

EXECUTIVE SUMMARY

The liberalization process, which picked up speed in 2001 with the entry into force of the Electricity Market Law no 4628 with an aim to establish a competitive electricity market, has moved to another stage with the Electricity Market Law no 6446 that was put into force in 2013. During this process, the Competition Authority has carried out its duties and responsibilities both with the examinations conducted and decisions taken under the prohibitive provisions of the Act no 4054 on the Protection of Competition, and with the decisions rendered on the relevant legislation under the scope of competition advocacy. The "Electricity Wholesale Market and Retail Market Sector Inquiry" report was prepared within the framework of competition advocacy, and it is comprised of four chapters addressing the following subjects:

- *assessment of the liberalization process,*
- *competitive structure of the wholesale market,*
- *competitive structure of the retail market, and*
- *institutional structure during the liberalization process.*

CHAPTER 1 - GENERAL OVERVIEW OF THE LIBERALIZATION PROCESS OF ELECTRICITY MARKETS

The first chapter of the sector inquiry on the electricity wholesale and retail markets makes a general assessment of the points that require consideration in the liberalization process of the electricity markets, following which it addresses the development and current status of Turkish electricity markets, laying out the subjects important for the establishment of competitive wholesale and retail markets. This chapter of the report is prepared from the perspective of setting up a "*workable competition*" environment, and it contains observations and assessments on the liberalization process which accelerated after 2001. Within this framework, the following points are emphasized:

- It is important that liberalization is viewed as a process that is continually monitored and evaluated, and if necessary, revised.
- Purchase contracts related to Build-Operate (BO) and Build-Operate-Transfer (BOT) projects, which constitute "stranded costs" in the process of switching to a more competitive structure for both electricity and natural gas markets, have a decisive role; the period of 2018-2019 when the majority of these agreements will expire becomes important for forward-looking competition policy assessments.
- Following the steps taken towards the liberalization of the retail market through the distribution privatizations and the reduction of the eligible consumer limit, the entry into force of the Law no 6446 has made the goal of establishing a liquid wholesale market a main subject for the next period.
- Up to the present, it is observed that the simultaneous implementation of the privatization process, realized via distribution privatizations, and the liberalization

process, comprised of legal unbundling and the reduction of the eligible consumer limit, caused some problems in ensuring coordination in practice; based on this experience, it is necessary to ensure harmonization in the steps to be taken for the liberalization of the wholesale and retail markets going forward.

- In light of the significant place of natural gas in the electricity generation resources of the country, the liberalization processes of electricity and natural gas markets significantly affect each other; hence, it is important to formulate compatible policies in these two areas.
- Following the privatizations, the role of the public as a market player has decreased and its role as a regulator and supervisor has come to the forefront, which places key importance on designing the institutional structure to best serve that purpose.

CHAPTER 2 - COMPETITION AT THE WHOLESALE LEVEL

This chapter emphasizes the fact that, when creating a well-functioning wholesale market, in addition to the existence of many buyers and sellers in the market, it is important that no market participant have sufficient market power to determine or affect prices or other economic parameters; it also addresses the subjects of *market power*, *vertical integration and vertical relationships*, *market monitoring*, *transparency*, and *demand-side participation*, which are thought to gain importance in the liberalization process of the Turkish electricity market.

Market Power:

Assessments concerning *market power* remark that problems related to the exercise of market power emerge following the privatization in areas where competition is insufficiently established, despite the fact that they were not an issue in the past when the market structure was controlled by the public undertakings. Within this framework, in the post-privatization period where the role of the public as a market actor is reduced, it is important to identify potential market power issues before they emerge or become significant, and to increase the efficiency in implementing mechanisms which reduce market power.

Another point emphasized in the chapter on market power issues is related to market power problems that may arise as a result of transmission limitations. The transmission infrastructure was planned and constructed under public-ownership to serve the vertically integrated structure, thus, it may prove insufficient and lead to regional market power problems within the framework of the market mechanism that will become operational as a result of generation privatizations. Taking this risk into account, the chapter points out the importance of market monitoring and transparency as well as the requirement for taking the necessary steps to ensure that the Public Economic Enterprise status of TEİAŞ and the operations and investments it will conduct under the procurement legislation can meet the needs of the electricity market, which is expected to have a dynamical structure due to the liberalization process.

Market Monitoring:

The section discusses the concept of market monitoring, and, following the finalization of the generation privatizations, it emphasizes the importance of preventing any conduct by undertakings which may lead to market failure particularly in relation to the generation and wholesale activities before they lead to bigger problems. *Market monitoring* practices and experiences of the United States and the European Union are mentioned, and it is stated that both sector-specific regulations and competition law practices may be insufficient to establish a competitive and liquid wholesale market. Accordingly, the key element in identifying the potential risks beforehand and ensuring the modernization of the legal infrastructures of the relevant regulatory bodies in line with the dynamical structure of the electricity markets shall be the market monitoring division, which must be designed in an independent and neutral manner.

Transparency:

The switch, due to unbundling, from a market structure with vertically integrated undertakings and regulated prices to a market structure which involves undertakings in competition with each other at the generation, wholesale and retail levels makes the subject of transparency important. In the assessments, which were conducted in light of the EU *acquis*, on the level of transparency in the Turkish electricity markets, it is observed that an efficient transparency regime must be built where collected information is published on a central platform and some suggestions are given to increase the level of transparency.

Demand-Side Participation

This part also deals with demand participation, which involves enabling the consumer to respond to market conditions; the contribution of economic demand participation to creating links between the wholesale and retail markets and to ensuring efficiencies at both levels is emphasized. Economic demand participation allows consumers to respond to sudden price hikes in competitive markets, which leads to a considerable decrease in the number of such hikes, making it a useful tool to solve the market power problem in generation and wholesale activities. Therefore, for the success of the privatization process, beyond giving the consumers freedom in choosing suppliers, it is important to develop the necessary legal and technological infrastructure to ensure efficient demand participation, to create markets which will allow consumers to respond to electricity prices in the short term and to facilitate entry into these markets. Within this framework, in addition to smoothing the way for "demand collectors" and similar new market participants for decreasing transaction costs in particular and facilitating the emergence of new market structures, it is also important to increase consumer awareness.

Vertical Integration:

The last point addressed under the competition at the wholesale level heading is the subject of *vertical integration and vertical relationships*, which concern all wholesale and retail sale activities. This section specifically deals with the vertical integration of generation and supply, and assesses the potential positive and negative effects that may be caused by the vertical integration tendency during the establishment of a liquid wholesale market. It is stated that the issue of vertical integration level and increasing liquidity at the wholesale market requires a coherent practice in which sector-specific regulations as well as competition law applications support and complement each other; it is also mentioned that the emphasis should be on the goal of establishing a liquid wholesale market that would minimize the vertical integration tendency and the risks arising from vertical integration. Within this framework, in addition to sectoral regulations and interventions under the competition law, the section points out the importance of establishing a liquid reciprocal agreements market, which plays a significant role in the creation of price signals and in the facilitation of efficient risk management. The report also remarks that a competitive retail sales market has a complementary role in the process of creating a functioning competitive wholesale market, however an "excessive" competitive structure at the retail level caused by entries and exits with short durations may pose a risk of focusing the market on the short-term and damage the formation process of an efficient reciprocal agreements market.

CHAPTER 3 – COMPETITION AT THE RETAIL LEVEL

This section of the report addresses the points that should be taken into account to ensure the desired level of competition in the Turkish retail market, in light of the fact that both the Act no 4628 and the Act no 6446 have set their final goal as the creation of a competitive electricity retail market where all consumers can exercise their right to choose their suppliers.

EMRA's goal of reducing the eligible consumer limit each year until it is eliminated is important since this will theoretically allow more consumers to freely choose their suppliers; however, it is not possible to talk about workable competition the market if consumers are unable to buy electricity in a competitive market at reasonable terms.

Within this framework, significant issues with relation to the establishment of competition in the Turkish electricity retail market are assessed under the following headings: *incumbent companies and competition at the retail level* and *pricing at the retail level*.

Incumbent Companies and Competition at the Retail Level:

In consideration of the complaints received by the Authority on the conduct and practices of the incumbent distribution and supply companies, this section deals with switching costs (*transaction costs, searching costs, contract costs and psychological costs*), competitive advantages of incumbent companies, and the difficulties faced by consumers in the process of switching suppliers.

Within this framework, in order to make sure that the legal unbundling, which is among the most important stages of the liberalization process, is not simply limited to unbundling of legal

entities and implemented efficiently, the report lists the measures which should be included in the electricity markets legislation with relation to *the unbundling of the organizational structure and ensuring administrative independence, unbundling of human and financial resources, and transparency and exchange of information*. In addition to the aforementioned measures, it is also stated that conducting "*harmonization programs*," similar to the practices in the EU member states, with an aim to ensure efficient implementation of the legal unbundling, may be beneficial for monitoring the process.

The following sections of the report include solutions and suggestions which may be implemented within the framework of sector-specific regulations, particularly in relation to raising consumer awareness, strengthening consumers and facilitating supplier switching. The section titled "*Raising Consumer Awareness and Strengthening Consumers*" deals with supplying information on the rights of eligible consumers, reinforcing the perception that the distribution company is obligated to provide independent and equal services, giving information on alternative suppliers and prices, accessing consumption data, and increasing competitive culture and awareness. The section titled "*Facilitating Supplier Switching*," on the other hand, contains assessments on the nature and duration of the contracts, expedition of the process, package offers, prohibition of penalizing switching by consumers, and prevention of the difficulties caused by the distribution and supply companies.

Pricing at the Retail Level:

This section deals with tariff-dependent final consumer prices and includes conceptual discussions on final consumer pricing within the framework of default supplier and supplier of last resort, in light of sample country practices, Turkish practice and the opinions of the market actors. Based on these discussions, assessments are made concerning final consumer pricing during the liberalization process. The relevant assessments touch upon the following points:

- When the market is not yet mature, final consumer tariffs implemented within the scope of default supply are, on the one hand, necessary in order to protect the consumer against imperfect competition, but on the other hand they are also harmful in terms of the creation of a competitive market. Hence, these tariffs should be seen as a transition mechanism which must be abandoned in accordance with a specific course of action.
- Final consumer tariffs in Turkey are mostly set within the framework of purchase obligations originating from BO-BOT power plants and which will expire in the 2018-2019 period; ensuring a healthy competition environment in Turkey depends on the expiration of said purchase obligations, on the completion of the generation privatizations, and on the creation of a liquid wholesale market; all of the factors above must be taken into account when determining the course of action for abandoning final consumer tariffs.
- During the transition period which should last until a market structure with a sufficient number of market actors and, by extension, workable competition is created, existing price tariffs for final consumers, which may be seen as default supply, must be

abandoned starting with the larger consumers and they must be replaced with last resource tariffs as a permanent aspect of the market, in order to provide security of supply under emergent and temporary situations.

- Throughout the transition period when price regulation should continue, it would be better to determine certain points such as how often tariffs should be updated and which of the goals of "competing with the market," "protecting the consumer," or "encouraging the consumer to enter the market" should be implemented on an individual basis, *in accordance with different consumer groups*.
- Until the market reaches a sufficient level of competition and a sufficient number of alternative suppliers, the right of those consumers which switched to the free market to return to the tariffs should be under protection.

Chapter 4 - Institutional Structure during The Liberalization Process

The last chapter examines the differences in the duties, powers and approaches of the institutions which have a say in liberalization of the electricity market as well as in ensuring and protecting competition in that market. For subjects which are thought to fall into the jurisdiction of both the sector regulator EMRA and the Competition Authority, the issue of which institution(s) should conduct the examination and how is analyzed in light of previous practices and decisions.

Any conduct and practice in the electricity market which can potentially have a restrictive effect on competition may be examined by both institutions, however it was assessed that individual problems—chiefly, the practices of the transmission and distribution companies—should be eliminated through the swift and efficient application of the sector-specific regulations, before they require investigation under competition law. Within this framework, one of the issues emphasized concerning the supervision of distribution companies is the need for the removal of the uncertainty arising under the scope of the duties and responsibilities placed on the Ministry of Energy and Natural Resources and EMRA with relation to the supervision of these companies under the Act no 6446.

In light of all the observations listed above, the importance of inter-organizational cooperation has clearly increased even more for both procedural and substantive investigations to be conducted by EMRA and Competition Authority in relation to the cases encountered in the electricity markets; as a result, it is emphasized that there is a need to set up a mechanism of cooperation and information exchange between the two institutions.