

Regulation of the oil sector

The liberalisation in Turkey in oil and gas industry started in the year 1954 when the Petroleum Law is enacted. The Petroleum Law has the importance of being the first law, which provides the opportunity to foreign investors to render public services such as exploration and production, transporting and refining of oil and gas in Turkey under the concept of concession. All licensing issues and regulation of these activities is governed by the agency of the Ministry; that is by the representatives of the State.

The Natural Gas Marketing Law enacted in 2001 and the new bill named as the Petroleum Marketing Law separate the activities and leave the exploration and production of crude oil and natural gas in the scope of the Petroleum Law and all midstream and downstream activities are handed over to the scope of these laws (or Bills).

The basic difference between the Petroleum Law and these new Marketing Laws (or Bills) is the concept of regulating bodies. The hydrocarbons underground are owned by the state and state grants permission to private companies to perform exploration and production activities so, therefore, governed by the state bodies. The following activities, distribution/transmission, sale are all market activities and governed by an independent regulatory body rather than the state body.

While encouraging the investment and setting the rules and regulations under the concession concept for upstream activities and while encouraging the investments and regulating the market in each law for the midstream and

downstream activities, the relationship between the activities of the upstream, midstream and downstream should not be damaged for the benefit of the other and should be kept at a balance. It must be avoided to protect any player of one of the upstream, midstream and downstream activity's which may damage the other player of the other activity. The flow through vertical integration between these activities should not be hampered.

These three laws (Petroleum Law, Gas Marketing Law and Petroleum Marketing Law) interactive each other may create a conflict. Therefore, the legislator should be very careful not to damage the chain of the flow of one barrel of crude oil or one cubic meter of natural gas from the reservoir under the ground until consumed by the end user. These laws or as formulated in any other way should protect the vertical integration of the activities from upstream to downstream. Oil companies have evolved into energy companies all over the world and have stakes in exploration, production, refining, distribution and power generation.

While the petroleum companies in the world are becoming energy companies by vertical integration, it is not rational and acceptable to prevent the enlargement of petroleum exploration and production companies by imposing restrictions on vertical integration in Turkey. On one hand, the Competition Law prevents monopoly and unfair competition in Turkey but it is not acceptable to try to prevent monopoly and unfair competition by preventing vertical integration with this new legislation. Existing Competition Law is designed to avoid unfair competition and hamper the companies benefiting from dominant position.

When considering the Gas Marketing Law and Petroleum Marketing Law Bill together with the existing Petroleum Law either gas or crude oil exploration and production activities should be governed by the Petroleum Law and crude oil transportation, refining and distribution of petroleum products under the petroleum market Law and natural gas importation, transmission and distribution under the gas market law; will all be considered as market activity.

Let’s ask a question to ourselves that why its unquestioned enormous offshore exploration potential and remaining onshore potential, is not being realised? The great optimism in Turkey when the Raman oilfield was discovered in 1947 has now changed to pessimism as exploration and production in Turkey is at an all time low, with no signs of improvement and oil production is at its lowest since the early 1960’s.

Today Turkey is at the bottom of a cycle of exploration activity and production and it is essential that the new Petroleum Law, to be enacted in the coming months, provides additional encouragement and removes or alleviates the identified difficulties in the existing law to stimulate oil exploration interest, foreign investment and the resulting increase in production.

After the enactment of the original Petroleum Law in 1954 discoveries by Shell, Mobil and TPAO resulted in oil production increasing to around 70,000 BOPD by 1970. Exploration activities declined through the 1970’s due mainly to the oil price being capped, a result of the general revision to the Petroleum Law enacted in 1973. Through the 1970’s the increasing

world oil prices resulted in a widening gap between that and the capped Turkey oil market price. Exploration interest in Turkey inevitably declined under these very unfavourable conditions.

The 1983 revision to the Petroleum Law, intended to renew interest in Turkey, removed the pricing cap and world oil prices were then used as the market price. At the same time as the revised Petroleum Law, Decree 20 was enacted in an effort to encourage existing producers to continue exploration activity as an alternative to a windfall tax on increased profits resulting from the removed price cap. The 1983 revision to the Petroleum Law resulted in a surge of exploration and many new companies entered Turkey. The renewed interest in exploration and major new discoveries resulted in an increase in daily oil production through the 1980's peaking at around 90,000 BOPD in 1992.

The increase in exploration interest that occurred through the 1980's and early 1990's provided sufficient exploration business to support many service companies to have a permanent base operating in Turkey. However, with the declining exploration activities, most of these companies no longer have a presence in Turkey. Availability of oilfield service and support companies is a crucial factor to achieve cost effective exploration conditions.

Foreign oil companies' interest in Turkey once again started to decline during the early 1990's due to many factors but primarily the attraction of the enormous potential of the former Soviet Turkic Republics. Interest in Turkey declined as in addition to the geological and geophysical complexity

of finding oil and/or gas security became a major issue as oil operations became the target of the PKK.

The only two oil majors producing in Turkey who had successfully operated here since the birth of the oil industry, both sold their operations to independents in 1996 which further accelerated the overall decline of the oil sector.

From 1996 many service companies with long standing ties to Turkey either reduced or closed their operations in Turkey. The costs associated with exploration in Turkey increased as competition in the service sector disappeared.

Effective January 1, 1996 Turkey joined the EEC Customs Union, as a result a 10% customs duty on the gross oil market price, previously paid to oil companies, was cancelled. This one measure significantly reduced the revenues of production companies operating in Turkey.

Arguments about the legality and continuance of the CABD system which had then been in force and functional for almost 40 years plus smaller but important difficulties and serious financial losses by the major producers relating to the disposal of used and scrap materials imported under the CABD system to MKEK, combined to create an environment of uncertainty and an impression that investment in the oil sector was not considered to be important by the then government.

Recovery of exploration investments through the CABD system ceased in 1997 when government auditors questioned the legality of Article 116 of the Petroleum Law and this issue has since been argued within the legal system. Since 1997 no recovery of registered exploration expenditures has been allowed which has inevitably lead to exploration companies operating in Turkey significantly reducing their exploration budgets. The continuing legal arguments relating to this issue are being watched closely by many other potential investors in Turkey, petroleum or otherwise, and the implications of the final outcome of the case will be enormously important for Turkey. If the interpretation of a law, that a High Appeal Court has ruled is beyond interpretation and that has been in force for more than 40 years, can be retroactively changed, then confidence in any investment, in any sector in Turkey, will regrettably be considered to be extremely high risk. Due to the generous provisions of Article 116 there are other restrictions placed on oil companies to prevent unfair gains for example, restrictions of gaining bank interest on revenues. Oil companies now face the worst possible scenario of not having the benefit of recovery of investments at historical exchange rates but still having the associated restrictions placed upon them. Oil companies accept the cancellation of historical exchange rate recovery of CABD but the past rights of investors must be protected.

The combination of these negative factors that occurred during the 1990's did not create a climate for serious investment in exploration in Turkey. There were better emerging exploration areas in the world with similar potential and more favourable and stable fiscal regimes. Currently in Turkey it is impossible to build a realistic economic model for the recovery of exploration investments due to the uncertainty relating to the existing laws.

Clearly this situation does not encourage high-risk investment in exploration.

More oil exploration companies have now left Turkey, which will undoubtedly result in 2003 recording the lowest number of, registered petroleum rightholders, the lowest number of exploration wells drilled and the lowest exploration expenditures for many years. All this has occurred at a time when oil production in Turkey is at an all time low.

The proposed new Petroleum Law provides Turkey with a unique opportunity to now attract deep-water investors and unlock the enormous potential.

Profit from all commercial sectors, except oil, can be immediately repatriated after the annual tax return is filed and taxes paid without the requirement for government inspection. However, oil companies must have their application to repatriate profits audited and approved by PIGM and Ministry of Finance. This delay further increases exchange rate losses and is fully dependent on when government audits can be arranged. Import taxes, stamp tax on contracts, withholding tax on production operation services all combine to unnecessarily burden oil operations.

Experience since 1954 clearly shows that when legislative conditions are correct oil exploration companies will invest in Turkey and there is a corresponding rise in production but equally when conditions are wrong the companies will focus their interests elsewhere. Provided that the revisions

to the Petroleum Law embrace the necessary encouragement then investment will increase resulting in increased domestic production

It is important to note that new legislation proposes to remove the existing formula for calculating oil market price in an effort to create a free market is a major concern to all producers. This step will result in lower market prices and endanger marginal domestic production. This is a very important issue and whilst the producers understand that refineries can purchase crude perhaps more suited to their refineries at prices lower than Turkish domestic production the strategic and economic benefits of domestic production must not be ignored. Under the existing Petroleum Law there are restrictions on how much production can be exported. These restrictions should now be removed to allow producers to have full access to world markets.

The Turkish oil sector has been a major investor and continues to be a very significant contributor to the Turkish government through the payment of taxes. The oil sector has always received the full support of PIGM and the Turkish Government and their continued support at this time to resolve the key issues that now face the sector will result in both increased investment in exploration and more importantly increased domestic production.

Oil companies worldwide are now increasing their exploration budgets again and searching for new areas of interest. This provides a unique opportunity for Turkey to recover its former position as a country worthy of exploration investment. If the new Petroleum Law can provide the confidence and encouragement to attract new oil companies to Turkey then these same

terms, in the shorter term, will encourage existing petroleum rightholders in Turkey to increase their exploration activities.

Thank you for your patience.

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