Istanbullish

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Energy consumption in Turkey is far outpacing supply and in theory state monopolies are being unbundled to the rhythm of privatization and foreign investment. But developments on the ground have so far failed to match the fervent pace of planning and revision. This will change.

Over the past 20 years, successive governments have tried to separate economy and state, to varying degrees of success. Now, it seems, the deep discomfort surrounding foreign ownership of certain state industries has been replaced by ample and tenacious support ? ?Ozal's reforms have taken off, people have digested them and Turkey has finally come of age as a people,? claims Intergen's vice-president and country executive, Christopher Wilkinson.

Now, the deftly fashioned models for private infrastructure development, mired for years in legal and bureaucratic complexities, anxiously await their execution ? if, that is, the bulk of projects can actually lure the finance and, as importantly, play into an as yet vague set of government priorities.

Broadly, the plan is to privatize power generation and distribution and to encourage more foreign investment. This has been the idea since the early 1980s. But only now is private sector power generation, and project-finance coloured foreign investment, inching towards a sizeable, and palpable, reality, with a few conspicuous energy projects reaching financial close, and several dozen projects in tender or awaiting approval.

There are conflicting estimates of the depth of Turkish power demand ? and of how much cash is required to finance the extra capacity. TEAS, the state electricity generation and transmission company estimates $5.5 billion a year needs to be spent on power until year end, 2020. World Bank calculations are somewhat more modest, rounding out to a demand requirement of roughly $2 billion a year.

But whichever way it is sliced, the vital fact remains that Turkey is Europe's fastest growing energy market and, in terms of forecast, the fourth largest energy market in the world, trailing China, India and Brazil. According to Citibank, the government plans to add 40,000MW of new generating capacity by 2010, of which at least 25% will be generated in gas-fired plants.

But plans have not yet been reflected in actual results. Although the machinery for resorting to international arbitration in cases of disputes involving the state has been locked in place, thereby eliminating a prime concern for financiers, many obstacles still face energy investment.

The sluggish pace of power project finance and development follows from a historically unwieldy political, economic and legal environment, only just emerging from its discrepant shell. This nexus of underlying obstacles is deeply convoluted, but it can be broken into distinct chunks.

With ideological resistance largely obsolete, a fundamental concern for foreign investors has been the erratic health of the economy. For the last decade, inflation has averaged over 80%. Add to this the deep mid-nineties recession, which helped push up the price of borrowing. And real interest rates at 40%. On the face of it, the situation seemed grim.

But, says Yavuz Canevi, former governor of the Central Bank and current chairman of Turk Economy Bank, hyperinflation was only a problem from the outside, ?those within the country had learned to do hyperinflation accounting ? it was predictable, calculable. Those who had already invested in the country knew how to play the game and were thus perfectly willing to take what, at the end of the day, was a negligible risk. The economy grew regardless.?

Politically, the outlook from the outside has also been uncertain and, as such, unsettling. Hefty country risk scared off many potential investors, while making it awkward to raise long term money. With governments passing the baton in quick succession, Turkey's credit rating persisted at sub-investment grade for US investors. And private power infrastructure financing suffered.

But now, the reasons for optimism are far more apparent. In December the government disclosed an IMF-crafted three-year reform program . To undercut public expectations of inflation, it announced a schedule for the devaluation of the lira month by month for the whole year in advance. In return for this, and other, obligations, the IMF agreed to provide $4 billion of loans. If all goes according to plan, Turkey will be down to single digit inflation by 2003.

Turkey has embarked on many such programs before. But this time the IMF has made sure that the government deploys not just painful spending cuts and tax increases but also much-needed laws on privatization and pension reform, before getting any Fund money.

The balances have changed. Says Canevi, ?the private sector has gained real power in this country. It used to be that Ankara was strong enough to impose conditions on Istanbul. Now Istanbul is imposing conditions on Ankara.?

Inflation has dropped to the lowest level in 14 years, the public debt to GNP ratio is falling, interest rates have declined rapidly and output growth is resuming. In sum, this has generated much needed credibility in international financial markets.

There are grounds for renewed optimism on the political front as well: Turkey is currently enjoying its most robust government in years, Prime Minister Bulent Ecevit's three party coalition, which is eager to see to completion the reforms it has helped initiate.

Consider also Turkey's geopolitical location. Turkey has the resources and the geopolitical poise to exert a beneficial effect not only on the region, but on all of Europe as well. These facts are not unnoticed. Formal EU candidacy was recently granted to Turkey. With a long-term commitment to Europe in the works, the repercussions will be felt in an ever-increasing mass of foreign investment

These factors neatly play into the country's credit ratings. Moody's is expected to upgrade Turkey's sovereign rating from B1, four steps from investment grade, to Baa3 later this year. For this, the agency cites the country's commendable efforts to tackle ?large fiscal deficits? and ?chronic high inflation? as well as implementing a successful privatization program. Standard & Poor's, on the more conservative?though still confident?side, expects to take slightly longer to notch the rating up from its current B+ to BB-.

International arbitration

The government's reform program includes room for international arbitration for disputes on contracts to which the state is a party. For project financiers, the complaint has typically been the lack of such a clause and the inability to sign private law contracts. Permitting international arbitration eases investor's fears of potential injury by local courts.

?On the legal side, we're now closer than ever to target,? suggests Asli Basgöz, partner, at the international law firm

White & Case, who specializes in international finance. On a broader scale, she continues, ?the passage of the recent constitutional amendment demonstrates that the government is committed to these projects and can organize a bloc of votes to pass one ? an important step indeed.?

The constitutional amendment allowing private law contracts for the energy sector was enacted in August 1999, with subsequent enabling legislation in October 1999 and most recently in January 2000. But although seven months have elapsed, the progress remains painfully slow.

?As the process of approving and signing continues, we haven't yet seen the vast majority of the projects reach financial close,? says Citibank's head of project finance, Eren Güra.

Moreover, of the dozens of projects permitted to either apply for international arbitration or convert existing administrative law contracts to private law contracts, many sponsors failed to act at all. Explains Ümit Hergüner, partner at local firm Hergüner, Bilgen & Özeke, ?for decades they used international arbitration as an excuse, but when the gates were opened for prospective applicants to make the necessary adjustments, they didn't even apply. This tells me the concern was more country-risk oriented than an issue of legal sensitivity.?

Another expert adds: ?International arbitration has been a proxy for a whole set of international standards that typically apply to project financing, from a lawyer's and lender's perspective.? These issues include allowance for government default, buy-out, and lender step-in or assignment rights.

The launch of international arbitration, then, though perhaps not strictly necessary, has in theory streamlined matters, according to one government adviser, making proceedings less costly in terms of bureaucratic wrangling.

Project pipeline

Yet to date, a handful of big-ticket power projects, all based on the Build-Own-Transfer (BOT) scheme, a concession-financing and risk-sharing model, have successfully circumvented these supposed legal concerns, ?slipping through the cracks,? and casting further doubt on the necessity of the constitutional amendment.

The author of the BOT model, a former adviser to then President Ozal, argues that the success of the early BOTs hinged on their following procedure, without hubris. ?There is no inherent problem in doing project finance in Turkey. There has been a sort of deep-rooted arrogance on the part of many foreign developers. They need to understand that they're not coming into a gold-plated situation. We understood this and we succeeded.?

The BOT program, first put forth in 1984, has seen only four power projects reach financial close: the 672MW hydro-electric project at Birecik in 1995; two Enron-sponsored 478MW gas-fired projects in Marmara, in 1996; and the gas-fired 180MW Esenyurt project in 1997. The other infrastructure project financed under the BOT scheme is Thames Water's Izmit water project, which reached financial close in 1996.

Says Mehmed Çavusoglu, manager at GE Power Systems, ?after this first round of projects, the Turkish mistake was to try to reinvent the wheel. They had four examples of IPP's which passed through the hurdles, secured financing and started production. With that sort of track record, the process was intact. It didn't need to be tinkered with.?

But it was tinkered with. And, just as new legislation cleared the field for a financeable BOT energy model, the Turkish Constitutional Court decided, somewhat ironically, that the generation, transmission and distribution of energy constituted a public service. The rules changed again, with private power projects redefined as ?concessions,? requiring considerable revision to the terms of contracts between developers and the state. Outcome ? the delays.

To provide a partial solution to this problem, the build-operate (BO) model was proposed in 1996. Despite its shroud of legal uncertainty, the scheme seduced hordes of developers and bankers eager to skirt perceived contractual quandaries. Nonetheless, it defeated the argument that it was a concession contract. A foreign developer, lamenting the legal cramps of late, argues that ?the government went down this traumatic route of changing the constitution when in fact it wasn't necessary. They would have been better off spending their energy highlighting the hallmarks of the BO program, which is an open, clear, international, pre-qualified tender process, and which achieves benchmark prices.?

Since then, four of five viable BO projects have reached the financing stage. The first deal, Siemens/Steag 1210MW coal-fired Iskenderun plant, reached successful syndication in July, 2000. The $1.4 billion deal is being financed under a 75/25 debt/equity split, with equity sourced from Siemens and Steag. The $1 billion of 15½ year loans will be guaranteed by Hermes, $389 million, OeKB, $125 million, and GKA, $386 million. Lead-arranging the deal are Dresdner Kleinwort Benson, KfW and WestLB.

An Intergen-Enka consortium is developing three gas-fired BO projects. The first two plants, Adapazari and Gebze, are slated to reach financial close shortly. The third plant, the 1,555MW Izmir, is still in preliminary financing. The $660 million Gebze deal is for a 1,555 MW plant, the bulk of financing for which is rumored to come from US Exim, OPIC, Hermes and OND. The 780MW Adapazari plant, at $660 million, will feature a similar financing structure.

The final BO project fluttering on a hopeful horizon is National Power/Bayinder's 700MW natural-gas fired Ankara plant. The project is still far from securing financing, though it is also likely to pluck its cash from ECA and commercial bank loans.

Of over 40 proposed energy projects, roughly half are BOTs. The balance consists of projects that transfer the operating rights (TOR) to firms who will rehabilitate networks and, in theory, run them more efficiently.

Ali Alpacar, vice-president of Chase Manhattan bank in Istanbul, says that after the recent legal amendments, ?the expectation at the beginning of the year was that the BOT's would take off. But, contrary to expectation, this did not happen. The government has cold feet for BOT projects.? Citibank's Güra adds: ?It's unlikely we'll see many BOT's come to fruition. Besides, if the core idea is to privatize state owned industries, then transferring the assets to the government after a certain period doesn't make sense. Accordingly, BO's are preferable.?

That leaves the TOR projects. ?The immediate need of the country is to advance on these projects,? contends a local developer. ?They lack sufficient maintenance, and they desperately need investment and rehabilitation. Moreover, they will provide a fresh new source of funding for the government, and hence should be a priority.?

Be that as it may, there are too many projects in the pipeline and not all of them will move forward, cautions Ahmet Tüzün, general manager of the local company Marketing, Aviation and Power.

But until the government states its priorities, most agree that it is not easy to speculate with any accuracy which projects will get done.

Such a priority list will likely be encouraged by the following key factors, says Tüzün. Projects with earlier realization dates will be favored. With Turkey's energy supply expected to shift heavily towards natural gas, those projects in line with new fuel supply requirements will be singled out. Projects that can get done more simply with commercial loans and private equity will have an easier time moving forward. Equally important are the demographics of the project: if the project meets an urgent demand in a specific area, it will be prioritized. Finally, projects which don't require treasury guarantees will become increasingly more attractive.

Projects fitting at least these criteria are more likely to attract foreign investment. First priority has since been given to the already agile BO plants. And with a clear project schedule, it should be much easier to raise finance for the relevant projects.

With deals like last year's Afsin Elbistan B coming to the market, it's hard not to be upbeat about the future of Turkish project financing. The deal, at $1.6 billion, is the largest power financing ever done in Turkey, adding 1,400MW to the country's 21,000MW capacity, now up to 24,500MW. Financing consisted of several loans backed by government and export credit agencies and commercial bank loans, lead arranged by Citibank. Although a full-recourse deal, it is a rousing example for those interested in the future of limited and non-recourse financing in the country.

Beating bureaucracy

With the resolution of alleged legal qualms, the gradual bolstering of government and economy, and ensuing credit rating upturns, the maddening question is why, aside from the advancing BO scheme, the momentum for further power project finance still dithers.

?This is essentially a Turkish domestic problem,? explains a local developer. ?What we've been seeing over the last several months is the state bureaucrats trying to seek coverage, trying to search for a responsibility sharing mechanism for the new contracts, and this is delaying the process. We, as developers, are still lumbering down the lane, while the bureaucracy is trying in its drawn-out way to diffuse its responsibilities.?

Also, with each swig of IMF stabilization, inflation drops further. This aggravates somewhat the problem in the short run: within a swiftly mutating business community, many private companies have not fully restructured themselves to play according to the new rules of low inflation.

Commenting on why several international developers have failed so far to advance their projects or have retreated entirely from the Turkish market, a foreign adviser to the government appeals to psychology: ?The problem is a question of misguided attitudes. Many developers approach Turkey the way they approach the US, neglecting the fact of a different motivational structure, legal framework and economic climate.? His appraisal, then: ?It's like trying to bang a square peg into a round hole.?

Part of this understanding means grasping the fact that power is fundamentally a public policy issue in Turkey. In fact, domestic power pricing is the largest single policy issue facing the government. And the single biggest risk to the government is no power. So, argues the adviser, when the government vacillates or cuts back developers' options, it is simply playing safe.

?If progress is to be made,? concludes Yüksel Güler, general manager of local company Zorlu Enerji, ?one or two new examples need to be set, to pave the way for new projects?.

The current friction, it seems, is primarily procedural in nature. But it needs to be addressed before non-recourse money comes to bear. ?If there had been a true non-recourse example set in another industry, that would have helped. But there aren't any,? shrugs another developer.

The only projects so far to slither along unimpeded are the auto-generation facilities. ?They have been a quiet success,? says Güler. The scheme allows local manufacturers to generate their own power, primarily for the producer's use, but it can also be sold on to the national grid. These projects are typically small enough to be financed by capital-limited local banks.

But suspicion lingers around the vast number of projects actually awarded tender. ?No one can say that the initial number of projects was truly realistic,? admits a local developer, ?the bureaucracy was inclined to create more projects than necessary in the hope realizing at least some of them earlier. But the number of projects piled up, in part because, despite the legal system being ill-equipped for true non-recourse project finance, the hope for a remedy persisted. As that remedy, constitutional amendment, was slow to arrive, many projects were created to simply bypass this obstacle using other financing techniques, such as commercial loans.?

Treasury guarantees

To boot, the question of treasury guarantees cuts directly to the core of the energy debate. The IMF standby agreement and World Bank reform package limit the issuance of treasury guarantees, in an attempt to restrict contingent liabilities. But all project finance deals to date have been fully guaranteed by the treasury.

Citibank's Güra clarifies: ?In line with the restructuring towards a free energy market, it's logical to reduce guarantees.? Referring to the projects already underway, he adds, ?those that have an earlier impact on Turkish energy shortage will still enjoy treasury guarantees. The others still to come on line will have limited guarantees.?

But the offtaker, TEAS, suffers from a limp balance sheet, and, accordingly, is having a hard time meeting its take or pay obligations. And the guarantees are on the utility company's payments. Many bankers argue that TEAS lacks credibility and thus needs treasury guarantees: ?there's no way a project involving TEAS will get done without treasury guarantees.?

The only thing that would ensure a treasury guarantee non-requirement, then, is the strength of TEAS' balance sheet. And until it perks up, through impending market reforms, the requirement, albeit curbed, will persist.

?I personally don't see a way out of this without raising tariffs,? concludes Tüzün. ?If subsidies are discontinued, the only way to correct the balance sheet is to raise the tariffs. And the net effect will be a net increase in tariffs to the public and to businesses.?

Local bank hunger

Problems notwithstanding, huge profits are to be made in the energy sector and in infrastructure investment in general. And Turkish banks are especially vigilant.

For years most of them have fed off hyper-inflation and high interest rates. But with the regular unwrapping of the IMF package, this is changing. The main, privately owned players ? Yapi Kredi, Akbank, Is Bank, and Garanti Bank ? are poised to make the largest gains. Hoping to expand their asset portfolios, from early this year they have begun to look to project financing. And as long as interest rates decline, this will become a still deeper source of appeal. But some medium-sized banks, like Turk Economy Bank (TEB), will also carve out their own plump profits.

Closely eyeing project finance developments is Garanti Bank, controlled by the Dogus group, a financial services conglomerate. ?Its difficult to quantify the depth of our project financing appetite, since it is such a new market in Turkey,? says Ugur Türkmen, Garanti's project finance vice-president. ?But our appetite is certainly there.?

It certainly is. Garanti Bank was the first Turkish bank to render its advisory services for Turkish project finance deals. ? We've been in the business for three years, we're ahead of most Turkish banks, we've worked on most of the deals and we know the market,? assures Garanti's Ebru Dildar.

Because of the large volumes and high availability periods, it will be difficult for many local banks to join the revelry. They will be involved primarily at the level of guaranteeing operational risk and those, like Garanti, with significant project finance experience, will flourish.

But for the bulk of local banks, says Chase's Alpacar, ?from a technical perspective they will have to participate in a group of real project financings to gain the confidence, knowledge base and expertise to do this with any fluency in the future.?

This fact is particularly acute for medium-sized banks like TEB. Canevi, the bank's chairman, explains it thus: ?Consumer finance is the current trend, with four-year lending. Ultimately, with money in hand, or in guaranteed deposits, we'll switch our portfolio to profitable five to 10 year projects.?

Which, for now, leaves TEB to shore up its project-finance skills in an advisory capacity. ?Without a local advisor, it's very difficult for big international banks to just swoop in and actually get the whole picture. The big financial institutions need the help of local players to guide them through the maze of complexities,? contends TEB's managing director, Omer Kahraman.

If the Turkish banking system restructures along Western lines, it will also inevitably discover consolidations. ?The bigger banks are harder to assess,? says Canevi, ?but with insurance coverage reduced, it makes sense for medium-sized banks like ours, with the highest capability in the market, to look for consolidation within the next couple of years.?

Akbank has already publicized its craving for a more absorbed relationship with an international bank. It also eagerly hints at a big-four merger. Whatever the outcome, an exciting time lies ahead for the Turkish banking culture, and for its project financing future.

Regulatory framework?

With this wide wave of reforms, Turkey is set to move much more aggressively towards real market energy models. It has reached a comprehensive agreement with the World Bank to fortify the legal framework, establish an energy regulatory body, and drain out costly ?take or pay? deals, all spearheaded by a $750 million World Bank loan.

In a letter to the World Bank, Recep Onal, Minister of State for Economic Affairs, insists that the government is addressing the frail regulatory environment for energy by moving to a competitive market, through privatization: ?The cornerstone of this new approach will be the electricity market law currently under preparation.? He continues, ?The law will meet applicable EU standards. It will establish an independent regulatory body with full authority over tariff policy, establish the framework for a competitive market and set a clear timetable for moving to the market model of 1.5 years following enactment of the electricity market law.? The government expects the law to be enacted soon, with technical assistance being provided by the World Bank Group.

But an informed local developer is not satisfied: ?Such a law can only be properly drafted when supply exceeds demand. But we're currently in a deficit situation in which it's not so easy to talk of a marketplace as such.? And there's more: ?The latest draft also lacks what's at the heart of the matter, namely, a priority list of projects, generators and their prices, from the purchasers' perspective, instead of an outline of how the committee intends to oversee procedures.?

As a preliminary step toward a real market model, the government has split TEAS into distinct generation, transmission and energy trading companies. Describing the anticipated market model, Sankaran Balasubramanian, the IFC's country head, points out, ?the regulatory authority won't be a free electricity on tap model, which some Latin American countries have adopted. There will be some kind of price-fixing. We're essentially looking at an intermediate market model where there will obviously be different producers whose pricings will be set by the authority, based in part on fuel supply.?

The World Bank Group wants to see a complete overhaul of the energy environment to avoid, as one expert puts it, ?a sector regulated by a bunch of ad hoc contracts between the developers and government.?

Herguner and his legal team expect many existing arrangements at the decree level to be advanced to the rule of law to create a much more consistently regulated energy environment. ?Of course, certain markets in the world are moving towards deregulation,? Hergüner reflects, ?but lets first regulate before we can deregulate.?

New Ways to Finance?

With the liberalizing of the market, an assortment of fresh financing instruments should begin to surface.

A mixed mood prevails around the immediate future for project bond financing. ?It will take a while for project bonds to be used,? claims Chase's Alpacar. ?It will take a number of deals for people to affiliate themselves with project financing coming out of Turkey, not only because people will want to see how potential problems are dealt with, but also to see and realize that there are obvious opportunities in Turkey,? he adds.

But given the impending credit rating upswing, there is hope yet. ?The turning point will be Turkey hitting investment grade,? insists Garanti's Türkmen.

The IFC's Balasubramanian agrees: ?With some firms already having proved themselves, they should have easier access to international bond markets. And with interest rates declining on government bonds, there's a good chance of setting off the domestic bond market.?

Securitization is also an efficient tool for creating ample headroom for companies by packaging and pooling the risks of their different assets. The problem, says Balasubramanian, is that ?it's a nightmare in terms of the current legal framework. The Central Bank has asked for our assistance in streamlining the securitization rules.? To date, the IFC has done the only existing asset securitization in Turkey, last year's Garanti leasing securitization, which picked up Euromoney's Deal of the Year Award. With the structure of asset ownership being reworked legally, securitization is set to become a more frequently applied tool.

A Multilateral perspective

With such rapid development, the future role of multilaterals comes into question. Balasubramanian anticpates their role to diminish with time. First, with the revival of international debt and equity markets as well as commercial banking markets, he suggests, ?multilaterals will be reduced to project financing in the traditional sense. That is, 15 year or 20 year money.? Second, he expects multilaterals to ?move a couple of steps down in the corporate ladder? with their focus directed more towards ?fulfilling their development mandate in poorer regions of the country.? Finally, multilaterals will assume second stage institutional reforms such as setting up pension funds.

But, he insists, ?the dollars will be pooled for infrastructure project finance. That's what this country needs.?