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European Competition Day

Which approach to competition in electricity and gas – are we tackling the right issues?

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Ladies and Gentlemen,

let me use my statement at this panel to put forward some questions which we may want to discuss and let me make some remarks relevant to them. For the context I am referring back to this morning's session and particularly the remarks of Neelie Kroes, the European Competition Commissioner.

I believe we should look at three questions:

- why the proposed third energy package addresses the right structural issues in the market and why we need both sector specific regulation and direct application of competition rules

- Why outside dependence on energy supplies should not prevent us from developing a competitive market inside the EU

- how more competition in Europe's gas and electricity markets will contribute to the achievement of the EU's climate change and renewables goals

Where do we come from?

First, a few words on where we are coming from in electricity and gas markets in the EU.

Many here will remember the main stages:

- The first EU liberalisation package of 1996 for electricity respectively 1998 for gas which introduced partial liberalisation into the electricity and gas markets,

- the second liberalisation package of 2003 which set the timetable for full liberalisation by 1 July 2007, and provisions for regulated Third Party Access to the incumbents' networks

And now:

- The Third Energy Package: the proposals of September 2007 which we have heard about this morning ant to which I will return.

Somehow less known are the main case lines which the EU has followed since the late nineties under its competition rules in the energy markets, probably because they were mostly settled by informal settlements and were not terminated by resounding formal decisions or fines. However these settlements had a profound impact on making liberalisation work:

- Firstly, the "Marathon line" of cases: a US company complaining about lack of access to the incumbents' gas networks particularly in Germany but also other Member States,

- Secondly, the "Gazprom & Sonatrach line" of cases: concerning territorial restrictions in supply contracts, with a clear market partitioning effect,

And now, post energy sector inquiry:

- The current generation of antitrust cases – procedures against EON, RWE, GDF, EDF, Belgian Distrigas, and others.

I do not want to go into detail of the cases. Neither on the informal settlements, the latest of which have just been concluded recently, such as with Sonatrach. Nor on the ongoing procedures that have resulted from the EU energy sector inquiry, known well to many here. Let me just make one general comment: The new procedures are very much focused on the roots of the problems in the EU's energy sector, as far as competitive conditions are concerned – the high potential of abuse resulting from the very structure of the industry, as the Commission has set out to substantial detail in the Inquiry that it has carried out over the last two years throughout the sector in Europe.

Instead of going into detail on the cases, let me discuss here the question:

Are we dealing with the right problems?

This takes me back to the questions I have mentioned. Let us go through the checklist:

- Are we right in focusing on the lack of competition that we find in the sector?

- Outside dependence – the EU is importing 25% of its gas from Gazprom alone, with much higher shares in its New Member States.

Is this the right time to address the deficiencies in competition? Or are we scrubbing the deck, while the ship is sinking?

- Climate change / Renewables: the 20% targets that are now a central goal for the European Union. Does more competition help or hinder the achievement of the Climate Change goals ?

Let me turn briefly to these points and leave details for the discussion.

Are we right in focusing on the lack of competition?

The sector inquiry has identified a number of core issues: high concentration in the Union's gas and electricity markets; vertical foreclosure by vertically integrated incumbents; a resulting lack of integration of the EU's gas and electricity markets; and a general lack of belief in fair prices.

These are the core issues that are addressed by the Third Energy Package of directives and regulations proposed in September 2007 as a follow up to the sector inquiry. As is well known, the full unbundling of supply and networks, and the creation of a new agency for the cooperation of the EU's energy regulators figure on top of those proposals.

As I have mentioned, the Inquiry has also led to a new generation of cases which in essence focus on the abuse of market power for damaging competitors and consumers.

Without now naming any particular company or case, there is a first category of cases concerning:

- Capacity hoarding on the networks owned by the incumbents. The networks - both electricity and gas – tend to be used to optimise the parents' market positions in production and supply to the disadvantage of competitors. Networks are not developed as the very basis for a competitive market structure, as they should,

- blocking of access to markets dominated by incumbents, through a combination of long-term upstream supply contracts and long-term capacity reservations

- Exclusionary practices, by inflating network costs for rivals and imposing stringent balancing requirements

- Foreclosure of competitors, by locking up the market through long-term downstream contracts with customers.

Many of these case situations are directly related to abusive conduct by vertically integrated incumbents with regard to the networks they control.

There is a second category of case situations that concern suspected conduct engaged in by incumbents to reduce production and supply, in order to increase prices to the detriment of consumers.

And there is a third category of cases concerning alleged collusion between incumbents.

Just to understand the type of situation the European energy market is in, look at the main import routes for gas, both the East West and the North South pipelines. We have found that transit capacity is reserved fully for ten years by the existing incumbents. This means very limited opportunities for new entrants if we let this situation persist.

The temptation for abusing the situation generated by current market structures to the detriment of competitors and consumers is substantial.

We have studied in detail the actual running and dispatching of the power plants in six Member States – 1 billion of data points, plant by plant, hour by hour. We have found pivotal market power in many cases for many hours and we have found substantial deviation of the wholesale price at the power exchange from the competitive price – which would result from applying correctly the merit order. For the German electricity market this has meant for 2005 a price of 50 Euro / MWh at the power exchange instead of 30 Euro / MWh - or 45 Euro / MWh if the CO_2 certificates of the period are priced in (which however were given for free to the generators at the time). In other cases, we found other merit curves – France is in a particular situation with its very high share of nuclear generation.

All this means that consumers are paying too much. Analysis has shown that prices in countries which have not broken the Gordian knot – i.e. who have still fully vertically integrated incumbents - have been in general consistently higher than those who have fully unbundled.

This means that the Third Energy Package targets right: strengthening regulation; filling the regulatory gap between our borders, with the proposed new coordination agency; and emphasising the unbundling remedy, be it via full ownership unbundling, operation of the network by an Independent System Operator, or substantial additional regulatory safeguards imposed on the Transmission Operator which should ensure compliance with the requirement for independent operation and investment planning for networks also in the case of vertically integrated companies, as far as they will remain.

Once we have agreed that the proposed measures will generate more competition in Europe's gas and electricity markets, the second question is: Can we afford more competition, given the EU's outside dependence in the energy field? Or are we scrubbing the deck while the ship is sinking?

Outside Dependence: are we scrubbing the deck while the ship is sinking?

We all know that the European Union is heavily dependent on outside supply in the gas market. The EU is dependent on a very small number of outside suppliers: three of them cover the bulk of our gas imports, with only one of them in the EEA area.

The EU therefore needs close cooperation with its suppliers and a strong trading position, in order to ensure a balanced situation. But this strong position cannot be achieved on a national base alone, not even by the largest Member States. Only the EU market as a whole will have the necessary weight to keep the balance.

This is where the promotion of a competitive energy market in the European Union gains its strategic dimension for Europe's energy futures. Without competitive markets open between Member States the integration of gas and electricity markets in Europe will not work. Market opening is the underlying condition and the direct prelude to market integration. And it is the larger market base of an integrated EU energy market that is the only sustainable way to balancing outside market power.

In its communication on an energy strategy for the Union, underlying the proposals for the third energy package, the Commission has looked at this dimension to substantial detail. And in its merger control decisions the Commission has taken systematically a positive attitude on market restructuring leading to a strengthening of energy structures in Europe - but not at the price of competition. You will find this in all major merger decisions for the sector which have been taken recently: GDF/Suez; EON/MOL; Iberdrola/Scottish Power; and others.

Let us then move on to the third test: How future proof are the measures proposed. How do they stand with the overarching climate change and renewables objectives - the famous 20% targets: 20% less CO2, 20% share of renewables in the total energy mix, 20% energy saving.

How does more competition align with the Union's climate change and renewables objectives?

The proposals tabled by the Commission in the January climate change package have set a clear framework: reform of the ETS – the European

Emission Trading System, and fair burden sharing are core principles. Does more competition help or hinder the achievements of these goals?

There is one single common denominator for the Commission's approach to energy market integration and to climate change: the use of market based instruments wherever possible.

This gives a key role in the climate change package to the fundamental reform of the ETS by 2012. But the ETS CO2 trading system can only work properly if competitive energy markets set the right price signals. Otherwise we will see windfall profits, distorted investment signals, and perversions of the trading market - and the system would rapidly lose the credibility it needs for being the generator of a radical reduction in Europe's emissions of green house gases.

The Commission has made it clear that a market based approach is the only stable base for climate change sustainable in the long term. But it has also acknowledged that subsidies will be needed, where we are faced with market failure. The new modernised approach to State Aid rules that the Commission has developed, is setting the right framework. In the revised Environmental State Aid guidelines of last January the Commission has increased the limits for subsidies by 50% across the board to provide that launch pad.

State aid will help where we find market failure

Let me add here some more general remarks on the Commission's state aid policy in the energy field. State aid can be vital for development and the transition to a market situation which otherwise would not take place, but we must be careful that the means will not become the goal. This is the very essence of a modern interpretation of Article 87 and 88 and the strict framework set for public intervention by Member States by these articles, as far as public intervention falls under Article 87(1). The European Commission's recent action in a number of fields in the energy sector has set clear sign posts:

- the Commission has taken generally a lenient view on public subsidies which help facilitate the transition – we have done so under the Commission's so-called stranded cost approach, also in the decision taken with regard to the electricity sector last year concerning this country,

- we have allowed for aid for the decommissioning of nuclear sites – however under strict conditions and only as far as the polluter-pays principle is not slapped into its face,

and

- we have analysed power purchasing agreements – the so-called PPAs – under the same perspective but only as long as they can be justified as a transitional measure under the stranded cost approach.

But we will have to look very carefully at measures which transfer resources to certain large users to the detriment of a competitive development – regulated tariff schemes in a number of Member States are a case in point. The Commission has opened procedures in a number of these cases.

Back to the essentials

Let me draw three conclusions from the above:

- Competition plays a key role for Europe's energy futures. Current decisions and cases are setting the direction,

- National isolation of energy markets will not be a viable strategy in the long term. As a consequence, national regulated tariffs will be neither;

- We must provide an acceptable path for the transition. This also means that we must develop the right strategy under the EU's State Aid rules to transit tariff systems to a competitive market environment.

There are therefore difficult tasks ahead. But we can be confident that the overall direction is right. The measures proposed in the Third Energy package aim at:

- cutting the vertical link where it impedes competition and leads to market foreclosure,

- This will allow EU-wide market integration and mitigate concentration in national markets,

- It will bring more liquidity to our electricity and gas markets and provide for real competition, clearer price signals and more energy security.

Member States, companies, competition authorities and energy regulators will have to take position on the core issue, as far as more competition is concerned: do we need more structural remedies, or can we rely on behavioural remedies. We have done an extensive review of remedies used in electricity and gas markets by regulators and competition authorities in Europe which we have discussed with the ECN – the European Network of Competition Authorities.

In balance we find that the time has come to cure the systemic problems of gas and electricity markets in Europe at the root – by taking clear structural measures. There will be sometimes hard decisions to take but do not forget: Customers must be confident that prices are fair if we want to build Europe’s energy futures and tackle climate change.