M. Monti keynote speech Energy Day 21/9/2004

Energy liberalisation: moving towards real market opening

1. Introduction

I would like to begin by thanking you all, both representatives from competition and regulatory authorities for coming here today. As the second liberalisation package has entered into force this summer, it is time to take stock of the recent developments and discuss the state of competition in gas and electricity markets. Moreover, the modernisation of antitrust rules reinforces the need to discuss synergies between the work of the different authorities to improve competition conditions overall.

Despite the progress made in liberalising the energy markets, the current level of competition is not encouraging. In most national markets, customer switching rates are modest, substantial barriers remain for new entrants, market structures are highly concentrated and, last but not least, a single European energy market has not been achieved.

The reasons for this situation are many. I know that several authorities you represent have recently published in-depth investigations into the state of competition on your national energy markets. And concrete measures to improve the functioning of these markets have been proposed, including at the legislative level, to tackle the problems identified. Reflections on the obstacles to real market opening and the need for further liberalisation measures are also underway within the Commission. Mr. Lamoureux, amongst others, has highlighted this in his intervention this morning.

Today, I would first like to explain our efforts to put flesh on the liberalisation bones. As you know, we have used numerous tools available in the European competition tool box: antitrust enforcement, merger policy and state aid control. In this respect, the Commission has a number of specific powers not available to national competition authorities which allow it to tackle also government-induced distortions in the market.

I will then touch upon a recurrent issue underlying recent energy cases treated by the Commission's competition services: the apparent tension between competition principles and measures to ensure security of energy supply. How can competition authorities, during their odyssey of overseeing energy markets, ride the rough seas without being drawn, on the one hand, into purely dogmatic application of antitrust rules without full consideration to the effects of its intervention? On the other hand, we should also avoid the trap of too prudent an antitrust policy because of overestimation of the security of supply arguments. We must avoid falling in the hands of both the sea-monster Scylla and the whirlpool Charybdis.

2. What have we been striving for so far?

Two waves of liberalisation Directives have challenged what was perceived, from a competition point of view, as inefficiencies, excessive prices, overinvestment and inertia in the largely monopolised energy markets in place at the time. The framework which has been created has focused essentially on third party access to networks, in addition to formally abolishing the legal monopolies. The ultimate objective though of the entire liberalisation exercise was and still is to ensure the fundamental principle of freedom of – eligible - customers to choose, from a variety of players, *the* supplier which would

respond to their specific needs with the best offer. We have tried to achieve this objective both through our antitrust and merger enforcement as through wider competition advocacy, endeavouring to ensure that the liberalisation Directives would, beyond statements of principles, allow for real rivalry on the market.

In order to kick-start competition overall, we consider that three pre-requisites should be addressed: first, effective access to the networks, second, supply competition at the wholesale level (gas production and electricity generation) and third a realistic ability for customers to switch suppliers.

The Commission has put great efforts into tackling access to the network issues, even before there was a regulatory framework ensuring this. I can refer in this respect to the saga of the Marathon case dealt with by my services. In this series of cases, the Commission addressed the practice of a number of established, vertically integrated operators, not to allow a new entrant to ship Norwegian gas through their networks. We have also dealt with problems concerning access to electricity interconnectors, like the UK-France interconnector. These investigations have been closed by means of settlements or in the context of merger cases, like the Veba-Viag merger leading to the creation of EON. I have also steadily promoted, in the context of the negotiations about the second liberalisation package, pro-competitive measures, including full ownership unbundling of energy networks.

As regards obstacles to supply competition, several actions have been undertaken. First, joint sales practices in the gas sector, which artificially reduce the number of upstream competitors, have been dealt with in the Norwegian GFU and Danish Duc-Dong cases. The latter case was dealt with in close cooperation with the Danish competition authority. Through these investigations, a more competitive market structure has emerged.

The territorial restrictions cases, also addresses supply competition and the way in which the upstream gas sector has been traditionally organised. Our intervention, slowly but surely, should lead to removing one of the obstacles against the development of gas-to-gas competition between European importers. The web of destination clauses can indeed be compared with classical demarcation cartels, although its set-up is not purely horizontal, but takes place in a triangular relationship with foreign suppliers. The bottom line remains, however, that competition between geographically close competitors is impeded.

A third line of our anti-trust action focuses on long term supply contracts. These contracts are being challenged when they are between dominant operators and key customers and lead to severe foreclosure effects. The Gas Natural/Endesa case relating to contracts between the biggest Spanish gas wholesaler and the biggest gas consumer of the country constitutes an early example. The Commission and several NCA's currently have a number of ongoing investigations relating to this key issue. This topic has been addressed in detail in this afternoon's session. I welcome the close cooperation between the Commission and the Bundeskartellamt on this issue, in the context of the ECN.

The initial phase of antitrust enforcement in the energy sector, has been one in which we have tried, largely by means of settlements, to make companies adapt their behaviour on the market. Most cases have been initiated by the Commission in the absence of complaints, as the vast majority of the energy industry still appears hesitant to report distortive practices to the Commission. The policy of settlements has had the advantage of offering quick and effective solutions to a certain number of infancy diseases of the market. It proved

successful in a period where the industry had to come to grips with the concrete consequences of liberalisation.

With the second wave of liberalisation Directives and the world of modernised competition rules the enforcement practice of the past needs to be reviewed. The Commission will focus on the most severe types of restrictive practices brought to its attention. The investigations are thus more likely to lead to formal decisions addressing those practices. Such an approach should also lead to increased transparency as to which practices indeed violate antitrust rules in this area.

The many electricity mergers which the Commission has dealt with in the last 5 years have led to a fundamental reshaping of the industry. The Commission has, in these cases, accepted a number of innovative remedies offered by the parties to alleviate concerns that competition would be significantly lessened.

In Germany, for instance, the remedies imposed in the merger of VEBA and VIAG, today better known as E.ON, has ended the former cross-shareholdings among all German players. This has allowed for the entry of new (foreign) players, like the Swedish Vattenfall, into Europe's largest electricity market. Another example is the entry of EdF in Germany's EnBW. In return for the disappearance of a potential entrant into the French market, the Commission accepted EdF's withdrawal from Compagnie Nationale du Rhône (CNR) to establish an independent player. Furthermore, EdF has had to release a significant amount of its generation capacity in the form of auctions in which many players still actively participate. This auction firstly created more liquidity and has contributed to the orderly development of the French electricity market.

Finally, it must be said that all major restructurings in the sector do not necessarily fall within the competence of the Commission.

To favour competition in the energy markets, we must ensure an effective merger policy. I understand, several participants of the Forum, including M. Vasconcelos, have advocated for a strict merger policy. Such policy should be facilitated, in the future, by the formulation of the reviewed standard for mergers. The new merger Regulation is indeed more obviously suited to dealing with anti-competitive mergers in the energy sector, due to its clearer focus on the effects of mergers and consumer harm. We should nevertheless remain attentive as to the medium-term effectiveness of certain behavioural remedies. As you may know, the Commission is carrying out a study into the effectiveness of the remedies it has adopted in a series of merger cases. Our future practice in energy mergers is likely to be shaped also in the light of the general conclusions of this study.

Recent price developments in electricity markets draw our attention to the fact that we have to remain vigilant and, indeed, steadfast in order to ensure appropriate market designs in a sector where market power can already be present where parties have market shares which would not be problematic in other sectors of the economy. Reinforcing our merger policy with respect to electricity markets will go hand in hand with a broader assessment concerning the functioning of these markets. These markets indeed have a particular structure which facilitates both collusive behaviour and the exercise of market power.

I cannot provide a full picture of our efforts to promote supply competition without mentioning our state aid record in the energy area. A series of complex cases have been dealt with involving aid to national incumbents. Amongst

others, in tackling stranded costs issues in the electricity sector, we have endeavoured to find the right balance between promoting effective liberalisation and respecting legitimate interests. We have therefore approved schemes limiting state intervention to compensate only for losses that have actually been incurred.

3. Between Scylla and Charybdis?

Let me now turn to the security of supply issue. We have, in our enforcement practice, tried to avoid, on the one hand, the excesses of blind application of antitrust rules and, on the other hand, the effusive calls for preserving "security of supply" at any price. We have nevertheless been criticised for ignoring the impact of our action on security of supply. Claims have been made, for instance, that prohibiting joint sale agreements would hamper the exploration of gas fields, that reducing the acceptable length of wholesale contracts would leave consumers in the hands of volatile price movements and hinder industrial investments. Moreover, it has been argued that obliging initiators of new infrastructure to grant access – against payment – to their future facilities would threaten the viability of such projects.

One difficulty when addressing these arguments is that security of supply is used as an umbrella for many different concerns relating, on the one hand, to the infrastructure and, on the other hand, to energy supply.

Different types of risks can indeed threaten security of energy infrastructure and thereby energy supply: technical risks relating to terrorists threats or other incidents affecting the network, as happened recently with the gas explosion in

Ghislengien in Belgium. This type of risks has few direct implications for competition policy.

A second type of risk relates to the commercial dependence on external sources of energy. This risk must however be balanced against the benefits of liberalisation both for consumers and for those companies who seize market opportunities in the new framework. For me, the concept of competition means that foreign suppliers should not be prohibited from entering European markets and competing on the merits. Their presence in the downstream markets indeed fosters both competition and security of supply, as does the presence of European downstream operators in upstream projects abroad.

A last type of risk, which I take very seriously, is the failure to mobilise sufficient investment for ensuring electricity and gas supplies for Europe. I believe that our enforcement practice has duly taken the concern of investment needs into account.

The examples I have provided earlier show, first, that our merger policy has allowed for a certain number of large energy companies to develop activities across Europe. These larger companies should be in a position to find the funds necessary to make the investments needed. The fact that large companies would more easily participate in funding upstream projects can however not be accepted as a justification in merger cases: the creation of such companies will only be acceptable if it does not significantly impede effective competition.

Moreover, the risks taken upstream, by importing, for instance large volumes of gas for a long period, have traditionally been offset by binding downstream customers on a long term basis. Such practices however also lead to foreclosure and rigidity in the market, thereby endangering the liberalisation process.

We therefore have to get the balance right between security of supply arguments and competition objectives. This is not an easy task. Comparing the long term contracts encountered in the energy sector with credit risk management developed in other sectors of the economy will provide useful guidance in order to find the right balance between risks and guarantees.

The fundamental principles on which liberalised and competitive markets are based are cost reductions and increased efficiency. In the traditional European energy markets, the underlying objective was the assurance of absolute security of supply at unknown, but inherently high costs. Liberalised and competitive markets cannot claim that they will be intrinsically more secure than the earlier world. But, liberalisation should indeed offer acceptable and efficient levels of security of supply at lower costs than before.

4. Conclusion

Allow me to sum up as regards the state of competition in the energy markets.

First, at European level, a legal framework has been set up for access to energy networks. It will be the Commission's role to ensure, in the coming months, that the existing legal framework is implemented in all Member States in a way which allows for effective right of entry. National regulators will, in parallel, have a crucial role in both shaping the national regimes and in applying them, on a daily basis, in a pro-competitive manner.

Second, an optimal structure for this industry has not been achieved. This should foster a reflection about both weaknesses of the existing legislative framework,

and the effectiveness of our merger and antitrust policy. Why has a single European energy market not materialised?

Some weaknesses in the legislative framework are in my view clear. Doubts about efficient network access arise because energy networks are still largely owned by vertically integrated companies. As long as gas and electricity interconnectors remain controlled by those who have an interest in preserving national markets, a single European energy market will not develop and competition will be kept on the fringe.

We should also seriously discuss to what extent the current problems can be addressed by pioneering antitrust and merger enforcement. I understand several examples of innovative approaches by the Spanish, Dutch and Danish NCA's, amongst others, have been given during the discussion this morning.

I would like to end by calling for *persistence* in the liberalisation efforts to reach real market opening for the benefit of energy consumers. Achieving effective liberalisation is like running a marathon: it is demanding and requires patience. Experience from countries where energy liberalisation started earliest (Scandinavia and the UK), shows that progress towards competition takes time. We should keep in mind that liberalisation in most Member States only took off in 1999 for electricity and 2000 for gas. As a benchmark, it took the UK approximately 10 years, from 1986 to the mid 90's, before gas-to-gas competition really emerged.

This does not mean that we can permit ourselves to become indulgent and allow the many remaining energy monopolies to think they need not adapt to the new framework. I pass on to my successor and to you the arduous responsibility to live up to the expectations the liberalisation process has created with consumers.

It is a Sisyphean task, but one which we have to tackle for the benefit of the competitiveness of our industry and the welfare of our citizens.

This task will not only require the coordination of the actions undertaken by all present here today, but, *above all*, a pro-competitive stance in the arduous decisions we will all have to take. I trust the ECN will become the forum where this, much needed, competition-friendly, cooperation will flourish. Whilst I hope to have contributed effectively to the energy liberalisation edifice in the last years, I am confident, when overseeing the quality and spirit of the audience today that the process is in good hands.