

SPEECH

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Can EU competition policy create competition in the energy sector?

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Ladies and Gentlemen,

The title of this evening's lecture is “Can EU competition policy create competition in the energy sector?” The short answer is no.

The longer, and more optimistic, answer is that competition policy cannot create competition – only companies can. But competition policy can contribute to an environment in which companies are freed up to compete. This evening I would like to explore this in more detail, primarily in relation to energy markets, but also, briefly, in relation to pharmaceuticals, an area in which we began another sector inquiry earlier this year.

When I last spoke here on this topic, two years ago, I said that the Commission had to take decisive action to help deliver competitive markets in the energy sector.

In spite of two waves of legislation liberalising energy markets in Europe, it was clear that there was as yet no Single Market in energy and that the choices open to consumers remained limited. Liberalisation in and of itself had delivered neither all the expected benefits for consumers, nor integrated and secure EU energy markets.

Since then, **we have acted** to resolve the obstacles to open and competitive European energy markets and to honour Member States' commitment to sustainability and security of supply. This is key to creating the right incentives for long-term investment, including investment in new technologies and in energy efficiency. We have pursued enforcement action under the competition rules and we have pursued legislative and regulatory reform.

Briefly taking a step back, let me remind you of the findings of our sector inquiry into competition in electricity and gas markets in the EU, which concluded in 2007:

- energy markets are often too highly concentrated and not liquid enough;

- there is a high degree of vertical integration or rather insufficient unbundling of network and supply activities;
- there is insufficient cross-border integration and cross-border competition between energy companies; and
- there is a lack of transparency, for example with respect to available transport capacity, with the result that there is no trust in the pricing mechanism.

All of these are serious barriers to competitive gas and electricity markets and it became apparent that without comprehensive change in the European energy sector the benefits of competition would remain out of reach.

In response the European Commission (and not just DG Competition) developed a strategy involving :

- first, using the full gamut of competition enforcement tools at our disposal to pursue individual cases that could significantly improve the level of competition in the market;
- secondly, drafting and proposing a legislative package of measures to improve the regulatory framework (the Third Energy package).

Our aim in competition enforcement is to implement a comprehensive strategy to put an end to anti-competitive behaviour by the companies targeted and to dissuade others from carrying out similar practices. With this in mind, the Commission is making use of the full range of our powers under the antitrust rules (Articles 81, 82 and 86 of the EC Treaty), the merger control rules (Regulation 139/2004) and the State aid rules (Articles 87 and 88 of the EC Treaty).

In antitrust, our strategy is to pursue cases that address key bottlenecks along the gas and electricity supply chains.

The investigations fall into three broad categories:

- (a) exclusionary conduct engaged in by dominant incumbents;
- (b) exploitative abuses by dominant incumbents;
- (c) collusion between incumbents.

Looking at the exclusionary conduct category, we are investigating whether incumbents have:

- engaged in capacity hoarding, i.e. failed to release unused capacity (ENI and GDF cases);
- failed to increase capacity in major import pipelines to protect their dominant position on supply markets (ENI case);
- blocked access to markets by a combination of long-term upstream supply contracts and matching long-term capacity reservations (GDF case); or
- excluded rivals by inflating network costs and imposing stringent balancing requirements in small balancing zones (RWE case).

This category also encompasses two cases not relating to networks, but which concern suspected foreclosure caused by long-term downstream contracts between the dominant incumbent and its customers (EDF and SUEZ Electrabel cases).

The second category, exploitative conduct, encompasses conduct engaged in by incumbents to reduce production to the detriment of consumers (the EON electricity

case concerning the German wholesale and balancing markets). This case is related to the issue of price increases due to the absence of effective competition.

The third category covers alleged collusion between incumbents in order to share markets (E.ON/GDF case).

What have we achieved so far? Substantial remedies have been offered by the parties in the EON electricity and RWE gas cases. The parties have undertaken to carry out full unbundling of transmission networks, which should structurally change the market to the benefit of consumers. For example the transfer of generation assets from E.ON to its competitors should lead to a reduction in prices for customers.

In 2007 we adopted the Distrigas decision relating to foreclosure of the Belgian downstream market in gas, which will facilitate new entry. Earlier this year (March 2008), we adopted the Greek lignite decision, which should ensure fairer access for competitors to the cheapest source of electricity generation in Greece. This should allow them to compete more effectively with the incumbent, who has so far enjoyed a monopoly on lignite. It will also open the way for more investment in power plants in Greece, which is currently badly needed.

So a number of antitrust cases are in the pipeline, so to speak.

Let me now turn to mergers.

The Commission's focus in mergers is always on identifying and addressing any anti-competitive effects of the specific transaction, taking into account the market situation and how regulation actually works on the ground.

So in the 2005 EON/MOL case, we imposed conditions before allowing EON Ruhrgas to buy the gas wholesale trading and storage activities of MOL, the incumbent oil and gas company in Hungary. Here our concern was that the acquisition would affect

competition on the markets in Hungary both for the supply of electricity and gas to final customers, and for the generation and wholesale supply of electricity. In order to prevent this we required, *inter alia*, the ownership unbundling of gas production and transmission activities (which were as a result retained by MOL) from the wholesale and trading activities acquired by EON.

The 2006 GDF/Suez merger as originally planned would have weakened competition on the gas and electricity wholesale and retail markets in Belgium and on the gas markets in France because it would have removed competition between GDF and Suez in markets with high barriers to entry. The parties addressed these concerns by agreeing to:

- divest Distrigas, part of the Suez group and the incumbent on the Belgian gas market and a significant participant in the French gas market;
- divest SPE, the main competitor to Suez-Electrabel on the Belgian electricity market; and
- relinquish control of Fluxys, part of the Suez group and the owner and operator of the Belgian gas network.

If necessary we will not shy away from prohibiting anti-competitive mergers. I think we made this clear in 2004 when we prohibited the acquisition of the Portuguese gas incumbent by the Portuguese electricity incumbent (EDP/GDP case). Similarly, in the OMV-MOL case earlier this year, the Commission's concerns relating to the combined market share of the companies in several energy markets resulted in the parties abandoning their merger plans.

And we are very careful to ensure that Member States do not infringe our exclusive competence to look at mergers, as Spain sought to do in the Endesa cases.

The Commission is also keen to ensure that competition in the energy sector is not distorted by illegal state aid. In 2007 we opened in-depth State aid investigation procedures on the regulated electricity tariffs for big industrial electricity users in France and Spain. These users seem to be paying substantially less than the market price for their electricity, and that anomaly may give these companies an unfair advantage over their competitors and block new entrants to the electricity market.

In Poland and Hungary, national governments decided to encourage modernisation in the power generation sector by guaranteeing long term purchasing of electricity produced in these power plants, i.e. over 20-25 years. This provided these power generators with a guaranteed return on investment and shielded them from commercial risks.

Our State aid investigation showed that these long-term agreements distorted competition. The Commission adopted decisions in September 2007 with respect to Poland and June 2008 with respect to Hungary, ordering termination of these long-term agreements. Poland has complied with the decision, terminating these long term power purchase agreements in April 2008: this has already led to a significant drop in electricity prices. In Hungary, the agreements should be terminated by the end of this year. We expect a similar effect on electricity prices in Hungary.

I am convinced that using the competition tools at our disposal we can achieve significant results in terms of bringing competition to the European energy markets. The examples above show this. However, some problems in the energy sector may be best resolved not by enforcement of competition law but by regulatory changes. Possibly the most important outcome of our sector inquiry into EU energy markets was that it enabled us to identify where we could achieve results with competition enforcement, and where legislative reform would be necessary.

Following on from the inquiry, the European Commission made robust proposals for a new legislative package to give a fresh impetus to competition on European energy markets (the Third Energy liberalization package).

The proposals focus on effective separation (or "unbundling") of transmission network activities from supply and generation activities, going beyond the "legal unbundling" required by previous legislation.

In March 2007 the European Council called for **effective** unbundling to deliver the following objectives: fair network access, connection of new production capacity, independent investment decisions and cross border cooperation. The Commission is determined to ensure that effective unbundling of supply and generation activities is implemented. We believe that the best way to achieve this is Ownership Unbundling, under which the supplier and the Transmission System Operator (TSO) have to be under different ownership. An alternative approach would be for vertically integrated companies to choose to establish an Independent System Operator, where the supplier can remain as shareholder of the TSO (thus retaining it on their balance sheets) but outsourcing its management to an independent company.

There is a growing body of evidence that structural changes would bring significant benefits to European energy market, as ownership unbundling has already been successfully implemented by many Member States. Without focussing too much on this issue I would like to point out some of the benefits we see in it: increased investments, a stable legal framework which is essential for large investments to take place (for example, € 900 billion during the next 25 years for new electricity generation alone), increased usage of congestion revenues to fund network building, and more cost reflective prices for industrial and end-consumers.

Although many Member States support our call for ownership unbundling, a number of Member States put forward an alternative, "Third Option" in January of this year. Under this alternative proposal, existing rules on legal unbundling are largely retained but they are reinforced by the appointment of a trustee whose task is to ensure that the TSO's management is kept separate. Whilst we think that our initial proposal was better, on a positive note, this Third Option is at least an implicit recognition that legal unbundling has not worked properly.

It is also worth bearing in mind that effective unbundling is a necessary but not a sufficient condition for creating competitive energy markets. Regulation will also have to play a role. For instance, the proposals provide for the creation of an Agency for the Coordination of Energy Regulators to complement the work of national regulators by enhancing its European dimension. The Commission believes that this Agency, focusing on cross border issues, is an important cornerstone for achieving market integration in Europe and consequently increasing competition. Moreover, cross-border co-operation between regulators and Transmission System Operators also needs to be improved. That is why the Commission has put a comprehensive package on the table which addresses these issues as well.

Following the Agreement of principle at the European Council in June 2008, the EU energy ministers held constructive discussions on 10 October and reached a political compromise on the Energy Package, which allows for the three different unbundling models I mentioned earlier, namely ownership unbundling, an Independent Systems Operator, and the Member States' proposed "Third Option". The package also includes a "third country clause", which means that third country suppliers and their direct or indirect affiliates will not be able to acquire networks in the EU unless they comply with EU rules on unbundling and do not raise security of supply issues.

As regards the Parliament, it has adopted its first-reading opinions on the legislative proposals: on 18 June, it endorsed full ownership unbundling in electricity as the only option and on 9 July it accepted in relation to gas a compromise unbundling proposal (i.e. an Independent Transmission Operator with a Trustee), in addition to Ownership Unbundling.

Some remaining stumbling blocks in the package will have to be resolved through inter-institutional dialogue next year, before the package is approved by the European Parliament. We expect it will be adopted during the first half of 2009.

Before concluding, I would also like to briefly discuss another sector which has been very much in the news recently - pharmaceuticals . In particular, I would like to explain how, just as in the energy sector, we are looking to use the competition policy tools in order to spur competition in the sector. We launched a sector inquiry last January and our preliminary report is due to be issued for public consultation on 28 November.

This inquiry was opened because the Commission was concerned about apparent delays to the market entry of generic products. For instance, generic versions of pharmaceutical products in some cases did not enter the market when they could have done so following the expiry of the R&D companies' patents. The Commission is investigating whether originator companies block each other in the innovation process. The fact that between 2000 and 2004 only 28 new molecular substances reached the market as opposed to 40 substances between 1995 and 1999 suggest that this might be the case.

Unlike previous sector inquiries, this one started with surprise inspections – a tool provided for under Regulation 1/2003. These seemed necessary in order to obtain

confidential and highly sensitive information, for example, relating to patenting strategies towards competitors. There was a risk that information of that type might not reach the Commission otherwise. The relevant companies were selected on the basis of objective criteria giving us a representative snapshot of the sector.

I expect that the barriers to market entry that the preliminary report will identify are likely to raise new and challenging questions concerning the potential use of **competition policy** in this heavily regulated field.

Although the sector is highly regulated, there remains ample room for competition between originator companies and generic companies as well as between originator companies themselves. Our inquiry focused on examining practices that threaten to distort this competition such as, for example, market behaviour to delay or prevent generic entry.

Secondly, barriers to market entry in pharmaceuticals also bring to the fore important issues of **regulatory policy, such as** the absence of a Community patent. At present, a European patent can be obtained via a centralised procedure before the European Patent Office, but this patent must subsequently be validated in each Member State. Litigation concerning these patents takes place at national level, so that conflicting court rulings do occur. Pharmaceuticals are often protected by a multitude of patents, each of which may be give to several enforcement procedures in national courts, so that launching a generic product in Europe can be like treading through a minefield.

Ladies and Gentleman, I came here this evening to talk to you about whether EU competition policy can create competition in the energy sector. I hope that I have said

enough to convince you that we can and are making a difference, even though we may be more accurately described as "enabling" competition.

I hope that I have also shown enforcing competition law through individual cases may not be enough. Our enforcement efforts must be accompanied by regulatory and structural changes to the markets, notably to remove the problems caused by vertical integration and to enhance cross-border competition. I believe that our sector inquiry under the competition chapter of the EC Treaty, helped identify where regulatory change can help achieve competition in the EU energy markets. And I hope we will have similar success in another thorny and highly regulated sector, namely pharmaceuticals.

Ladies and Gentlemen, thank you for your attention.