

## Turkish Competition Authority Considers Key Factors to Achieve a Competitive Electricity Market

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Turkish electricity markets has gone through a series of reforms since 2001 when the Electricity Market Law numbered 4628 was enacted. These reforms have generally meant a shift to a liberalized market structure by securing adequate, uninterrupted, efficient and environment-friendly electricity supply, in a more competitive environment. Since then, a process of privatizing electricity facilities has occurred to reduce concentration levels and government involvement. Several regulations have been amended to meet and support the new market structure's needs. The main changes to the market structure were introduced by the Electricity Market Law numbered 6446, which entered into force on 30 March 2013 (**the "EML"**). The EML superseded and revoked Electricity Market Law numbered 4628.

The changes in the legal and structural landscape described above require supervision to ensure a well-functioning competitive energy market in Turkey. In this regard, the Turkish Competition Authority (**the "Authority"**) plays an important role. In executing this role, the Authority undertook an in-depth analysis of the wholesale and retail electricity markets. The Authority recently published its report (**the "Report"**) for the purpose of guiding market players and regulators to establish a competitive market structure. The Authority's aim was to identify elements which may have an adverse effect on the industry's competitive structure during the liberalization and privatization process. The Report concentrates on four main topics, as summarized below. We include our insight on the issues elaborated under each topic.

### (i) General assessment and considerations regarding the liberalisation process

The Report discusses practical aspects of the market which were problematic due to adoption of several new regulations and public policies during the liberalisation process of the electricity market since 2001. It also discusses the significance of the Authority's evaluations and establishment of "workable competition". The main items discussed can be summarized as follows:

**Importance of 2018-2019:** Most of the purchase contracts executed within the scope of build-operate and build-operate-transfer projects in relation to power facilities will expire during this period. The final consumer tariffs determined by the Electricity Market Regulatory Authority ("**EMRA**") are in line with purchase obligations in these projects. Expiry of these purchase guarantees and completion of privatization for generation activities (which are aimed to be finalized by 2019) will lead to a more competitive market because the final consumer tariffs will be abolished.

### **Wholesale market actions should be consistent with retail market regulations to prevent**

**competition-related problems:** Another issue noted by the Authority relates to the final consumer tariffs, which are applied to non-eligible consumers and to eligible consumers, who choose to remain with the default retail sale company in their region. Final consumer tariffs are determined by the EMRA, taking into account the retail sale tariffs which are proposed by the default supply companies and approved by the EMRA. The EML states that final consumer tariffs should include the profit margin of the default suppliers.

As a result, final consumer tariffs are determined based on the prices which default supply companies purchase electricity from the wholesale market at, which are then reflected onto their consumers to include a profit margin. The Report notes this as potentially problematic. The Report says that steps taken to liberalise the wholesale and retail sale markets should be consistent with each other. It also points out that the lack of harmony in previous regulations led to problems in the privatization process for distribution systems.

### **Despite the eligible consumer threshold has been gradually decreasing, the number of consumers switching suppliers remains low:**

After the privatization process, the right to distribute and to undertake retail sale of electricity to end consumers belonged to the state-owned distribution company which existed in each region. As a result of the "legal unbundling" procedure, distribution companies were required to separate their distribution and retail sale activities from 1 January 2013. Therefore, distribution and retail sale activities are now required to be undertaken by separate legal entities.

With the EML, separate licences for wholesale sale and retail sale activities (which existed under the former system) have been abolished. These two licences have been combined into a single supply licence. Holders of a supply license are allowed to operate and sell electricity to eligible consumers (who exceed the EMRA's electricity consumption threshold) without being subject to zone restrictions. Nevertheless, retail sale to non-eligible consumers is still exclusively carried out by the retail sale companies incorporated as a result of legal unbundling.

The retail sale companies incorporated as a result of the "legal unbundling" have an established customer portfolio in their respective regions, due to their already established position in the market. Therefore, a very high number of consumers continue to purchase electricity from these companies, despite the customer qualifying as an eligible consumer and being able to purchase electricity from other companies. As a result, it could be argued that "legal unbundling" has not yet been achieved completely in practice. This is particularly so considering the default supply companies continue to operate in practice under the supervision of the distribution companies which they were legally separated from. This issue is also raised by the Authority within the scope of the Report.

In January 2015, the threshold for being an eligible consumer was reduced from 4.500 kWh to 4.000 kWh. The EMRA's ultimate aim is to reduce the threshold to zero. However, the timeframe for this is not yet set out. If the consumer exceeds this threshold, he or she becomes eligible to select an electricity supplier without being subject to zone restrictions.

The Report also provides statistics showing that after the legal unbundling of distribution and retail activities, almost all consumers who became eligible to purchase electricity from other supply companies, continued to purchase electricity from the default suppliers in their area. The Report concludes that the theoretical liberalization efforts were not enough to achieve actual liberalization. Therefore, further actions should be adopted to achieve a truly liberalized market structure; which may include (i) introducing strict rules on information sharing between distribution companies and retail companies unbundled from them, (ii)

separation of financial resources, (iii) separation of management.

**Establishment of a liquid wholesale market should become a primary target:** The Report states that once actions which lead to liberalization of the retail supply market are complete (such as decreasing the eligible consumer threshold and completing distribution system privatizations), the establishment of a liquid wholesale market should be a primary goal.

## (ii) Competition in wholesale markets

The Report emphasizes the importance of establishing a competitive environment at the wholesale market level. The wholesale market is comprised of generation companies and supply companies. Establishing a competitive wholesale market is deemed crucial to being able to protect consumers' best interests. This is because electricity suppliers which sell electricity to consumers initially purchase the electricity from the wholesale market. Thus, prices at the wholesale supply level are directly reflected onto consumers at the retail supply level.

The Report also notes that with the liberalization of the market, the risks which consumers and market players face have increased and diversified, making risk management more difficult. The Report addresses each aspect separately.

**Market power:** The Report notes the importance of determining potential problems in relation to market power, particularly during attempts to decrease the role of public authorities as the market player.

Dominant positions are more easily abused in the electricity market than in other markets. This is mainly due to the fact that supply security is highly important and entry barriers are high. Therefore, the market share restrictions referred to above are seen as necessary precautions against market power problems arising during the post-privatization phase.

The Report notes "capacity withholding" as a possible way for market players to abuse their market power. This practice involves electricity generators physically or economically withholding their electrical capacity in order to manipulate price levels, or execute direct price escalation strategies.

The methods to evaluate capacity withholding or market power in electricity markets may be different to those used in other markets. In other markets, definitions for "relevant product market" and "relevant geographical market" are used. The Report notes that due to the electricity market's structure, "temporal market definitions" can be used to evaluate market power.

The current transmission system infrastructure was originally designed for a vertically integrated market configuration, during the public ownership era. The Report notes that the transmission configuration poses possible problems. It notes the current transmission system could prove to be insufficient to meet the new market mechanism's needs, in turn leading to market power problems at a regional level. The Report notes this as a possibility particularly after generation systems have been fully privatized, noting that prior to generation privatizations, state-owned generation companies usually chose to protect the system security over their own profit; which is not expected in a free market structure. In this manner, transmission system constraints should

be eliminated by infrastructure works should be adopted, along with mechanisms that would eliminate market power problems.

**Vertical integration and relationships:** The Report evaluates possible positive and negative effects of the tendency towards vertical integration when establishing a liquid wholesale market structure.

A "liquid market" is defined as a market structure which enables fast and easy sales and purchases, and enables sale of products in a high volume without significantly impacting the market price of those products. The Report emphasizes the significance of establishing a liquid bilateral agreement market for achieving price signals and efficient risk management. It notes that a market structure with low liquidity poses an entry barrier to electricity generators and suppliers.

The Report notes the supplementary role of a competitive retail sale market in the establishing a workable competitive wholesale market. However, it notes that an "extreme" competitive environment in the retail market could be considered a risk because it would eventually cause the market players to focus on short term targets, thus damaging establishment of an active bilateral agreement market.

**Market monitoring:** The Report emphasizes the key role of a "market monitoring unit", positioned as an independent structure. It suggests a market monitoring unit which would determine and eliminate potential risks, as well as take the necessary actions to amend the legal infrastructure to meet the dynamic structure of electricity markets. The Report states that with the establishment of Energy Markets Operation Joint Stock Company ("**EPIAŞ**"), a new era for the wholesale markets will begin in Turkey. Operation of wholesale electricity markets, including financial conciliation activities for these markets, will be carried out by EPIAŞ under a "market operation license" which must be obtained from the EMRA

It goes on to say that an independent market monitoring unit would be of great significance during the transition period and to ensure establishment of a competitive market. The market monitoring unit would be expected to evaluate and test applicable market rules in order to determine the reasons for price changes and pre-emptively detect problems in the market. The Report considers market monitoring activities to have three steps:

1. Collecting data
2. Analysis of the data in a meaningful manner,
3. Reporting the findings in order to increase market efficiency.

Although these activities are currently carried out by EMRA within the scope of its monitoring authority, the Report considers the prospective monitoring unit to be more of a separate entity which only observes the market activities, without the authority to issue punishments.

**Transparency:** The Report emphasizes the importance of a transparent environment which provides all market players with the same conditions in accessing information about supply, demand, and grid conditions. The Report states that an efficient transparency regime should be accommodated by establishing a central platform which would be used to publish electricity market related information collectively. The platform would also publish other suggestions to increase market transparency. It would also play a significant role in

market monitoring activities.

**Participation of demand side:** The Report emphasizes that establishing markets which allow consumers to quickly react to price changes is crucial to support the right granted to the consumers to select their suppliers. Therefore, the necessary legal and technological structures to enable participation by demand side should be developed. Further, new market entries should be encouraged to ensure the success of the liberalization process. The Authority sets out three conditions to enable participation of interested parties:

1. Dynamic pricing,
2. Digital technology and measurement infrastructure at the final consumer level,
3. A market structure which empowers consumers and new market players.

### (iii) Competition in the retail market

The Report explains that the ultimate goal for the Turkish electricity retail markets is establishment of a competitive environment, where all consumers are eligible to choose their electricity suppliers, without being subject to consumption thresholds. The Report addresses two aspects in particular which it views as integral to establishing a competitive environment.

**Competition in established companies and retail supply levels:** The Report specifically considers transition costs, competitive advantages for established companies (which are suppliers unbundled from the distribution companies), and the problems consumers experience when changing electricity providers.

The Report discusses possible measures to ensure that "legal unbundling" of retail and distribution activities is not only limited to separation of the legal entities, but rather actually applies in practice. Since privatization, "eligible consumers" have been entitled to purchase electricity from other retail supply companies (or generation companies) besides their default retail suppliers. However, the Report notes an important obstacle to competition has been the advantages which established companies have inherited as a result of their previous vertical integration in the distribution and retail markets.

In reality, the number of eligible consumers who have actually chosen to change their electricity retail supply companies has been low. The Report concludes that many advantages arise from being established in the market prior to the privatizations and legal unbundling. It goes on to explain that these advantages give the default electricity suppliers a major advantage. Since the market structure is not used to competition and consumer awareness is low, even "eligible consumers" who have the right to switch companies do not exercise this right.

The Report discusses key things which are necessary to establish legal unbundling in practice. These include separation of organisational structures, independence of company management, as well as separation of human resources and financial resources. It also notes possible regulatory changes in relation to transparency and information exchange.

The Report discusses possible solutions and initiatives which could increase consumer awareness. It deems the most important points in this respect to be facilitating methods for changing

electricity suppliers (for eligible consumers) and informing consumers of their right to change their supply company.

**Pricing at the retail supply level:** The Report discusses application of the final consumer tariffs. It concludes that even though these tariffs are a necessity for consumer protection in an imperfect competitive market, such tariffs would eventually damage formation of a competitive market. Thus, such tariffs should be abolished within future roadmaps. It suggests a tariff system should only exist in a limited manner for emergencies and accidents.

The Report discusses the effect the build-operate and build-operate-transfer projects expiring will have on pricing in retail supply. Since the purchase guarantees contained in these agreements are directly reflected to the final consumer tariffs, the final consumer tariffs must remain in place until the expiry of these agreements. Alongside this, completion of the generation facility privatizations and establishing a liquid wholesale market are noted as the main steps necessary to allow the final consumer tariffs to be abolished.

## (iv) Organizational structure of the government in liberalisation process

The Report states that practices in the electricity market which might pose as restrictions to competition should be proactively evaluated by both the EMRA and the Competition Authority. It states that precautions and sector regulations should be adopted to address individual problems in the sector. In particular, irregularities in applications made by transmission and distribution companies should be addressed before such applications reach a point that a competition investigation is inevitable. Lastly, the Report proposes a co-operation and information exchange mechanism between the EMRA and the Competition Authority.

## Conclusion

Following the drastic changes made in the Turkish electricity market to liberalize the structure and minimize the role of government institutions, competition-related issues are likely to arise in the near future. The Competition Authority's Report mainly concentrates on the issues that could become significant problems after the completion of privatizations in the sector.

The Report is important as it sheds light on possible solutions that might be implemented before the market is forced to come face-to-face with a thorough competition investigation. The EMRA plays a vital role in realizing these suggestions. If regulations are not structured to meet the market needs, major problems could result from the completely new privatized market structure, involvement of the EPIAŞ, and the planned abolishment of the regulated final consumer tariffs.

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