Once a premium destination for overseas investors, Turkey's power sector has recently been struggling with the impact of lower-than-expected growth rates, partial market liberalisation and fixed, long-term natural gas contracts. Power generation firms face further stress as the economic impact of the pandemic bites. Efforts to arrange a new debt restructuring deal have been delayed by the virus and wider economic woes, casting uncertainty over future demand. However, the sector retains some high-grade assets, however, which may attract future investor interest.

Turkey's power companies face a difficult period ahead, as coronavirus lockdowns shrink workplace electricity consumption and further squeeze bottom lines. Yet, this is by no means the first challenging period the sector has encountered. Indeed, just a decade ago the power industry was facing the opposite problem.

Rapid GDP growth in the early part of the century – over 9% in 2004 and 2005, and 11.1% in 2011 – had created fears of a future power supply *shortage*.[1]In fact, Turkey's response to that past challenge now directly underpins the major difficulties the sector is facing today. However, at the same time, that response also suggests some potential solutions to these longstanding problems.

Great expectations

At the time, the high levels of growth from 10–15 years ago were widely forecast to continue, with this economic expansion expected to drive electricity usage. For example, in 2009 the International Energy Agency suggested that Turkish electricity demand would more than double over the following 10 years.[2]

To meet expected growth, the country undertook a series of market-based reforms designed to attract investment and boost capacity.

A privatisation boom followed, with a 2018 report by Boston Consulting Group and the Turkish Industry and Business Association suggesting that some $95bn had been invested in the electricity market in the previous 15 years.[3] As a result, generation capacity doubled between 2007 and 2014, while by the first half of last year private companies accounted for some 73% of the country's 90.4 GW of installed generation capacity.

Turkey also embarked on a programme of energy diversification. This included a substantial increase in the use of natural gas, which by 2014 accounted for around half of all electricity generation.[4]Russia became the largest source market, with a steadily increasing number of pipelines supplying gas to Turkey under take-or-pay contracts.

Disappointing realities

Yet, as it turned out, earlier levels of GDP growth proved unsustainable, while electricity demand growth never met expectations. In 2018, for example, electricity consumption increased by just 0.8%.[5]

Meanwhile, although the sector was privatised, it was never fully liberalised. The state Energy Market Regulatory Authority keeps a firm grip on electricity prices, holding them down to boost growth and – some would argue – government popularity.

This has meant that private companies running natural gas-fired plants have been unable to hike prices even if the cost of gas rises. With imports of this feedstock priced in US dollars, Turkey's currency depreciation issues have made it an increasingly volatile and costly business.

In addition, the government's energy diversification plans have steadily boosted the market share taken by hydropower and – most significantly – domestically produced coal. Official figures show that the latter supplied 37.3% of total power generation last year, while natural gas slumped to 29.8%. For its part, hydropower accounted for 19.8%.[6]

So, with overall demand failing to meet expectations, costs soaring, market share falling and an inability to adjust prices, private natural gas-based generation companies rapidly began to face difficulties.

The issue came to a head in 2018 during the currency crisis, which pushed up financing costs while the lira tanked. Many power companies jumped ship, with Austrian oil and gas firm OMV exiting the market after selling its plant for barely half the €600m it had initially invested in it.[7]

COVID-19 exacerbates underlying challenges

With some $40bn-50bn of the $95bn invested in the market over the preceding 15 years reportedly made up of unpaid debts, a debt restructuring package was hastily put together, led by Garanti-BBVA Bank.[8]

While this helped re-stabilise the sector, since then the industry's underlying problems have not significantly changed. And challenges have now been exacerbated by the coronavirus pandemic, which has shut down significant industrial demand.

The potential benefit of this year's oil and gas price collapse has also been obviated by the long-term nature of the gas import contracts signed with Russia and others. Thus, plans to restructure more of the sector's debts have been underway.

The International Finance Corporation and European Bank for Reconstruction and Development have suggested assigning the debt to a special fund, which would sell this on over time – almost certainly at a substantial discount. With many power companies having invested in brand new stations, the quality of sector assets is generally high, making them potentially attractive if the price was right.

Such a special fund would have to take a major financial hit, however, with the banks suggesting that a change in tax regulations to benefit the banks might help ease some of the burden. Regardless, the spread of COVID-19 has meant that any restructuring efforts are likely to be delayed.

Investors weigh opportunities and risks

In the meantime, potential investors will be looking at the lessons of the last two decades – particularly when it comes to estimating future electricity demand. Clues to this, however, are unlikely to emerge until the virus recedes.

They will also be looking at the impact of failing to fully liberalise the sector, particularly on pricing, as well as an apparent failure to properly sequence the shift to a wider energy mix with sufficient investment in natural gas-fired plants. Indeed, the lack of transparency on gas supply contracts will also be a concern, as will such fixed, long-term gas supply deals. The potential pitfalls of such arrangements prompted the EU to forbid such deals among its own member-states, with Turkey likely to benefit if it is able to follow suit.

Going forward, Turkey's power sector possesses a range of high-value assets soon likely to be available at discounted prices. These are likely to be attractive to overseas investors, once a suitable restructuring and pricing framework has been worked out. While past projections of demand growth have proved woefully optimistic, Turkey is still a country of 82m people and some strong economic fundamentals. Power demand is already beginning to inch back up again, as the country exits lockdown. A sector still worth waiting for, then, despite its current challenges.

Jonathan Gorvett is a journalist and analyst with many years experience researching and writing about the Gulf and the wider Near and Middle Eastern region. His interests include political and economic risk, development and the evolving place of GCC countries in the international diplomatic, political and economic landscape.

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