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Competition Policy and Energy Security

- Some comments

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Application of competition principles to the energy sector is often presented as being in contradiction with the objective of security of supply. I will argue¹ that the creation of a competitive environment for Europe's energy market is a fundamental requirement for enhancing Europe's energy security. I will

- explain in brief terms the basic relationship between energy security and a competitive environment
- comment on the situation that we find in the European Union
- clarify three common fallacies about the application of EU competition rules to the European energy sector.

Security of supply means risk management

Competition policy is applied within the framework provided by the EU's energy policy.

As the Strategic Energy Review² of 10 January 2007 has set out, our environment is characterised by:

- The EU's outside dependence in energy will grow from today to 2030 from 50% to 65% overall ("business as usual" scenario)

¹ An article based on this speech is published in a forthcoming special edition of European Review of Energy Markets devoted to Security of Energy Supply for Europe.

² Communication from the Commission - An Energy Policy for Europe, COM(2007) 1 final, 10.1.2007. Available at www.europa.eu

- For oil from 82% up to 93%
- For gas from 57% to 84%

Gas has become the Achilles heel of European energy security. One single outside company provides 25% of our gas imports – Gazprom. Dependence on Gazprom is substantially higher in the EU's Member States to the East (over 90% in a number of cases).

Security of supply is nowadays first of all read as

- Security of outside supplies.

However it means more. It means also

- Security of distribution within the EU

And

- Security in emergency situations

In electricity security of supply implies in addition to access to primary fuels - such as gas, coal, uranium - sufficient capacity for generation, transmission, and distribution; and functioning of emergency systems in case of unexpected events (blackouts);

In gas it means access to supply of gas short term and long term, diversification of supply regions, and diversification of transport

modes; access to LNG terminals, transmission pipelines and gas storage; and internal distribution.

Security of supply is therefore a highly complex issue. Security of supply is ultimately efficient management of a diverse number of risks. Efficient risk management means, however, diversification of risks.

A competitive market is the best proven platform for diversifying risks

This is where the profound link between competition and security of supply sets in: A competitive market is by far the best proven platform for diversifying risks.

Competition leads to:

- More market actors looking for more opportunities outside established supply areas
- Diversification of infrastructures and new investment
- Correct investment and price signals

Europe's security of energy supply will therefore depend to a large extent on the creation of effective pro-competitive market structures.

Diversification of supply risks is held back by the current market situation in the EU

During the last 18 months, the situation in the EU gas and electricity markets has been reviewed carefully under EU competition law.

The Sector Inquiry³ found:

- High levels of concentration persist at wholesale level
- Incumbent gas and electricity operators continue to largely control imports and domestic production
- Traded markets are dominated by incumbents

With the exception of some markets, such as the UK, the historic incumbents hold market shares of 80 – 90% in their national or regional markets.

Liquidity at gas hubs and power exchanges is insufficient. Almost all commercially available gas is covered by incumbents' long-term contracts. As a consequence, trading at gas hubs remains very limited in most of Europe, with the notable exception of the UK.

Supply structures are built on the juxtaposition of national gas markets that compete for long-term outside contracts, with little diversification of risks between them.

³ Communication from the Commission, Inquiry pursuant to Article 17 of Regulation (EC) No 1/2003 into the European gas and electricity sectors (Final Report), COM(2006)851, 10.1.2007. Available at <http://ec.europa.eu/comm/competition/sectors/energy/inquiry/index.html>

This is confirmed when taking a look at the main supply routes. During the Inquiry, pipelines have been investigated in detail, both North / South, the Benelux to Italy axis allowing for Norwegian, Dutch and UK gas to flow through France and Germany in the direction of Southern Germany and Italy; and East / West, the critical axis that allows for imports of Russian gas, in particular via the Ukraine and Slovakian transit networks into Central and Western Europe.

For the East to West axis it turns out that nearly all capacity is reserved until at least 2015, primarily by incumbents and large producers. This implies that any company wanting to flow gas on these pipelines will have to request capacity from the incumbent players, who are in fact likely to be their direct competitors, for at least the next 10 years. A similar situation exists on the Benelux to Italy axis.

LNG progress remains insufficient to balance the risks resulting from this frozen supply structure. While receiving capacity of EU terminals is likely to expand from 75 bcm per year to around 140m bcm in 2010 and LNG has sizeable shares of up to 70 % of gas imports in some of the EU's Southern Member States, in many instances the "hinterland" is missing. Gas cannot be transported easily from the LNG terminals to the consumer. It is indicative that LNG terminals constructed by competitors are only developing in those EU Member States which have fully unbundled their gas transport networks. With the current situation, LNG cannot weigh in the diversification balance as heavily as it should.

Europe must overcome the deficiencies of its energy markets

The European gas and electricity markets are facing three deficiencies that hinder the reduction in risks that a Europe wide market normally would provide.

The structural deficiency: The systemic conflict of interest through insufficient unbundling of production, supply and transport networks.

The EU's national gas and electricity incumbents consider the networks as strategic tools to defend their market position, not as part of a common platform that must be developed to diversify risks. Insufficient unbundling of production and supply, on the one hand, and transport networks, on the other, blocks risk sharing in Europe.

The regulatory deficiency: The persistent regulatory gap where borders are crossed.

The EU's regulatory systems have been built with a national vision in mind. They do not easily allow our markets to operate across frontiers, and they therefore deepen the structural deficiency. Current coordination mechanisms are too weak to balance this.

As a result of these two deficiencies there is: *The deficiency in liquidity.*

Gas hubs and power exchanges cannot function as they should, as has been amply demonstrated during the price hikes on the UK gas

market during Winter 2005/2006 - when gas did not flow into the right directions in the short term in spite of clear price signals.

All this means that a third EU liberalisation package will be required, in order to give full effect to the wider EU market.

The EU needs

- further regulatory reform, addressing particularly the cross border gap
- Structural reforms, addressing the unbundling issue
- Strict application of competition law to curb market power that forecloses markets along national frontiers

The three fallacies about the application of EU competition law to the energy sector

In current debates, a number of flawed assumptions can be noted that often bring about misleading conclusions.

First fallacy

False: Application of competition rules hinders stable outside supply relationships

The truth is that EU law recognises the requirements for long term stable outside relationships to develop gas fields and pipelines as demonstrated by the EU Directive on security of gas supply that

entered into force last year, and the EU Directive on security in electricity supply⁴.

However, EU competition law does not allow these relationships to be used to partition markets downstream and thereby undercut the very EU-wide market integration that is needed to balance the EU's supply risks. Long-term upstream contracts must not be used to cement the current market fragmentation, nor can they be mapped into long-term downstream contracts to tie in customers. Customer allocation agreements in exchange for long-term upstream contracts have a high risk of falling foul of EU competition rules.

Second fallacy

False: Application of competition rules hinders the establishment of strong European actors which are required to match the power of external suppliers.

The truth is that competition rules recognise the need for restructuring of the sector on a European scale but do not accept foreclosure of national markets during this process.

The EU has made this very clear during a series of merger control decision under the EU Merger Regulation during the last two years; the Gas de France / Suez decision⁵ being one of them.

⁴ See Council Directive 2004/67/EC of 26 April 2004 concerning measures to safeguard security of natural gas supply, OJ L 127, 29.4.2004, p. 92-96; and Directive 2005/89/EC of the European Parliament and of the Council of 18 January 2006 concerning measures to safeguard security of electricity supply and infrastructure investment, OJ L 33, 4.2.2006, p. 22 - 27

⁵ See Case No COMP/M.4180 Gaz de France/Suez, Commission Decision of 14.11.2006. See also Case No COMP/M.4517 Iberdrola/Scottish Power, Commission Decision of 26.3.2007 and Case No COMP/M.4685 Enel/Acciona/Endesa, Commission Decision of 5.7.2007. Available at http://ec.europa.eu/comm/competition/mergers/overview_en.html

The European Commission has allowed restructuring to go forward, as a basic requirement for adjusting to the evolving market integration.

However, it cannot allow monopolisation of markets which would undercut the role of an integrated European market as the basis for future risk diversification.

Third fallacy

False: Application of competition rules hinders long term investment

The truth is that competition rules accept the need for stable regulatory conditions but do not accept that the current regulatory status quo is used to maintain monopoly positions.

Regulatory conditions must be stable once the current deficiencies are corrected with the tabling of necessary measures.

Current incumbent stake holders tend to use their ownership grip on the network infrastructure to keep out their competitors. They tend to refrain from investments that would increase presence of competitors – even if they would at the same time substantially diversify risks. When there are indications of restructuring being used as a defensive measure to shield off national markets, this will inevitably lead to measures under EU competition law. Incumbent companies cannot be allowed to undermine the very market integration that is needed.

Conclusion

Stable outside partnerships are needed to secure Europe's energy futures, as well as a profound shift of Europe's energy mix towards renewables and low carbon emissions. However, a sustainable reduction of our supply risks will not be possible without a competitive market structure that shares risks out between all market participants.

Europe will have to do its homework, alongside the building of stable outside supply relations and necessary solidarity mechanisms. It needs rapid progress towards a competitive Europe wide market platform, in order to reduce its energy risks, increase flexibility and make the transition to the new energy structures as efficient as possible.

Europe's energy structure will have to look very different in the latter part of this century, as the economics of declining oil and gas reserves and the requirements of climate change will work through the system. A truly competitive energy market is the best risk diversification and security insurance programme for energy in Europe. The application of EU competition rules will have to play its role in this process.