VIEWPOINT

MARCHING AHEAD

Phillip Rosenblatt, Managing Partner of Phillip Rosenblatt & Company, on energy security.

Turkey is fast proceeding to realise its long-term strategic goal of buttressing its energy security while acting as an energy bridge to Europe. The vision is of a Turkey that becomes an indispensable transit route between the enormous gas reserves in neighbouring countries – representing some 50% of the world's known reserves – and the large consumption demand in Europe. The accomplishments to date show that Turkey is making steady progress in realising this goal – no mean feat for a country with hardly any discovered oil or gas resources of its own to speak of.

TURKEY'S STRATEGY: The strategy for Turkey was to build the pipeline infrastructure from the key suppliers of gas: Russia, Iran, Caspian sources such as Azerbaijan and possibly later Turkmenistan and Kazakhstan. It was also to connect these suppliers to the large consumer markets of Europe by pipelines crossing Turkey.

For Turkey, a country with limited hydrocarbon reserves of its own, having the pipeline infrastructure that connects to multiple suppliers serves to enhance its energy security. Having excess capacity in such pipelines (or in additional gas pipelines that transit Turkey) to supply the large European markets not only adds to that security, but also provides economic benefits to Turkey.

Since 1986 when BOTAŞ, the Turkish state-owned pipeline company and gas importer, first purchased pipeline gas from Russia's Gazprom, Turkey has managed to build an internal gas pipeline network that crosses the country. By signing substantial and expensive "take-or-pay contracts" with Russian and Iranian suppliers, it also funded the construction of two major gas pipelines from Russia and a major gas pipeline from Iran that are capable of transporting billions of cubic metres of gas each year to the Turkish border. Now that these pipelines are built, the incremental costs of expanding gas supplies should be substantially lower than before.

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With Turkey having received a date to commence EU accession talks at the end of 2005, the momentum of liberalisation will continue.

The methods and the adjustments that will enable Turkey to develop a stable long-term gas market structure are generally known. However, some of the detailed regulations that have not yet been worked out, and the ways in which the supplier countries react to this market structure, will have major economic consequences for Turkey's gas sector.

FUTURE MARKET STRUCTURE: Turkey, in its World Bank-inspired Natural Gas Market Law adopted in 2001, chose the classic current orthodoxy: it created an independent Energy Market Regulatory Authority, it required BOTAŞ to divest itself from its monopoly importer status by reducing its share of imports to 20%. BOTAŞ will do so by releasing some of its gas import contracts (if the suppliers agree) or volumes (if they do not) to the private sector.

The Natural Gas Market Law also created open competition in the gas wholesale market and, once the existing quantities of the import contracts are used, would allow competitive additional imports. In the gas distribution segment, the regulator has begun the process of offering 30-year city gas distribution concessions to companies that bid to build out gas distribution networks in cities across Turkey on the basis of the lowest bid distribution tariff. Gas costs would be passed through to the consumer together with this tariff.

While this process has started, how the resulting market will coalesce is not yet clear. This is because the subsidiary regulations affecting the tariff for transmission within Turkey will have an important impact on the prices and the level of real competition in the Turkish market.

So far, BOTAŞ is in the process of seeking purchasers to take over portions of its existing gas supply contracts. Whether this process will be successful and whether it will succeed in injecting any competition into the process is still uncertain.

BOTAŞ, the importer and transmission company, finds itself performing different functions with different rules applying to each function. It is also in the process of a painful readjustment in light of legislative imperatives requiring it to reduce its position as a gas importer and wholesaler by providing its competitors with a portion of its own supplies. In the importation and wholesale sectors, it must play to lose.

At the same time, the respective roles of the Ministry of Energy and Natural Resources, the energy regulator and BOTAŞ are too new to have settled into a comfortable and mutually accepted arrangement. Some adjustment is possible as the market restructuring proceeds. Some adjustments to important details of how the market advances have been mooted. Until these goals are clearly enunciated in a consistent and clear manner, investors will need to anticipate alternative market structures while preparing their investment plans.

NEXT STAGE – STRUCTURAL SEPARATION: With the recent announcement by the EU of its intention to start accession negotiations with Turkey, the forces that seek to proceed with rapid market deregulation are on the ascent. Turkey will take all necessary measures to harmonise the Natural Gas Market Law and regulations with European Union directives adopted since 2001.

The future gas market will need to segregate the transmission roles of BOTAŞ from its wholesale sales role. This has been suggested by the World Bank in a recent strategy paper. The pressure will build to divide BOTAŞ into a monopoly transmission company and separate trading arms. The trading arms could, at some point in the not too distant future, even find themselves on the privatisation agenda.

For now, Turkey sees the transmission function as a key government function and this is likely to continue for the foreseeable future.

The good news for BOTAŞ in this unhappy readjustment phase is that the energy regulator will need to provide it with a transmission tariff system that is transparent and that provides it with fair and reasonable returns on its investments. Without cross-subsidisation, the regulator will need to revisit transmission access rules and questions of gas storage . However, the complexity of regulating equal access rules and policing against an institutional bias in favour of the entrenched market leader would be much simpler if there was a structural separation. Indeed, it should be largely self-enforcing.

IMPACT ON EUROPE & EUROPEAN GAS SECURITY: Turkey's move towards reducing the "overhang" of excess contracted gas purchases should help the EU in one of its confluent strategies.

Europe has been recently looking at its strategic options to reduce the concentration of its dependence on any particular source of gas supplies. Of the three main sources of supply, Russia, the North Sea and North Africa, Russia (through Gazprom) represents close to 20% and its share is expected to grow. Russia currently represents a majority of Turkey's own current contracted capacity.

Gas pipelines transiting Turkey, itself heavily dependent on Russia for gas supplies, offer the prospect of additional alternatives. Besides the benefit of reducing the dependence on both suppliers and consumer on key transit countries, Turkey offers the promise of alternative sources of gas for the European markets – Iranian, Azeri and possibly the vast Turkmen gas reserves. At one point, even gas from countries with lesser (but not inconsiderable) gas reserves such as Iraq and Egypt could be connected via Turkey. In this, Turkey competes as a transit route with the North African countries such as Algeria and Libya, which plan to increase the volumes of gas imported by Europe via pipelines crossing the Mediterranean.

A complicating factor is that while Europe looks to expand its sources of supply, it does not have sufficient current unmet demand that would justify the additional cost to the European consumers of building additional transmission pipelines from existing sources of supply. Supply from new markets, or suppliers who wish to increase their market share, such as those in North Africa, might absorb some of the costs in return for increased market access.

CHALLENGES & CHANGES AHEAD: Turkey's gas market is not yet mature and its market and regulations have not yet found their equilibrium. However, certain patterns can be seen that will impact the market for 2005 and beyond. These include the extent and pace of the domestic consumption growth as Turkey expands the city gas distribution and builds more gas-fired power plants. It also includes the manner in which the domestic main gas transmission tariffs are set (and how BOTAŞ adjusts to its new role), the ability of Turkey to manage the seasonal fluctuation of gas demand (including whether gas storage is shifted to BOTAŞ as a pipeline function – as the World Bank suggests – or not), Turkey's success in attracting transit gas and how currently powerful supplier countries react to the liberalisation of the Turkish gas market.

How Turkey manages these complex tasks this year will have a large impact for years to come.

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