Argus Insight: Coal

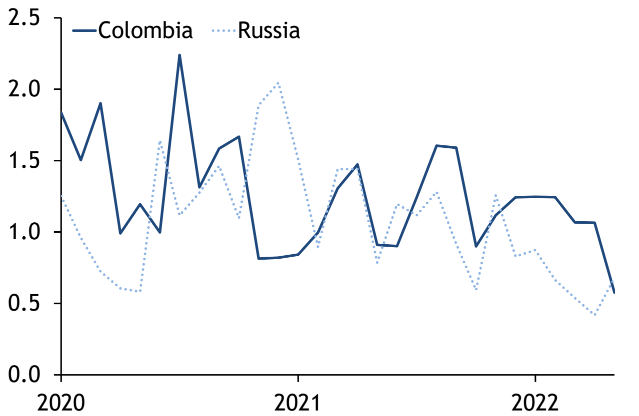
Turkish power sector's Russian coal trade after EU sanctions

The rapid improvement in the Turkey-Russia relationship since Turkey's downing of a Russian warplane in 2015 is hardly an exceptional period in the two countries' chequered history. Their relationship has been volatile over the past century with both nations adjusting their stances against one another in line with their interests.

The severity of the conflict between the EU and Russia suggests the relationship between the two nations is set to be tested once again as tensions triggered by the European energy crisis might prompt Turkey, a member of the North Atlantic treaty organization (Nato), to choose a side in the Ukraine-Russia conflict in the Black Sea.

Turkey is heavily dependent on gas and coal imports from Russia for power generation, as the country have insignificant production capabilities of both commodities compared with its consumption. Meanwhile, the EU's is Turkey's biggest trade partner, underlining the delicate balance in Turkey's relationship with Russia, the EU and its Nato allies.

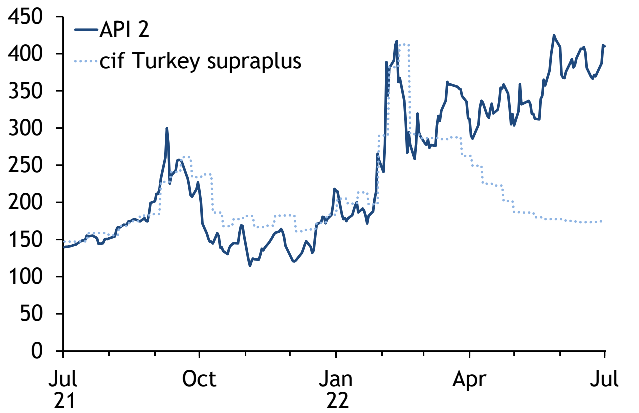
Turkey thermal coal imports Colombia vs Russia *mn t*



Trade flows after 10 August

The EU's sanctions do not have any direct implications for Turkish buyers as Turkey is not an EU-member state and does not have unrestricted access to the EU's single market. This means Turkish buyers have optionality to source Russian coal at steep discounts against the API 2 index, while prices for non-Russian coals offered to European buyers, including from Australia, Colombia, South Africa and the US, have risen to record highs amid European buyers' efforts to diversify away from Russian product. Please see chart 2 below.

API 2 vs cif Turkey coal prices *$/t*



Turkish customs data shows the divergence between the cost of Colombian and Russian coal, with the average cost per tonne for Russian coal averaging $208/t in May, compared with $260/t for Colombian supply. *Argus*' cif Turkey supra plus assessment, which is mainly representative of Russian-origin coal under current market conditions, averaged $217/t during the same period. The Colombian cost of $260/t is lower than the *Argus*-McCloskey May index of $324.18/t, likely a result of some Turkish buyers agreeing term contracts at fixed prices well in advance of shipment.

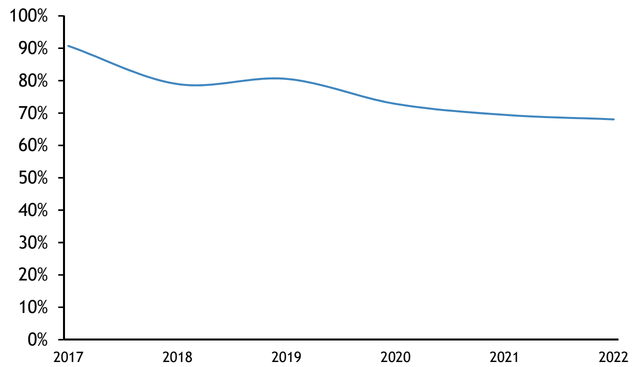
The current divergence between Russian and non-Russian origin coal prices provides Turkish coal-fired utilities an opportunity to reduce their generation costs. This would also help the country to keep power prices under control, a mandate shared by most governments around the world amid the energy crisis.

But Turkish utilities typically source coal via annual term deals indexed against API 2, suggesting switching to Russian coal is not a straightforward task for most utilities.

Sourcing cheaper Russian coal is only an option for utilities which still need to source spot cargoes from the seaborne market this year, otherwise they would need to cancel some of the volumes from their existing term deals for Colombian supply.

Most term cargoes include destination restriction clauses, meaning they need their suppliers' consent to cancel or divert their cargoes. Colombian suppliers were heard asking for unreasonable penalties to cancel their contracts, which is expected to weigh on utilities appetite to displace Colombian cargoes with Russian supply for this year. This suggests that utilities who are willing to eliminate Colombian coal from their import mix are more likely to do so in 2023, after their existing term-contracts expire. Chart 3 below shows Colombian coal's estimated share of Turkish power sector's coal imports.

Colombian coal share of Turkey power sector imports %



In the meantime, Russian sellers are aggressively targeting the Turkish market by offering cargoes at significant discounts against the API 2 index for both term and spot shipment. But a sector-wide switch towards Russian coal seems unlikely unless the EU and Turkish governments clarify their position against Turkey's trading of discounted Russian supply.

In theory, the Turkish power sector's switch to Russian coal should narrow the discount between Russian and non-Russian origin coal in the seaborne thermal market, as it would drive the price for Russian supply higher and soften the sentiment in the Atlantic basin by increasing availability from Colombia.

The Turkish power sector has the capacity to consume around 25mn t of thermal coal annually, and historical data from the customs suggests a complete withdrawal of Turkish demand could free up around 15mn t of Colombian coal, which should ease tightness in Atlantic supply and help EU-based coal plants to reduce their generation costs.

But not all Turkish utilities are expected to displace Colombian coal with Russian product in their fuel mixes, as further sanctions on Russia would be disruptive for their operations. This could more than offset the cost advantage that utilities would look to achieve by sourcing cheaper coal.

It also remains to be seen how the EU will react to a significant increase in Turkey's Russian coal imports. The bloc might try to exert pressure on Turkey to limit its intake of Russian coal as Turkey presenting itself as an alternative market for Russian coal would diminish the impact of sanctions against Russia.

Utilities with no interest in Russian supply

Russian coal's discount against other origins itself might not be enough to prompt some utilities which have EU-based shareholders to switch to Russian supply. Those utilities have so far refrained from sourcing Russian coal since the beginning of the conflict.

Moreover, Turkish utilities are shielded by a power market mechanism which protects them against sharp increases in the API 2 index.

Turkish energy regulator EDPK's new power price scheme, which was instated in March, offers monthly rebate payments to the utilities calculated by a formula which is partly indexed against the API 2. The mechanism should ensure that imported-coal plants will continue operating with positive margins even if prices in the power market fall below the costs of coal-fired generation. This could discourage utilities from taking excessive risks with Russian coal to reduce their costs in the short term.

But the scheme was instated as a temporary measure and the fact that there is no official deadline might also prompt some buyers to reduce their costs while the window for Russian trade is open.

Another key factor weighing on demand for Russian supply is the banking and insurance aspect of this trade.

Since there is no formal future guidance on whether buyers are expected to refrain from sourcing Russian coal cargoes, banks are applying their own internal policies on Russian coal trade, with some banks reportedly denying requests to facilitate payments for Russian coal amid fears of running foul of their US and EU-based counterparties.

Some Russian coal suppliers and traders have shifted their operations to the United Arab Emirates in efforts to have unrestricted access to their alternative markets should they face tougher financial sanctions.

But historically sellers demand payments in dollars which means most of these transactions will remain in the Swift international payment system. This suggests these payments will remain under the oversight of EU and US regulatory bodies unless the trade is carried out in alternative currencies.

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