COMPETITION POLICY AND LIBERALISATION OF ENERGY MARKETS

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1. INTRODUCTION

The electricity and gas industry in Europe is currently undergoing a radical transformation. Liberalisation adopted by the European Union makes it move from stable national markets with a monopolistic supply structure to an Internal Energy Market with vigorous competition among suppliers. This creates a challenge not only to the individual electricity and gas company but to the whole energy sector. The organisers of this Conference state in their invitation very correctly that the "*final vision needs still to be defined*". I will try to contribute elements to defining the "*final vision*" by speaking about energy liberalisation from the angle of Community competition policy.

Commissioner Monti already stated last night, that the European economy depends on cheap, clean and reliable energy supplies and innovative energy services in order to be and remain competitive on global markets. The provision of such supplies can be best achieved by means of liberalisation. The Heads of State and Government of the European Union therefore requested the Commission at the recent of the Lisbon European Council of March this year to "*speed up liberalisation in areas such as gas and electricity*". This statement of the Council is a clear message to industry and should certainly be taken into account in the formulation of any "*final vision*" from the point of view of business.

The Lisbon Council also emphasised that "*fair and uniformly applied competition and state aid rules are essential for ensuring that businesses can thrive and operate effectively on a level playing field in the internal market*". The European competition policy obviously has to make a contribution to the liberalisation of the electricity and gas markets. Commissioner Monti pointed out to you last night that competitive electricity and gas markets can only be achieved if three conditions are fulfilled. There must be:

- Free suppliers,
- Free customers, and
- Open network access.

Let me explain how Community competition policy can contribute to realize of these three conditions. I will address all three instruments of competition policy: antitrust, merger control and state aid rules, and will indicate how we are setting our priorities.

2. THE ROLE OF COMPETITION POLICIY IN LIBERALISED ENERGY MARKETS

The electricity and gas industry are network industries. Customers can only be supplied by use of the gas pipeline or the transmission grid. The network constitutes a natural monopoly. It is unlikely that the existing network is duplicated in the near future.

Liberalisation requires that competing suppliers are allowed to use the existing network. Since almost all existing networks are part of a vertically integrated electricity or gas supply business, an effective Third Party Access regime is needed.

2.1. Network issues

Due to the vertical integration of supply business with network operations in the European electricity and gas industry no transmission market existed in the past. Effective competition calls thus for the emergence of a transmission price and rules for granting access to the network, in particular to the congested parts of the infrastructure. Community competition policy attempts to contribute to the emergence of a real transmission market. It can do so with its tools, because network operators normally enjoy a dominant position in the geographical area covered by their grid.

2.1.1. Transmission pricing

Let me first turn to the issue of transmission pricing. Community competition law prohibits the imposition of unfair selling prices or other unfair trading conditions. Unfair are either predatory or excessive prices. Prices should also be non-discriminatory.

Generally speaking, my Directorate General has three means to assess whether prices are unfairly high: First, the prices do not reflect costs related to the product sold or service provided (excessive pricing). Secondly, the prices charged to different customers deviate from each other without sufficient justification (discrimination). And thirdly, the prices charged by operators deviate from each other without sufficient justification (benchmarking).

Let me give you an example for our policy: As many of you will remember, the issue of calculation of transmission prices in the energy industry arose first in the electricity sector in

Germany where industry associations concluded a framework agreement setting out joint principles for the calculation of prices. I am referring to the so-called *Verbändevereinbarung*. This framework agreement foresaw a transaction and distance based price model. This model raised competition concerns since transmission pricing should rather reflect the costs of actual physical flows than commercial transactions for reasons related to physics that I do not need to explain to you.

In December 1999, the second *Verbändevereinbarung* provided for a non-transaction based tariff without any distance component. The Commission regarded this as a very significant improvement in the development of a sound transmission pricing system.

However, the second *Verbändevereinbarung* also foresaw the division of Germany into two "trading-zones", one covering the North and another the South of the country. The system included a special fee, the T-component, to be levied each time the parties to the transaction are located in different zones or one party operates in another Member State. At the same time, a balancing mechanism was designed so that companies could compensate their flows in opposite directions crossing those borders.

In the Commission's view, this system was incompatible with European competition law. First of all, the T-component lacked cost-reflectivity as transmissions over a short distance, but over the borders led to the imposition of the additional fee, whilst transmissions over long distances within one trading zone were free of additional charges. Secondly, the Commission was of the view that T-component was discriminatory since it would have provided to large German electricity suppliers with the possibility to balance counter-directed flows and thus to avoid the payment of the T-component, whilst this possibility was in practice not available to smaller market actors or foreign suppliers. Finally, the Commission noted that transmission costs in Scandinavia were significantly lower.

The Commission thus sent a warning letter to the Associations concerned. The abandonment of the internal T-component also became a pre-condition for the approval of the VEBA/VIAG merger. As a result, the T-component is no longer applied to transactions within Germany.

The principle of Community competition law that prices lacking cost-reflectivity may be abusive has not only been applied to the German tariffication system. It has also been an issue in the case of the Dutch transmission tariff. The dominant Dutch Transmission System Operator intended to charge suppliers for imports into the Netherlands, as well as for transit

transmissions of electricity through the Netherlands, the same fee that domestic suppliers pay for the use of the grid.. In this case the Commission took the view that the Dutch network operator can only charge for import and transit transmissions to the extent that these cause extra costs on the lines interconnecting the Dutch grid with other grids. Since electricity may be traded several times across borders and the Dutch system did not foresee any precaution to avoid multiple charging of the same transmission, the Commission urged the Dutch Transmission System Operator to adapt its tariffication system accordingly.

As these examples also demonstrate, competition law does not prescribe the implementation of a particular method for the calculation of transmission prices. Only sector-specific law or regulation can do so. Competition law sets only the outer boundaries for the pricing behaviour of dominant network operators in individual cases. Within these limits, they are free to use the method that suits their particular situation best. A coherent tariffication system for the Trans-European network which does not impede but foster trade would thus seem only be possible on the basis of a voluntary agreement or new legislation.

Apart from transmission pricing access to the network is a very topical competition issue. Dominant Transmission System Operators are obliged to grant all suppliers non-discriminatory access to the network in order to enable them to compete effectively against each other for customers. This should in my view also apply to vertically integrated companies, which are – according to the liberalisation directives - anyhow prevented from granting favourable terms and conditions to its related supply or distribution business as far as transmission is concerned.

2.1.2. Interconnector capacity allocation

Access to interconnectors has become a priority for Community competition policy. They are key components of the Trans-European network which itself forms the backbone of the Internal Electricity and Gas Markets. Importers depend on interconnectors to enter the markets of other Member States. In Member States with a monopolistic supply structure interconnectors are the only source for competition, at least in the short term.

Many of these cross-border lines lack sufficient capacity – in particular in the electricity sector - to carry all the electricity and gas which producers, traders and large consumers wish to import or export, now that markets are open for competition. Two issues are of particular importance from a competition point of view, when it comes to the allocation of scarce transmission capacity, namely

- The allocation of the available capacity – in other words: which method should be used to allocate the scarce resources, and

- Whether long term capacity reservation agreements – old or new - are compatible with EC competition law.

2.1.2.1. Allocation methods

Let me start with the first question, the allocation methods. You know that Transmission System Operators are currently exploring various methods to allocate the available transmission capacity whenever demand exceeds supply. The most frequently applied methods are pro-rata rationing and auctions.

Pro-rata rationing is currently applied at several borders as well as to bottlenecks inside some Member States. It seems to work in practice as long as demand does not exceed available capacity to a too large extent. If, however, demand largely exceeds free capacity, pro-rata rationing may lead to the allocation of so little capacity that the individual transaction looses its commercial value. This undesirable result can be avoided by the use of auctions.

Competition law again does not prescribe the implementation of a particular method for the allocation of transmission rights. It sets only the outer boundaries for dominant network operators.

The allocation method that might raise most doubts under the European competition rules is arguably "first-come-first-served". This method can, under certain circumstances, favour former monopolists over new entrants, for instance, in a situation where the dominant firm concluded long-term capacity reservation contracts before liberalisation. In addition, it seems also to facilitate discrimination by the network operator in favour of its vertically integrated supply business. This could have the effect to foreclose other traders from entering the downstream supply markets.

Let me finally say a word on auctions. In the past months, national authorities inquired whether this allocation method is compatible with European competition law - taking into account the Commission decisions on mobile phone licences in Italy and Spain. In these decisions the Commission had ruled that an auction relating to the allocation of the second mobile phone license is incompatible with competition law if the first mobile phone license was granted free of charge to the incumbent state owned telecommunication company.

In my view, these cases were misunderstood. The Commission decisions were no general condemnation of auctions as an acceptable allocation method. They rather clarify that no discrimination must take place – also in an allocation by means of an auction. Auctions are and remain therefore an acceptable allocation method.

2.1.2.2. Long-term reservation contracts

As I said before, the allocation of scarce resources often also leads to the question whether existing long-term reservation agreements are compatible with European competition law. If the agreements are protected by grandfather rights, the capacity cannot be reallocated. If, on the other hand, they are incompatible with competition law, the capacity – available for reallocation – increases accordingly. The validity of the contracts and their exclusion from the regular allocation procedures have thus become subject to the antitrust scrutiny of Community competition policy. We are currently carrying out a number of investigations relating to these questions. However, none of them is finally concluded. I will therefore limit myself to some general comments taking into account that each case has to be assessed on its own merits.

Let me start by saying that the beneficiaries of long term capacity reservation agreements are very often the former monopolists.

In this respect, I need to underline – once again – that the European Commission expects the introduction of competition in the supply markets to stem very often from import competition. Existing operators will aim at extending their sales activities outside their traditional supply areas and new entrants such as traders will try to benefit from price differences between national markets. In order to do so, they all need access to interconnectors.

If, thus, the incumbent supply monopolist has reserved for itself a significant part of the interconnector capacity, it protects itself against import competition. The capacity reservation agreements thus have significant foreclosure effects.

When considering the effects of long-term capacity reservation agreements, the European Commission will also assess the necessity to recoup the investment costs incurred when constructing the interconnectors. The Commission therefore does not generally oppose the conclusion of long-term capacity reservation agreements if such agreements are necessary to finance the interconnector and the principle of non-discrimination is applied.

To conclude on this difficult issue, let me give you an example of a past intervention by the Commission in a case of a *new* interconnector. In this case, the Transmission System Operators originally granted the power supplier priority rights for up to 100% of the available transmission capacity for 15 years. The Commission regarded the long-term reservation as excessive both in terms of capacity utilisation and duration. After discussions with the competent national regulatory authority, the parties informed the Commission of modifications of their agreement reducing the reserved capacity utilisation to 50% for the duration of less than 6 years. Subsequently, the Commission approved the modified agreement by comfort letter. Whilst I do not want to rule out that the Commission comes to different conclusions in other cases, I think the case indicates clearly what type of capacity reservation agreement the Commission could normally accept when speaking about new interconnectors.

2.2. Free suppliers

The second of the three conditions that I mentioned before to achieve competition in liberalised energy industries is that there must be free competition on the supply side.

This applies to companies active on the same product and geographical market, as well as to companies which intend to enter new product and/or geographical markets. Let me give you an example for each of these scenarios.

Companies acting on the same product and geographic market might decide not to enter into competition with each other, be it in the form of a straight forward cartel, be it in form of a joint venture arrangement. Obviously, such arrangements attract the attention of all competition authorities including the Commission.

For instance, the Commission currently investigates a case relating to a gas field located in the Atlantic. In this case, the owners of the gas field have requested an exemption from EC competition rules because they intend to market the gas jointly for a certain period. They argue that joint marketing is necessary to get the project started. I my view, one of the decisive questions will be whether the joint marketing arrangement is really "indispensable" for the field to be developed. No final decision is taken yet, but I think this will be an interesting test case for the future.

Let me now turn to the second scenario: companies acting on different geographical markets. In this respect, we are of the view that the scope of gas and electricity markets is currently at most

"national" and that, as I said before, competition in these markets will mainly develop through imports. Consequently, any restrictions to import or export energy into or from other national markets will be investigated thoroughly. In this regard, the Commission recently learnt that a number of gas supply contracts between producers and importers in the Community contain resale prohibitions or limitations. These clauses have the object and effect to prevent the importer to resell the gas outside the Member State where it is located. Such resale restrictions are obviously not compatible with the aim of EU liberalisation policy, namely to create an internal gas market.

Let me finally turn to the scenario of companies acting on different product markets. In this respect, the Commission is of the view that companies currently acting in the same geographical market, but on different product markets, should not be be impeded from entering other energy markets.

Again, let me give you an example from our recent practice. In Spain the dominant supplier in the gas market, Gasnatural, entered into a long-term gas supply agreement with one of the most important electricity producers, Endesa. The gas was to be used for Endesa's power plants. Gasnatural insisted that Endesa could not resell gas to other customers, thus intended to prevent Endesa from entering or reinforcing its position on the gas market in Spain. The Commission took the view that this clause was incompatible with EC competition law. Following our intervention, the companies abandoned the use restriction and the investigation could be closed.

2.3. Free customers

Let me now turn to the third condition necessary to create and maintain competition in the gas and electricity markets: free customers. In this respect, the Commission considers that it is important for customers to have the possibility to choose freely between suppliers, in other words customers must not be "locked in".

The most prominent example of "locked in" customers are those that entered into a long-term exclusive supply contract with the dominant operator. These contracts impede the customers from choosing freely their supplier. The contracts also increase the entry barriers for potential competitors. The market foreclosure effects are particularly apparent if all key customers justifying a new market entry are locked in.

The Commission has recently attacked such a long-term exclusive supply contract between Gasnatural and Endesa. In this case Endesa was obliged to purchase its entire gas demand for new gas fired power plants for a period of more than twenty years from Gasnatural. Following the Commission's intervention the companies reduced the duration of the supply contract and the quantities to be bought to such an extent that Endesa became again an attractive customer for new entrants in the Spanish gas market.

3. MERGER CONTROL

I will now turn to merger control. As I said in the introduction, the opening-up of markets creates new opportunities for energy companies. Some may regard it as a challenge that they can only meet in co-operation with other energy providers. Customers may contribute to this development in demanding single sourcing either for all their energy requirements or, at least, for all their requirements of a particular energy source in respect of all their locations in the Community. Liberalisation is thus leading to a re-structuring of the European energy industry through mergers. A similar increase of merger activity could be observed before in the European telecom and air-transport industry.

When assessing mergers in the energy industry, the Commission will apply the normal rules of the merger regulation. In this respect, the energy industry is an industry like all others. We will analyse in particular whether the merger leads to the creation or reinforcement of a dominant position in the common market.

As Commissioner Monti said last night, two types of mergers can be expected in the energy industry: those driven by economies of scale and those driven by economies of scope. That is to say, some companies try to extend their customer base either by acquiring companies operating in a different geographic market, or by acquiring companies active in other energy markets. Some recent examples would be Exxon/Mobil for gas, or Veba/Viag in the electricity sector.

Mergers between electricity suppliers are rather pro-competitive, if they allow these companies to enter the new electricity markets for trading at exchanges or network services. The same is true for joint ventures or mergers with the objective to enter into new geographic markets, in particular if these are highly concentrated.

Mergers between former monopolists having become direct competitors through liberalisation are more problematic, however. They create the risk of consolidating the strong market position

of the parties in their former exclusive supply area. The actual and future conditions for supply competition will have to be assessed. The degree of market opening, the economic independence of Transmission System Operators and the actual conditions for "Third Party Access" are important in this regard. Competing suppliers must have real opportunities to enter the supply territory of the merging or co-operating companies. If entry into the supply area of the former monopolists becomes less likely, the merger will most probably not be compatible with Community competition law.

We have illustrated our position in the the VEBA/VIAG merger to create E.ON. This merger would have resulted in a dominant duopoly on the German wholesale market for electricity. In order to overcome the competition concerns, VEBA/VIAG proposed to dispose of numerous holdings in other companies, and make improvements to the ground rules governing the market in electricity. These commitments allowed the Commission to approve the merger of direct and leading competitors.

Another case that has raised competition concerns is the EDF/Louis Dreyfus case. EDF envisaged to form a joint venture for the trade of electricity with Louis Dreyfus. The French market had not been opened up at the time of the notification. The conditions and terms of "Third Party Access" as well as the identity of eligible customers in France were not known. EDF would have been the only trader on the French market and thus be able to gain a competitive advantage over its competitors which were barred to enter. The Commission decided that the joint venture would reinforce EDF's dominant position on the French electricity market under these conditions. The venture was subsequently cleared after EDF had undertaken that would not offer trade services in France until the market is effectively open.

As you know, we are currently investigating another case concerning EDF and the *Zweckverband Oberschwäbische Elektrizitätswerke*, an association of nine public districts in the Southwest of Germany, who would like to acquire joint control over EnBW. EnBW, which has its supply area along the France-Germany border, can be considered as potential entrant into the French electricity market. The Commission is concerned that the transaction could lead to the elimination of a potential competitor entering the French market. Considerable imagination of the parties will be necessary to allow a positive outcome

Finally, I will turn to mergers between suppliers of different energy sources. Again, these can be pro-competitive, if they lead to new market entry. However, a merger between the dominant electricity company and the dominant gas supplier would allow the electricity company to gain

significant influence over the cost of production of its competitors in the electricity market, given the importance of gas for electricity production. Competing electricity producers, who intend to enter a new geographic market on the basis of a gas-fired plant, would most probably have to purchase the fuel from the incumbent dominant electricity supplier. Furthermore, the dominant electricity producer would be able to influence the choice of industrial consumers whether to engage in own-production of electricity or to purchase from the incumbent. The two merger cases of Tractebel/Distrigaz and Neste/IVO met thus the opposition of the Commission. They were only approved after the parties had undertaken to divest their industrial gas sales business to a third party.

Summing up, mergers and acquisitions on energy markets characterised by former monopolist need to be carefully examined. Many operations in preparation for the Internal Electricity Market are pro-competitive. This is absolutely true for many, not necessarily all cross-border mergers. Purely national operations or mergers to multi-utilities will very often only be acceptable under the condition of open network access for all potential competitors.

4. STATE AID

The last competition issue arising from the liberalisation of energy markets I would like to address today is the issue of State aid.

Generally speaking, we consider that State aid does not significantly contribute to lasting economic welfare. Experience shows that it rather leads to unfair competition, market distortions, and inefficient allocation of resources. However, as Commissioner Monti indicated last night, in certain cases and on the basis of a thorough analysis in the individual case, the Commission does accept that State aid may be justified. In particular and in relation to the energy sector, State aid is granted mainly in two different types of scenarios:

– First, aid deemed necessary to counter-balance adverse effects of liberalisation.

– Secondly, aid granted with the objective of supporting the development of renewable and environment-friendly energy.

4.1. Counter-balancing adverse effects of liberalisation

Counter-balancing the adverse effects of liberalisation is by its own nature an issue that we only will have to address during a limited period of time. In other words, this is a short term

issue, as opposed to aid for promoting renewable energy, that will be an issue also in the longer run.

In the past, many energy companies were given commitments or guarantees of operation by their governments. Examples for such commitments and guarantees are purchases of electricity at a higher than average cost on a long-term basis or the construction of a coal-fired power plant in order to secure employment in coal mines. After liberalisation, the costs for these commitments or guarantees cannot be recovered in a competitive market and become "stranded".

Whilst a financial compensation for stranded costs may be justified under certain circumstances, such a compensation can also endanger emerging competition on recently opened up markets and seriously distort trade in the developing internal energy markets. The Commission and the Member States agreed therefore that guidelines for the examination of State aid granted to electricity companies will be established and that all aid schemes will be scrutinised in accordance with these guidelines, that is, in a coherent and equitable fashion.

The guidelines will provide, inter alia, that the alleged stranded cost is a real cost and not only a risk. Furthermore, a causal link must exist between a stranded cost, which will be compensated for by State –aid, and the opening up of energy markets. A compensation for all turnover losses since February 1999, the date of the opening-up of the electricity markets, would not be acceptable. Furthermore, the actual amount of State aid must be fixed in view of actual price developments after liberalisation. It cannot be fixed ex-ante. Payments may be effected beforehand. However, provision must be made for the return of payments, if price reductions are smaller than expected.

4.2. Development of renewable energies

The main issue of state aid in the energy sector is the development of renewable energies, which is a priority for the Community. The Commission has since long recognised that the protection of the environment is a major goal. I understand therefore the interest to foster renewable energy through State aid.

A strong policy of protection of the environment should, as a matter of priority, be based on the principle of "polluter pays".

At the same time, the long-term development of new energy sources, such as the renewable ones, is only instrumental to rendering these new energy sources competitive. Maintaining companies on the long term thanks to public resources cannot constitute a reasonable solution.

Against this background, the Commission intends to adopt a new framework allowing state aid be given to renewable energy sources. The aid could compensate the difference between the production costs and the market prices until the new investments are amortised.

This approach is very flexible, but I think justified at the same time because of the need to ensure the development of renewable energy sources.

5. CONCLUSION

I would like to conclude by underlining that the first experiences in liberalisation of energy markets have been very positive despite some less brilliant spots on the picture.

The Commission focuses its enforcement activities mainly on restrictive practices with a structural and with a cross border impact.

Let me summarise the Commission's priorities in this respect illustrating this for our main activity areas:

- The Commission will be scrutinising very carefully issues regarding network, such as transmission pricing and non-discriminatory access to the grid. This includes particularly access to interconnectors between different Member States; in this respect, the Commission will be looking at capacity allocation methods, as well as to long term capacity reservation contracts.

- In order to promote free competition on the supply side, the Commission will monitor the horizontal demarcations currently existing mainly in the gas market.

- In addition, the gas sector raises also competition concerns with regard to network access. It is therefore my view that the gas sector will demand a particular effort. The Commission and the national competition authorities will have to co-ordinate their efforts in order to assure a rapid a efficient implementation of the new rules.

- Regarding merger control: while many operations in preparation for the Internal Electricity and Gas Market are pro-competitive, mergers by former monopolist will be carefully examined.

- Concerning State aid, the Commission will soon establish guidelines for the examination of the state-aid granted for stranded costs and adopt a new framework on State aid for renewable energies.

I am confident that the contribution of Community competition rules will assist companies in defining their strategies for this radical transformation period and create a European level playing field for the gas and electricity markets.

Thank you.