling of rhetoric reflects a realization that sooner or later Lebanon will have to engage in some tough-nosed compromise.

The wealth to be made from, and the energy security implications of, further oil and gas development in the Eastern Mediterranean are likely to eventually overcome the political obstacles. Yet, a complex web of commercial and strategic considerations is in the process of shaping the national programs and the affiliations between them.

As Fattouh reasons, "The politics will not so much affect the pace of development of the reserves but they will affect the flow and trade of this gas. By that I mean how and where it goes."