

12 June 2006

Competition in Energy Markets

- **EC's Reaction and Key Views**

Eurelectric – Oslo Convention and Conference

12 – 13 June 2006

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Thank you and Eurelectric for the opportunity to participate in this forum and in the joint analysis of the current state of Europe's electricity industry.

Let me concentrate my remarks on the competition perspective of current developments in the electricity market—and for the general context I refer to the keynote speech, and to the other speakers on this panel.

As many here will know we have carried out an intensive inquiry into the sector under the European Commission's competition powers based on Article 17 of EU Regulation 1/2003. Preliminary results were published in February and open for comment for a two month period.

The Inquiry assesses the competition conditions on European gas and electricity markets and examines whether current indications of market malfunctioning result from breaches of competition law. The overall objective of the Inquiry is to address the barriers impeding the development of a fully functioning open and competitive EU-wide energy market by 1st July 2007. I should add that the EFTA Surveillance Authority is carrying out a parallel inquiry into the electricity sector of the EFTA states that is closely correlated with the EU-wide Inquiry.

The wider context has been set out in the Green Paper on a European Strategy for sustainable, competitive and secure energy that was published in March.

We have found

five main barriers to a fully functioning EU wide electricity market:

- (1) Persistent Market concentration
- (2) Vertical foreclosure that hinders competitors' market entry
- (3) Lack of market integration
- (4) Lack of transparency
- (5) Price formation mechanisms

For the Electricity Markets this means in more detail:

Market concentration:

Most wholesale markets remain national in scope, with high levels of concentration in generation, which gives scope for exercising market power. Analysis of trading in power exchanges shows that, in a number of them, generators have the scope to raise prices, a concern also expressed in the inquiry by many customers. Analysis of generation portfolios also shows that the main generators have the ability to withdraw capacities to raise prices.

Further assessment will be needed in order to determine whether operators have unduly used these possibilities to raise prices.

Vertical foreclosure:

Vertical integration of generation, supply and network activities has remained a dominant feature in many electricity markets. Vertical integration of generation and retail reduces the incentives to trade on wholesale markets. Low levels of liquidity are an endemic entry barrier. The strong links between supply and network companies reduce the economic incentives for the network operators to grant access to third parties.

Many respondents are highly critical of the efficiency of existing unbundling obligations and call for stricter measures, because they believe that discrimination in favor of affiliates continues.

Lack of EU-wide Market integration:

The low level of cross-border trade is insufficient to exert pressure on—dominant—generators in national markets. Integration is hampered by insufficient interconnector capacity and long-term capacity reservations, pre-dating the liberalisation in a number of markets. Improving access to interconnectors requires better methods of congestion management.

There is a persistent lack of adequate incentives to invest in additional capacity to eliminate long-established bottlenecks. Different market designs hamper market integration.

Transparency:

There is a serious lack of transparency in the electricity wholesale markets that is widely recognised by the sector, with notable exceptions such as the Nordic market and the UK market.

Improved transparency would minimise risks for market players and so reduce entry barriers to generation and supply markets, provide a level playing field, and improve trust in the wholesale markets and confidence in its price signals.

More than 80 percent of market participants are not content with the current levels of transparency. Users and competitors request more information on technical availability of interconnectors and transmission networks, on generation, on balancing and reserve power, and on load.

Price formation:

Price formation is complex, and many users have limited trust in the price formation mechanisms.

In summary,

- we continue to be faced with high levels of concentration in still effectively isolated national markets—with a few notable exceptions such as the Nordic market.
- We are faced with a vertically integrated supply chain, which leads to a chronic lack of liquidity in the wholesale market,
- We are suffering from the deficiencies which go in hand with such a market structure: lack of transparency and deficient price formation mechanisms.

As regards the latter, analysts cannot yet agree on the extent to which the EU emissions trading scheme has affected electricity prices but we will now carefully watch how far decreases in the carbon price are handed back to the users.

The current state of price formation mechanisms in a number of EU markets has led to a substantial burden on energy intensive users, such as examined by the EU High Level Group on Competitiveness, Energy, and the Environment that has published its first report. We will have to watch carefully that the current pressure on these user industries does not lead to anti-competitive arrangements that may seem to offer relief in the short term but that could heavily damage a sound development in the longer term.

Let me then turn to the future.

We will have to analyse further the substantial data accumulated during the Inquiry concerning a number of issues, such as the operation of the electricity spot markets and, more generally, the price setting mechanisms in the sector, before we publish the final report on the Inquiry by the end of the year. And we also intend to look in more detail at the retail level – the consumer market.

However, the application of competition law to anti-competitive practices in the sector must be immediate, wherever we find such practices. As set out in the February report, the focus of attention will be

- *Vertical foreclosure*: i.e. tying practices in downstream markets, and at other relevant levels of supply. The Inquiry has

confirmed that foreclosure of the market by long-term contracts is a priority under competition law.

- *Impediments to EU-wide market integration:* Access to interconnectors has been found to be a major stumbling block towards more market integration and should be another immediate priority for review in terms of anticompetitive conduct.
- *Any suspicion of market partitioning* that prevents the handing on of the advantages of a competitive market to the final users and consumers—a core infringement under competition law.

The inquiry has identified the high level of concentration

in many markets as a major problem and this makes the Community's action under the EU merger regulation all the more essential. While each merger case during the current wave of market restructuring will be assessed according to its specific characteristics, recent EU decisions in this area have indicated the line the Commission intends to take.

The Commission is favourable to restructuring to allow optimisation of market operations within the new EU-wide dimension opened by liberalisation—however only on condition that competition is maintained or enhanced. It will ask for the necessary structural and behavioral remedies wherever required to avoid market foreclosure.

Regulation and market structure

While competition law can offer relief, its action will become more effective, as the regulatory and structural environment is improved. As has been said, the Commission will review the implementation of the EU regulatory framework by the end of the year. We are seeing encouraging plans of regional integration of electricity markets by the CEER to make the current framework of Directives and guidelines (such as on congestion) work in practice—as a useful stepping stone to full EU-wide integration. These initiatives go substantially beyond the traditional fora of exchange of information, such as the Florence forum. I refer here to the remarks at this conference.

But as the Inquiry has shown we will need substantial progress at least on three essentials for moving the industry forward and bringing the advantages of competition to the final user:

- we need decisive progress on transparency of markets
- we need decisive progress on filling the transborder regulatory gap that has led in most parts of the Union to the continued isolation of national electricity markets
- and we need decisive progress on the basic structural question in Europe's electricity markets—insufficient unbundling of generation, transmission and distribution

Let me add a comment

on this basic structural issue in Europe's electricity market.

Insufficient unbundling is leading to a regulatory quagmire and is at the root of the endemic lack of incentives to develop the transborder interconnectors that we need to make the European electricity market more efficient, more diversified and therefore more secure.

The report by the broadly industry- and user-based High Level Group that I mentioned has emphasised this. It finds that “inadequate unbundling and a lack of regulatory certainty might provide insufficient motivation to increase available capacity and avoid cross-border congestion.”

It calls for “unambiguous unbundling” and states in its recommendations for taking the functioning of the electricity market forward rapidly that “coordination requires that TSOs are effectively separated from competitive electricity ... businesses.” It continues that “this needs to be achieved through strict application of the existing Directives and, if necessary, stronger measures.”

Let me end on a more general note

Taking the European electricity market forward will require – sometimes difficult—efforts from all sides. We have to end the isolation of national markets. Ending this isolation will open new avenues and a new dimension for the industry. It will deliver sustainable service at best prices to the industry’s customers. And it will help the sector to fulfill its fundamental role for society—the leitmotiv of this conference.