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Recent developments in the European Gas Sector

- A Competition Perspective

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Dr. Herbert Ungerer

Director, DG Competition

European Commission

Ladies and Gentlemen,

Thank you for giving me the opportunity to speak this morning to this distinguished audience[1]. Energy is one of the most important issues for the EU. The European Commission brought forward the Strategic Energy Review on 10 January and intends to make formal legislative proposals later this year. In March the Heads of State adopted a comprehensive Energy Action Plan, based on the Commission's proposals.

A single competitive European energy market will improve security of supply, help to ensure that we meet the climate change goals at least cost, and provide cost-reflective prices. We will see full liberalisation of gas markets across the EU on 1st July of this year, with a number of minor derogations for some Member States. However, the Commission's in-depth inquiry into the gas and electricity sectors as published on 10 January as part of the energy package has shown that we are far from having competitive energy markets at this point in time. The inquiry identified a number of key barriers to competition in these markets. Let me briefly recall the main problems identified in the gas markets:

- Excessive concentration. At the wholesale level gas markets remain mainly national in scope and the incumbents largely maintain their dominant positions from the pre-liberalisation period.

- Vertical foreclosure. The current level of unbundling of network and supply interests has severe negative repercussions on market functioning and on incentives to invest in networks. Incumbents tend to view their networks as a strategic tool for defending their market position. This is a

[1] The opinions put forward in this paper are the views of the author and cannot be relied on as statements of the European Commission. Thanks are due to Mr. Alexander Gee, European Commission, DGCOMP, for contributing to this paper.

major obstacle to new entry and ultimately the most profound threat to security of supply.

- Lack of integration between markets. Cross-border sales do not currently impose a significant competitive constraint on incumbent's conduct. Insufficient or contractual congestion of cross-border transport and transit capacity and different market designs undercut market integration.

- Lack of transparency on the markets. There is a lack of reliable and timely information on the wholesale markets, the supply and demand balance and the use of the networks. The incumbents generally have this information, given their market position, but new entrants do not—a massive barrier to entry to these markets.

- Deficient price formation mechanisms. Users have no confidence in the price formation mechanisms, which often do not seem to reflect the balance of supply and demand.

- Limited competition in retail markets, and persistent problems on balancing markets.

In essence, we have found:

- A profound structural deficiency: a systemic conflict of interest through insufficient unbundling of production, supply and networks

- A persistent regulatory deficiency: a regulatory gap where borders are crossed.

Both hinder our markets to grow together into an integrated market.

And, resulting from this, combined with our outside dependence in the gas markets:

- A lack of liquidity for the new entrants that does not allow our newly liberalised markets to work.

In the Strategic Energy Review of 10 January, the European Commission has taken a broad view of the global challenge, the market situation and the external supply constraint which we are facing. It has identified stringent goals for:

- limiting global warming and a shift to renewable energy sources
- promoting security of supply

And,

- The completion of an integrated, open, EU-wide energy market in order to cope with the deficiencies that we have established in the Inquiry.

Let me here only mention the main points:

- Review of regulation, for making the 2007 market-opening date fully effective,

- Clearly identified priorities for the upgrading and construction of new infrastructure, with the Nabucco project as one of the new priority links.

- Intensified dialogue with major external suppliers, reaching from Russia and the Caucasian region, to Algeria, the Near East and Africa.

And

- Intensified application of antitrust to combat anti-competitive market blocking, Open gas markets will be an essential element of this comprehensive strategy. Let me therefore have a closer look at three main elements which will determine strategy in this sector: upstream access to supply, access to transport and distribution networks, and downstream access to customers.

Access to gas

46 percent of our gas consumption is produced in the EU and 13 percent come from Norway, thus nearly 60 per cent from within the EEA, with 24 percent currently imported from Russia, and 10 percent from Algeria. However, this is changing, as is well known to everyone at this conference. Our domestic production is decreasing and our imports of gas will increase substantially in the coming decades. To ensure that companies in the EU have sufficient access to gas we will have to set the right investment incentives. But in doing so we must also make sure that the possibility of future diversification of supplies is kept open, in order not to jeopardize our future security of supply for some short term gains.

Let me add some comments here.

- Diversification of supplies will be the essence of future energy security for the Union. We cannot accept the continuation of a situation where most of the essential pipelines leading into the European Union are contractually blocked for ten years and more—not for the existing pipelines, and even less so for new facilities to be built. As will be known to most of you, the EU disposes of an efficient instrument for ensuring the delicate balance between investment incentives for building new facilities on the one hand, and ensuring Third Party access to our supply pipelines and to the LNG terminals on the other. Under Article 22 of the EU Gas Directive, energy regulators can approve—with agreement by the Commission—derogations from third party access rules for new infrastructure capacity under certain conditions. We have approved a number of derogations, particularly for new LNG re-gasification facilities but also for new gas pipelines within the EU. In these cases we have to weigh up the advantages to competition from the additional investment in the new facilities against the loss of regulated access for third parties—particularly when exclusive use contributes to maintaining the current downstream positions of the incumbents and the shutting out of new entrants.

However, the exception cannot become the rule. If we want to bring more competition to the markets and therefore lay the base for future diversification, we will have to screen carefully the requests for derogation, particularly where incumbents control the entry points—both as regards length of derogation as well as the degree of exclusiveness of use.

- The European Commission supports the restructuring of companies, as long as the restructuring serves market development and does not monopolise markets. Two weeks ago, the Commission gave the green light to the merger between Statoil and Hydro. However a close look at the effects of those mergers is needed as regards potential coordination effects both upstream in the supply markets and downstream in the regional or national markets. In Statoil/Hydro, such effects were not established in the current markets—in other cases they may be.

- As regards coordination effects at the upstream level, the Commission has shown that it will act when needed—for example in cases such as the Norwegian gas committee GFU for joint selling of North Sea gas earlier this decade. Upstream market coordination can easily translate into downstream market partitioning or market foreclosure. Distorted competition upstream due to monopolies or anti-competitive agreements with competitors reduces the efficiency of the market, discourages investment, and hinders customers from diversifying their sources of gas. Linking upstream supply agreements or participation in gas exploration and joint field development with downstream customer allocation freezes market development and undercuts diversification. In the long run it is counter-productive for all—and it has a high risk of falling foul of competition rules. .

Access to networks and infrastructure facilities

As is well known, effective unbundling is at the centre of the conclusions of the Inquiry and of the Commission's proposals of 10 January. We view the effective unbundling of networks from supply interests as the key for the creation of a European wide integrated market. Bringing a European dimension to our energy markets is the very basis of diversification of supplies and therefore of energy security.

As the Inquiry has shown, Europe is still largely living in the traditional system of vertically-integrated gas and electricity companies which tend to view their vertically-integrated networks as a strategic tool for maintaining their monopoly positions. For our outside supplies this means that we are basing our energy futures on nationally closed off systems which compete for the best contracts with outside suppliers for serving their national markets. What we need for the future is a system where gas companies and new entrants can purchase gas from any outside supplier in any part of the Union, and where our transport infrastructure provides the necessary facilities for that. Only fully unbundled networks which can link up with each other, without disincentives to doing so, can provide the gas transport infrastructure platform that we need for that.

In March the European Council agreed on the need for "effective separation of supply and production activities from network operations", and set out a number of detailed requirements that any such solution would have to fulfil:

- Equal and open access to transport infrastructures
- Independence of decisions on investment in infrastructure
- Easy integration of new plants into the network—for gas this must also include easy access to the necessary "hinterland" for new LNG terminals
- A new degree of coordination and integration of TSOs, the transmission system operators—without infringing competition law, very difficult to imagine with structures which integrate network and supply functions

It is hard to believe that these stringent requirements can be fulfilled without a clear cut full structural separation of network from supply interests, and therefore full scale ownership unbundling.

Access to customers

Without ready access to customers new suppliers cannot enter a market and competition cannot develop. Ready access to network capacity for new entrants is one condition. Another one is that incumbents cannot block access to customers by covering the market excessively with long-term downstream supply contracts. National competition authorities are increasingly addressing this issue. The action by the German competition authority against EON Ruhrgas concerning the foreclosure effects of its long-term gas supply contracts with Stadtwerke, or gas resellers, can serve here as an example.

As is well known, the Commission is focusing on this issue as a matter of priority. The procedure against Distrigas—the dominant gas supplier in Belgium—has entered its final phase. In April the Commission has market-tested commitments submitted by Distrigas to address the foreclosure concerns. The replies to the market test are currently being assessed.

Our approach aims to limit the foreclosure effects resulting from long term downstream contracts concluded by market dominant companies. There is no point in handing out with one hand liberalisation and taking it back with the other by locking customers in an excessive manner into long-term contracts. The commitments now offered and published on our website could show the way forward.[2] In essence 70% of the volume contracted by the dominant operator with industrial customers and electricity producers would come back to the market every year and therefore would be contestable. The dominant operator could not tie up more than 30% of its sales or 20 % of the market for more than 1 year whichever is larger. No contract could be longer than 5 years, with some justified exceptions; and no longer than 2 years as far as gas resellers are concerned.

It will be up to the dominant operator to develop its contract portfolio in a way that fulfils these requirements. We believe that this approach will address concerns about the locking out of competitors, while leaving the dominant operator with maximum flexibility to tailor its portfolio of contracts to the desires of its customers. Once the current assessment of the market test is completed, a final decision making these commitments binding on the operator will be taken by the Commission. We believe that such a decision could also provide guidance to other undertakings with single or jointly dominant positions in the sector on how to manage their portfolio of downstream customers in accordance with the requirements of EU competition law.

Final remarks

We understand that there can be objective justifications for long-term upstream gas contracts in certain circumstances such as large investments in pipeline

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[2] http://ec.europa.eu/comm/competition/antitrust/cases/index/by_nr_75.html. See also Art 27(4) notice *OJ C 77, 05.04.2007, p. 48-49*

connections or production facilities. However we must not allow these long term contracts to be replicated downstream, thereby undercutting entirely the very purpose of an open market. Regulators will have to think proactively how to counter the danger of concentration that can result from current upstream contractual patterns. More frequent use of regulatory measures such as gas release programmes of sufficient scale could be a way to ease the liquidity gap that we have identified in the sector inquiry and allow more market entry.

We also believe in the need in a number of circumstances of partnerships and joint projects in order to secure future gas supplies. We need joint development of gas exploration and field development—at a time when there is the spectre of underinvestment in exploration of fields in some of our major supply regions. But cooperation cannot come at any price. We have to agree common rules of the game—and respect for competition rules and free market development is a fundamental one. Development efforts and partnerships must not be turned into a cartelisation or monopolisation of markets whether upstream or downstream. This would be a direct route for undercutting future market development and security of supply, and would ultimately be to the disadvantage of both our suppliers and our consumers.

Let me add a word in this context on our relationships with our Third Country suppliers, including our largest one, Russia. The EU has stated on a number of occasions that the EU and Russia "are, and must remain, in a position of mutually beneficial interdependence." Third Country energy companies entering the EU will be screened under EU competition law no differently from EU enterprises, as regards their impact on the competitive market structure. But this also means that one will have to take into account both the upstream position in the energy supply market and the downstream acquisitions—as we would do with any other enterprise screened under EU competition law. Clearly common open regulatory principles in upstream supply markets would facilitate such a competition analysis.

The Sector Inquiry, the Strategic Energy Review of 10 January and the subsequent guidance by the Energy Council and the European Heads of States have shown the way forward towards a fully competitive energy market in Europe. We will see a new legislative package on the table of the Council of Ministers and of the European Parliament in autumn. Dealing with the structural deficiencies of the market and particularly the unresolved conflict of interests resulting from insufficient unbundling of networks will be at the core of this package. This unresolved structural question in the European energy markets holds up the development of open markets, undermines investment signals, undercuts security of supply and incites to anti-competitive behaviour. It forces the European Commission to open procedures to deal with these situations under competition law, as it has done last week with the opening of procedures against two major European companies in the gas sector.

In conclusion, let me quote the European Competition Commissioner, Neelie Kroes: “simply toughening regulation will not be enough; we need structural solutions to ensure that our energy markets deliver competition and security of supply”. We believe that we should work together towards this objective, in order to take the European gas market forward.

Thank you for your attention.