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A new European Energy Policy

- The Importance of a functioning Internal Energy Market

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Thank you for giving me the opportunity to pass on a few messages from a competition point of view on the second day of this conference —and to convey to you the greetings and the encouragement of Neelie Kroes, the European Competition Commissioner.

This conference takes place at the cross-roads of the future development of the European electricity sector. The sector must make up its mind if it will embrace in time the necessary structural changes—and will be able to live up to the central role it will have in attaining the European Union's climate change goals, as set forth by the Commission's Strategic Energy Review of 10 January and the European Heads of State at the European Council of March 8/9.

The broader aspects of the Strategic Energy Review have been discussed at this conference, reaching from the low carbon goals and the energy mix to energy security and external relations. The targets are ambitious, as everybody in this room realises: by 2020 20% lowering of carbon emissions; 20% share of renewables in the overall energy mix by the same date; 20% increase in energy efficiency. And the electricity industry will have to deliver much of this.

The issue ahead will be how Europe can attain these objectives at affordable cost to its consumers and its industries, all dependent on energy. And how we can do this without dampening economic growth in the Union on which we depend for delivering the Union's overall political, economic, and social targets. I believe that there is now a general conviction that the basis for this will have to be a European-wide integrated market—with the efficiencies that only competition can enforce.

The full opening of the electricity market in the European Union is only a fortnight away—1 July of this year, and a number of Member States have implemented liberalisation well before that date. The consensus on market opening is there. The issue now is to make market opening a market reality. We have to deliver to the consumer and to industry—real choice, real transparency and prices they consider fair, as we move towards a low carbon world.

As most here will know, we have extensively screened the energy sector—both electricity and gas—during an 18 month exercise under competition law. The results of this Sector Inquiry provided a basis for the Strategic Energy Review of January.

The findings on market reality were bleak. Three years after the adoption of the second EU electricity liberalisation directive, and on the eve of full formal EU-wide market opening, we found substantial deficiencies in the working of the markets. As set out in the Final Report on the Inquiry, published on the 10 January in detail as part of the Strategic Energy Review, the result after one decade of efforts to make electricity markets work in Europe is as follows:

Persistent high level of market concentration:

Most wholesale markets remain national in scope, with high levels of concentration in generation, which gives scope for exercising market power. Analysis of trading in power exchanges shows that, in a number of them, generators have the scope to raise prices. Analysis of generation portfolios also shows that the main generators have the ability to withdraw capacities to that effect.

Inadequate unbundling of supply and networks

Vertical integration of generation, supply and network activities has remained the dominant feature in many European electricity markets. This reduces the economic incentives for the network operators to grant access to third parties.
Third Party Access as mandated by the Electricity Directives cannot counterbalance this distorted market structure – our regulators are engaged in an uphill struggle, which they will find hard if not impossible to win as long as the basic imbalance is not corrected.

Lack of EU-wide Market integration:

The low level of cross-border trade is insufficient to exert competitive pressure on—dominant—generators in national markets. Integration is hampered by a chronic lack of interconnector capacity.

There is a persistent lack of adequate incentives to invest in additional capacity to eliminate long-established bottlenecks. Congestion revenues do not flow where they should. Just quoting from the results of the Inquiry: three out of ten operators surveyed have not used at all congestion revenues for investment in infrastructure interconnectors. In total a bare 250 million € out of 1.3 billion over a five year period (2001 -2005) have been used for that purpose—and this at a time of systemic lack of interconnector capabilities.

Lack of transparency

There is a serious lack of transparency in the electricity wholesale markets that is widely recognised by the sector, with the exception of only a few markets. More than 80 percent of market participants were not content with the current levels of transparency.

And all this leads to deep

Doubts about price formation mechanisms

the main issue which is destroying the trust between the electricity industry and customers.

We have carried out in the context of our investigations a refined analysis of the working of the electricity market in six Member States for the period 2003 - 2005, by mapping on an hourly basis optimal dispatching of plants , as it would happen in a fully competitive market, and comparing that price with the respective power exchange wholesale prices. We find substantial mark-ups between the competitive price and the power exchange price throughout the period, in a number of cases far above any explanation by the increase of input fuel prices. For example, in one of our major Member States we have established an average mark-up of nearly 30% during the period, and more than 70% for 2005 if the CO2 price is not taken into account. We accept that the opportunity cost argument for CO2 certificates is used to explain part of mark ups for that year – even if certificates were given mostly for free. We are however all the more astonished that some companies are now talking about further price increases resulting from possible auctioning of certificates, when certificates have always been said to have been priced in on an opportunity cost basis.

We will have to gain consumer trust in the price setting mechanisms in the electricity sector or we will be faced with massive requests of price regulation for end users, which can at best serve as a short run remedy and will run counter to the development of competitive markets in the long run. Energy liberalisation can only be successful if consumers are convinced that competitive markets can guarantee public service at reasonable cost.

Ladies and Gentlemen

We will have to address the stumbling blocks that stand in the way of a fully competitive integrated European market. Liberalisation of markets cannot stop half way. It must bring about the competitive pressures it promises in order to deliver the advantages of competition and choice to the consumer.

On the way to a competitive market we find, in Europe, three major stumbling blocks:

- The structural deficiency: the systemic conflict of interest through insufficient unbundling of generation, supply and networks in a number of Member States.

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

- The deficiency in liquidity: liquidity is lacking for allowing our markets to work.

While we face major deficiencies, we also find, following the publication of the Strategic Energy Review in January and the European Council of March, a broad consensus on the need to address these deep structural problems head on. Of course, on some issues the detailed approach will still have to be discussed when the European Commission puts its regulatory proposals on the table in September, in compliance with the mandate given by the European Council.

The third internal energy market package that we will see as a consequence on the table of the EU Parliament and the EU energy ministers in September is intended to give full effect to the first two liberalisation packages and the opening of the energy market in the European Union. Opening the markets effectively will be the basis for moving forward towards a low carbon economy in Europe and for securing supply at fair price. As the Commission has announced, the main focus will be

- Addressing the structural issue. We must achieve effective unbundling as a necessary condition for taking the market forward

- Setting up a regulatory system based on our existing national energy regulators, that can work in practice and fill the regulatory gap at our borders

- TSO (transmission system operators) cooperation, once the vertical integration issue is out of the way. This should move us nearer to the dream of a European wide copper plate and bring liquidity to our markets.

All of this is currently being worked on and it is too early to go into any detail. We have seen a lot of thoughtful contributions to the process during recent months, not least by the European electricity industry and by the regulators. Earlier this month the European gas and electricity regulators (ERGEG) published a comprehensive package of analysis reviewing in substantial detail the basic principles of unbundling, legal and regulatory framework issues, network regulation, ETSO cooperation and transparency.

Let me just shortly comment on two issues that are crucial for the future debate:

Effective unbundling

The EU energy ministers have given us a demanding list of requirements to which any solution in the EU must respond:

- Equal and open access to transport infrastructures

- Independence of decisions on investment in infrastructure; and this includes independence from supply and generation interests

- Ease of integration of new power plants, particularly those based on renewables

- New mechanism for TSOs to improve coordination, filling the cross border gap and ending the messy situation of 27 different systems that we are still facing.

Just run down this list. In clear terms it means:

- Non-discrimination

- No influence whatsoever of upstream on downstream network investments

- It means proactive investments to connect new power plants of competitors

- And it means much closer coordination between TSOs, be it via Regional System Operators or more traditional mechanisms—but this without tying in supply interests and without market sharing which would fall foul of competition rules and would raise our immediate attention

Taken all this together, the European Commission has found, as is well known, that full ownership unbundling would be the most natural and in the end least burdensome solution—as has been found to date by more than half of the EU's 27 Member States who have implemented this structural change. Any solution short of full ownership unbundling will require complex regulation and detailed oversight, as we will have to emulate by regulation an ownership unbundled situation, in order to ensure the attainment of the objectives set out above. We are now comforted in this position by the clear statement in favour of this solution of those who should know best—ERGEG, the European energy regulators.

Let me then turn to my second point

The substantial strengthening of the regulatory system that we need.

The regulatory system must provide the stable framework that the industry will need. The electricity industry must be able to plan for the huge investments ahead—900 billion € in generation alone over the next 25 years, as plants have to be replaced. It must be able to count on a fair system, in order to play its key role in moving Europe to a low carbon emission environment; and it must have confidence that everybody will have to play by the same rules and that nobody will be allowed to rest on monopoly rents.

The future regulatory system will therefore be at the core of the proposals announced by the Commission. In addition to the resolution of the structural issue we need a system which

- Makes national regulators stronger and guarantees their independence

- Interlaces their action at the European level. Our companies need a European market dimension, and a European market dimension needs a European dimension in regulation

- We need a system which streamlines and simplifies current rules

The structural issue of separation of supply and networks, and the regulatory issue of developing the European system of regulation will dominate the forthcoming debate. We have interesting weeks and months ahead for the European power market.

At the same time,

Application of competition rules will proceed. The European Competition Commissioner, Neelie Kroes, has left no doubt that we will apply the full range of competition policy tools to remove the remaining barriers—as we have shown over recent months during the vetting of a number of high profile merger cases, by initiating sweeping investigations at company sites and opening related antitrust procedures, and by applying EU state aid rules in fields such as regulated tariffs for specific customer groups.

We will also have to find fair solutions to the issue of long term customer contracts in the electricity field. We need solutions which comply with current needs of certain customer groups, without locking competitors out of the market in the long term. We cannot sacrifice general long term consumer benefits which the competitive market will bring for the sake of privileged contractual relationships of a few large users with the dominant operator which can foreclose the market for a long time. Market participants are called upon to work out the right contractual solutions—but they will be well advised to keep the avoidance of market foreclosure in mind if those contracts should not fall foul of competition rules.

Let me conclude,

We are at a decisive turning point for the electricity sector in Europe. Europe-wide market operation is in reach. We will have to resolve the structural and regulatory issue if we want to reap the benefits of a Europe-wide market. And a Europe-wide market is the only viable base for the power industry in Europe to offer fair prices on a sustainable basis; to attain the efficiencies needed to make the huge investments ahead under best conditions; and, most important, to have the necessary framework in place for its leadership role in developing a low carbon emission future.

Thank you