



## **TURKEY IN THE FRAMEWORK OF THE EU ENERGY UNION: ENERGY SECURITY AND GOVERNANCE RISKS**

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The Crimean crisis, the continuing instability in Eastern Ukraine and in the Middle East have turned into a rude wake up call for Europe's energy security vulnerabilities. In response, the EU leaders have increased their focus on the development of a viable European Energy Security strategy. The outcome has been the publication in early 2015 of the European Energy Union Roadmap, which points to the main steps to be taken by member-states in diversifying the EU energy supply, strengthening the bargaining power of Member States and the EU vis-à-vis external suppliers, the development of indigenous energy sources in the EU, and reinforcing the Energy Community. The successful creation of a European energy union though will not be possible without the active involvement of Turkey. The latter is going to play a vital role as the major transit country of future alternative natural gas supply from the Caspian region and the Middle East. Similarly, Turkey will benefit from the development of the Energy Union because it can transform itself in a major energy-trading hub, Turkey's long-term energy policy objective. Both the EU and Turkey's positions will also be influenced by the development of the foreign and economic policy of Russia.

In January, 2016, the European Commission and Turkey began a formal energy dialogue to integrate Turkish energy markets with the EU and focused on the development of an interconnected power and

### **KEY POINTS**

- As Turkey is a strategic bridge for new energy sources, it will play an increasingly critical role in helping the EU in completing the energy security pillar in the Energy Union initiative.
- Despite EU's activism for developing universal rules for Europe for liberalisation and security in gas and electricity, Turkey and the countries in the Black Sea region still pursue mostly a bilateral approach to energy security, which is insufficient for the development of a strategic regional energy security partnership between EU and Turkey.
- Turkey's energy sector transformation towards becoming part of the planned European internal energy market is happening only very slowly. Given that the inevitable changes will have an effect on both industries and individual consumers, politicians have been reluctant to sign on the dotted line and initiate the final stages of liberalization.
- Turkey is one of the most vulnerable countries from possible energy supply cuts, especially during the seasonal peak demand period. Most of oil and gas, and half of coal supply came from imports leading to serious macroeconomic imbalances and producing a negative impact on business and investment confidence.
- Turkey should work not only on diversifying energy import sources but also its domestic energy mix, where it is underutilising the country's enormous renewable energy and efficiency potential.

gas market, synchronization of renewables, energy efficiency and climate change policies and completion of the major diversification projects in the region<sup>1</sup>. However, the difficulties of advancing the Southern Gas Corridor projects revealed differences in strategic intentions between Turkey and the EU. The EU and Turkey have missed the opportunity of elevating their geostrategic cooperation through the promotion of the Nabucco pipeline. The scaled-down version of Nabucco, which includes the significantly smaller Trans-Anatolian (TANAP) project, is mostly implemented on a bilateral basis between Azerbaijan and Turkey. So far Europe has not been able to propose a strategic partnership in this respect to Turkey and Azerbaijan but rather is seeking to develop the South Corridor on a commercial basis. This is likely to take a much longer time and efforts, and might ultimately fail in the face of the Russian counter-strategy push at any cost. The recent series of high-level meetings between Russia and Turkey on energy at the backdrop of the lack of communication even in certain cases between EU and Turkey at the same time seem to confirm such worries.

Despite EU's activism for developing universal rules for Europe for liberalisation and security in gas and electricity, Turkey and the countries in the Black Sea region still pursue mostly a bilateral approach to energy security, which is insufficient for the development of a strategic regional energy security partnership between EU and Turkey. The latter erodes efforts for a multilateral (pan-regional) approach to the region's energy challenges, and puts at stake Europe's opportunity to diversify its energy supply.

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<sup>1</sup> Joint Press Statement after the 'Turkey - EU High Level Energy Dialogue' Meeting on 28 January, 2016.

<sup>2</sup> Energy security, solidarity and trust; A fully integrated European energy market; Energy efficiency contributing to moderation of demand; Decarbonising the economy;

However, Turkey has been generally reluctant to entirely embrace the EU Energy Union, which is reflected in Turkey's discontent with the sluggish pace of the accession negotiations, and the country's overall pivot to stronger relations in the East. There is a need for developing strategic understanding for the challenges and opportunities EU's Third Liberalisation Package and the Energy Union creates for Turkey and for the Black Sea and South East Europe, as well as reformation of regulatory bodies to ensure adequate decision-making. The implementation gap in terms of the introduction of the EU Third Energy Package will depend not only on the independence of the energy regulator's decision-making but also on the improvement of the corporate governance of the Turkish state-owned energy enterprises (SOEs). The latter are still marred with inefficiencies related to the persistent meddling of politicians in their day-to-day management as well as their common attempts to stem competition on wholesale markets or transparency in the public procurement process. Patronage politics and clientelism are still preventing some key market transformations from happening, which could not only delay the full implementation of the energy acquis, but also the projects developed jointly with EU member-states.

## The Energy Union's Turkey Dimension

Resting on five pillars<sup>2</sup>, the Energy Union aims at enabling the delivery of the EU energy and climate objectives<sup>3</sup>. The new EU project is driven by the need

and Research, Innovation and Competitiveness.

<sup>3</sup> Reduce EU territorial greenhouse gas emissions (by 20% by 2020, and by 40% by 2030), increase the share of energy coming from renewable sources (to 20% by 2020 and to 27% by 2030) and improve energy efficiency (by 20% by 2020, by 27% by 2030).

to coordinate energy policy-making to ensure the implementation of the 2020 and 2030 renewable energy and energy efficiency targets. The second reason for the emergence of the Energy Union initiative is to drive diversification projects and strengthen the cohesion of the internal energy market. The third priority is to establish a well-functioning European energy market to facilitate trade, enable competition, and drive costs down for consumers.

The development of the Energy Union should be observed, though, as pre-determined by the chosen pathways of the different Member-States leading to very different responses to the collective action aspiration of centralized institutional bodies such as the European Commission. Despite the ambitious plan to create an Energy Union, the attitudes and interests of Member States differ when it comes to supply, use and transformation of energy sources. The discrepancies in the energy policies of EU members

have already hampered the adoption of a long-term approach to energy policy to ensure security, affordability and sustainability of the energy supply for Europe’s citizens and businesses.

Turkey is no exception to this paradigm. Turkey is at a pivotal point in its economic development. As with other industrializing economies, Turkey is experiencing rising energy consumption wedded to supply challenges. However, Turkey, with the development of proactive policies, is able to change the current paradigm of industrial inefficiency (such as rising energy intensity rates) and promote economic competitiveness. To achieve this goal, Turkey needs to take advantage of its strategic geographic role as a potential hub for oil and gas.

The development of the Turkish energy policy in the framework of the completion of the Energy Union should not be seen though only in terms of natural

Table 1. Progress of the CEE EU member states on the EU energy liberalization reforms

	Bulgaria	Croatia	Czech Republic	Estonia	Greece	Hungary	Latvia	Lithuania	Poland	Romania	Slovakia	Turkey
Third Energy Package	Compliance Review	Transposed	Transposed	Transposed	Transposed	Transposed	Granted derogation from the Third Energy Package	Transposed	Compliance review	Not transposed completely	Transposed	Transposed
Organised Day-ahead Market	Further efforts required.	Further efforts required.	Coupling with Slovakia and Hungary	Member of the Nord Pool Exchange.	Further efforts required.	Coupling with the Czech and Slovak markets should be extended to other countries.	Active participation of Latvenergo to Nord Pool Spot market is necessary.	Baltpool operation is based on the Nord Pool Spot model.	In progress.	In progress.	Coupling with the Czech and Hungarian markets	Further efforts required on coupling with Bulgaria and Greece. Most contracts are still bilateral
National Balancing Market	Further efforts required.	Further efforts required.	Yes.	Yes.	Yes.	Yes.	Yes.	Yes	Yes.	Yes.	Yes.	Yes
Price Deregulation	No.	Further efforts required.	Yes.	Yes.	Yes.	Regulated prices were cut by 20% in 2013.	In progress.	Deregulated gas prices and regulated electricity prices.	Electricity prices for non-households are deregulated.	In progress. Electricity prices for non-households are deregulated	Regulated gas and electricity prices.	Wholesale prices are not regulated; partial regulation of retail markets
TSO Unbundling	Legally Unbundled	In progress	Legally unbundled	Legally unbundled	DESFA independence under review	Legally Unbundled	Legally unbundled.	Certification in progress.	Accomplished	In progress since 2000.	Legally unbundled.	Unbundled completed in electricity but not in Gas Markets
DSO Unbundling	Legally Unbundled	In progress.	Legally unbundled.	Legally unbundled.	Legally unbundled.	Further efforts required.	In progress.	Legally unbundled	In progress.	In progress	Legally unbundled	Unbundled
NRA Independence	Further efforts required	Further efforts required	Independent	Independent	Impaired by severe budget cuts.	Cannot set tariffs autonomously.	Independent	Independent	Further efforts required.	In Progress	In Progress	Dependent on the Executive

Source: DG Energy, Energy Community Progress Reports, CSD

gas geopolitics. A key prerequisite for the functioning of the energy markets in SEE and CEE is the integration of the Turkish energy system. While Turkey is already an active gas and power market participant, the country is still poorly interconnected with neighbouring EU member states and market coupling based on common capacity allocation mechanisms and price convergence are works in progress. Regulatory barriers prevent a deepening of the regional energy markets and its integration into the wider European energy system.

To improve the energy interconnections in the SEE, the European Commission has emphasized the importance of regional cooperation among independent national regulatory authorities. The independence of the energy regulator is crucial to guaranteeing the correct application of the market liberalisation in this field.<sup>4</sup> Turkey has a mixed track record in implementing the energy acquis including in the field of regulatory governance, but in some areas has been actually more advanced than the EU member-states in the CEE (see Table 1). In order for the country to be able to play a bigger role in the regional energy market though Turkey needs to reassure its neighbors that it is not only committed to liberalization but is actively implementing it. A particularly important milestone in such a strategy is the increase in international transparency and accountability of Turkey's energy market, and its regulator. This will build trust and will encourage further EU investments in Turkey's energy markets.

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<sup>4</sup> Directive 2009/72/EC - preamble 33.

## Regional Integration and Diversification

To foster regional market integration, Turkey should join regional policy initiatives in the framework of the Energy Union. These include the Central and South East Europe Gas Connectivity (CESEC) High Level Group bringing together 15 EU and Energy Community countries engaging in high-level discussions on improving the security of gas supply and diversification of sources. Turkey could play a critical role in this format as it has already become a natural transit country for alternative gas supply that would feed most of the regional interconnectors expanding and deepening the SEE gas market. The fact that the decisions of CESEC are not legally binding makes the energy cooperation preferred by Ankara unlike the Energy Community, which mandates strict implementation of the EU energy acquis. Members of the CESEC Group have suggested a voluntary opt-in mechanism in various energy issues that can be used by Turkey as an entry point to the regional discussions.

In general, there should be a stronger focus on multilateral energy cooperation in both gas and power markets in SEE (which are also very much interrelated in the Turkish energy context). Currently, the countries in SEE prefer to work on bilateral basis with their neighbors instead of fully opening the market to cross-border gas and power flows. The fragmented approach to improving the security of supply has left the region exposed to future disruptions and Russian intimidation amid continuing turmoil in eastern Ukraine.<sup>5</sup> The domination of bilateral energy deals instead of a

<sup>5</sup> CSD Policy Brief No. 47: EU and NATO's role in tackling energy security and state capture risks in Europe.

common vision for SEE energy markets has also diminished the ability of the Energy Union initiative to push through crucial liberalization reforms and new supply security infrastructure.

The influential presence of Russian economic interests in the region has further complicated cooperation. Russia has successfully conducted a 'divide-and-rule' energy policy in SEE. Turkey could and should play the role of a counterweight driving forward regional market creation through diversification projects (such as the completion of the Turkey-Bulgaria interconnector) and the implementation of energy liberalization reforms.

More specifically in the natural gas sector, regional market integration would not only depend on making new diversification options possible. It also depends on the creation of a new regulatory framework that encourages competitive entrants through the promotion of a gas volume release program through public auctions instead of a contract release method, which would increase the Turkish market's liquidity and spot trading levels. The natural gas volume release program will encourage diversity of supply sources fostering the security of supply, especially in winter times. It will also forge a more dynamic gas supply and demand equilibrium than the monopolistic structure established by the state-owned company, BOTAS. Releasing gas volumes on auctions would also stimulate global and European capital investment and also the transfer of financial risk to the private sector diminishing the burden on the budget already under significant strain.

In addition, expanding domestic LNG and storage capacity would prepare the country for the upcoming new LNG capacity on global markets that is likely to drive spot prices down increasing the attractiveness of

Mediterranean and CEE markets. Currently, Turkey has only two LNG regasification terminals: the Marmara Ereğlisi and Aliaga with combined annual import capacity of around 14 bcm. These are largely underutilised especially outside the winter season due to not only the high spot prices compared to the long-term contracts, but also because of the contractual rigidity and limited spot trading options.

In order for Turkey to build a vibrant and active gas trading hub, it must focus on four main factors as the core structure of the hub: depth, breadth, immediacy and resilience.<sup>6</sup> Depth requires large liquidity that prevents severe price fluctuations at a virtual trading exchange; breadth refers to the inclusion of a large number of diverse market players trading spot, forward and futures contracts; immediacy requires the elimination of contractual congestion and a vibrant spot trading; and finally resilience relates to the ability of the hub to absorb external shocks including supply cuts that can be easily replaced by LNG, storage capacity or an alternative pipeline routes. To establish such a virtual trading point that could easily become a reference to the whole SEE region, Turkey would need to demonopolise the gas import and wholesale supply, increase storage capacity, optimize the use of LNG regasification facilities and launch a transparent electronic clearing system that would be open to all private market participants on equal terms. To prevent capacity bottlenecks, the transmission systems operator would have to ensure open access to capacity booking and efficient balancing mechanisms.

## Conclusion

Turkey with its natural role as a bridge between Asia and Europe will be instrumental for the

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<sup>6</sup> Ian Cronshaw, et al, *Development of competitive gas trading in continental Europe: how to achieve workable*

*competition in European gas markets?*, International Energy Agency, May 2008,46.

diversification of the regional and EU energy supply with alternative sources from the Caspian basin and the Middle East. For this to happen, though, there is an acute need for improved energy policy coordination between the EU and Turkey. Some success is already visible with the progress of the Southern Gas Corridor aiming to ship 10 billion cubic meters of Azeri natural gas by 2020. By taking part in the construction of the Trans-Anatolian Pipeline (TANAP), Turkey is a major contributor to the improvement of the region's energy security. However, as noted in subsequent Reports on its progress to EU accession Turkey is still lagging in the transposition of EU energy law and the implementation of the market liberalization reforms.

Turkey's energy security in times of rising demand can be ensured only through a meaningful restructuring of the energy market system, which lacks efficiency and is barring competition. Investment in energy infrastructure needs to be urgently scaled up to improve power and gas connectivity and to enable Turkey to fulfil its policy objective of becoming a transit country for oil and gas from the Caspian basin and the Middle East. Also, in attempt to decrease its dependence on foreign energy imports, Turkey needs to further develop its renewable energy market, which currently lacks enough investment and has been barred by an ineffective regulatory framework for economic incentives.

A new EU-Turkey energy initiative is necessary, which matches the EU's and Turkey's energy security demands. Such an initiative would require common diplomacy in order to unlock new energy supply sources in the Caspian Sea, the Mediterranean and the Middle East. It would also require a common political will to work for regional market integration by investing in cross-border energy infrastructure and the synchronization of the regulatory framework. More specifically, Turkish policy-makers need to follow-up with their commitment to fully liberalize the energy sector, improve the transparency in decision-making

and corporate governance, and increase the investment in regional energy links. On the latter issue, EU can provide both financial and political support using its dedicated infrastructure funds and drive forward a common energy strategy that focuses on diversification of resources and the narrowing of energy imbalances. The year 2017 would be critical in whether EU and Turkey would be able to take advantage of their mutual work on energy security so far or would lose initiative to Russia, locking SEE into a high-gas prices and low gas consumption energy scenarios.

## Policy Recommendations

Improving the energy security and the governance of the energy sector in Turkey in the context of better integration in the EU Energy Union entails, at a minimum, the implementation of the following actions:

- Enhancement of EU efforts to form an energy security policy based on close cooperation with its extra-EU key energy partners.
- Expansion of the regional natural gas and power interconnectors to facilitate the physical integration of Turkey in the European internal energy market leading to an increase in liquidity and competitiveness.
- Natural gas diversification away from pipeline trade, and development of LNG capacity on the Mediterranean coast to tap world markets and assist the development of a virtual natural gas hub.
- Improving the governance of the Turkish energy sector through the introduction of transparent regulation and management of the state-owned companies, as well as a consistent regulatory framework.
- Introduce prioritization and selection of large investments projects in the Turkish



decision-making process, based on clear and transparent procedures and fact-based analyses, synchronized with the EU priorities.

- Turkey can benefit from a strong push for renewable energy sources and implementation of energy efficiency and energy conservation policies.

The effect of energy efficiency improvements would help the Turkish government achieve three energy policy objectives at the same time, namely to reduce the macroeconomic effect of energy imports on the current account balance, improve the security of supply and raise the competitiveness of Turkish businesses.