

POWERING TURKEY

Phillip Rosenblatt, managing partner of Rosenblatt & Company, on Turkey's energy choices.

Turkey today faces historic challenges and opportunities in restructuring its energy sector that will have long lasting economic and political consequences. A number of factors, some unique and some general, conspire to constrain Turkey to live with the choices it must soon make. In choosing how to restructure the energy sector, Turkey must look carefully at the investment environment it will create for the private sector, particularly over the critical short and medium term, to take advantage of its unique position as a bridge between Europe and the world's largest gas supplies while at the same time providing an environment where energy can spur economic prosperity and better living standards for Turkey.

UNIQUE FACTORS: Turkey is in a unique geographic position, neighbouring some of the world's largest gas reserves, Russia (with the world's largest reserves), Iran (the second largest) and the other Caspian basin countries (particularly Turkmenistan and Azerbaijan), a region that contains a full fifty percent of the world's proven gas reserves. While much focus has been given to Turkey's successful role helping finance and build the Baku-Tbilisi-Ceyhan oil export pipeline, gas pipelines are far more important to Turkey than oil pipelines.

Oil is a widely available commodity product that is easily stored and transported and does not require substantial investment by the purchaser to receive. Turkey is not constrained in its ability to import sufficient oil for its own use at world market prices and can supply its domestic market with oil from multiple sources without risk of interruption. Oil can be purchased on spot markets

were there any shortages. Increased purchases of oil will not reduce their purchase cost, and oil and its derivative products while important for the transport sector are not a major source of fuel for the power sector or other industrial uses.

Gas, however, has no unified world price. The cost of transporting gas and the uncertainty of the market, the lack of easy means to store and divert gas to markets (absent connections to international grids, such as the European gas grid) have conspired to make gas pipelines far more dependent on local factors in the purchasers' market. Unlike oil, gas purchases are often based on long term supply agreements with substantial penalties for rejecting delivery (the so called "take or pay" contracts) – for the understandable reason that supplies cannot be diverted to other customers and substantial investment is required to build the necessary transportation infrastructure. Likewise, these purchase undertakings must be received from financially credible purchasers to support private funding of gas pipeline construction. Where such undertakings are not available, governments are forced to step in or to provide guarantees to enable these projects to proceed. It is in Turkey's economic and political interest to have gas pipelines from as many sources of supply enter and transit Turkey. Economically, additional sources of supply should reduce the relatively high price Turkey currently pays for gas. Politically, it would reduce the high level of dependence Turkey has on Russia for gas supply (which is set to increase further when in about

2006 the Blue Stream gas pipeline from Russia reaches its supply capacity).

For Turkey to achieve this goal, absent government guarantees, the availability of which is limited, Turkey needs a well functioning regulatory structure to both its gas and electricity markets, free from interference from short term political considerations to achieve this important long term strategic goal.

Where there is certainty of a functioning market and the regulatory environment over a period of time, the market need itself may be sufficient to justify either the purchaser or the seller or both to undertake building the necessary infrastructure without substantial government guarantees or funding. Ultimately, the connection of the supply to a grid would further reduce the risk to the supplier and enable the seller to rely on the purchase of gas in a much larger market. At the same time, the price for such supplies would become far more dependent on competitive forces as such other markets will have competing sources of supply.

THE ELECTRICITY CONNECTION: The markets for Turkish gas are inextricably linked to Turkey's internal market for electricity. Turkish industry pays one of the highest tariffs in the world for electricity – while the electricity infrastructure needs critical investment to keep pace with a burgeoning demand. The need for backup power in offices and factories is ample evidence that Turkey requires substantial investment in its power sector to serve its current needs, while the growing population and the aim of attaining the levels of economic prosperity of its neighbours in the EU will require sustained investment over a

period of decades, to the tune of tens of billions of dollars of private sector investment.

Turkey's system is broke and broken and in desperate need of restructuring. And restructured it will be. The Turkish government, with the urging of the IMF and the support of the World Bank, has made steady progress in adopting framework laws regulating the gas and electricity markets in line with the modern approach to open energy markets – separating electricity production from high voltage transportation and low voltage local distribution – and separating importation from transportation and distribution of gas.

The focus of the restructuring efforts is aimed at reducing costs to consumers, increasing stability of supply and creating transparency in the energy sector. The restructuring should also increase efficiency by introducing competition to the parts of the market that can be opened to competition, while establishing a transparent regulation of those parts that are natural monopolies (such as local distribution). The other aim of the restructuring is, of course, to get the government out of the business of business. This should help alleviate the current constraints of the limited government resources to fund necessary infrastructure needs.

Because of the importance of lower cost and reliable electricity supply in bringing prosperity to industry and for its role in spurring Turkey's ambitions as a supplier and transporter of competitively priced gas, Turkey should focus on accommodating the needs of private investors in the power sector.

Investors need stability and certainty. Since the government currently cannot (and in a working system, should not) provide financial guarantees to private sector owners of power plants that it will purchase and pay for the power they produce, investors will absolutely require a stable regulatory environment and creditworthy purchasers. The first step is to ensure that the companies that are licensed to provide the critical service distributing power to consumers are companies with the financial wherewithal and expertise to operate these distribution systems efficiently with the sole aim of earning a reasonable return for their investment and risk. This critical section underpins the entire system – if the companies running the distribution networks are not profitable and do not have substantial financial resources – they cannot be relied on by those selling the electricity to fulfil their purchase obligations. Ultimately, either the power producers will refuse to make the necessary investments or the government at some level will need to provide financial guarantees. By ensuring that companies with their own substantial investment at stake have an incentive to reduce the endemic high levels of losses (both from theft and technical reasons), Turkey can reap the benefits of additional supply more efficiently and easily than by building additional capacity.

Second, Turkey needs to be far more concerned that the regulatory system works than with whether particular investors are receiving "unfair" profits. Initial new investments in the system are sure to command high returns. The risks of investing in newly regulated markets are high, and the returns

will have to be commensurate. But as investors in the power industry know, where returns are high in transparent and stable markets, competition soon brings even more investment, which eventually will lead to lower prices and lower returns to the late-comers. With the substantial investment required over such a long period, high initial returns for investors would not be a bad result for Turkey's greater interests.

Finally, in deciding to privatise the power sector, Turkey should bear in mind the trade-off between price maximisation and energy prices. The higher the investment required, the higher the return and the higher the electricity rates must be to justify the investment. There is more than the balance between the purchase price the government receives and the investment costs required. There are also critical issues of the anticipated cost of compliance with regulations, particularly with respect to environmental rules concerning the level of emissions of lignite-powered plants. While the government can afford to choose from a number of reasonable standards and regulatory schemes, it cannot afford the substantial uncertainty of changing these regulatory standards afterwards. The risk of such changes – and the corresponding risk to investors – is a price too high for Turkey to afford. Turkey needs profiting investors to build its power sector – without major government funding – and ultimately to build the energy bridge that will bring Turkey prosperity. 🗑️

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