Emerging competition in European energy markets

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1. Introduction

Thank you for inviting me to speak to such a distinguished audience at a crucial moment of energy liberalisation in Europe. As you know, the Spanish presidency of the Union has decided to push forward with the plans to enhance competition in the electricity and gas markets. It is one of the priority issues for its six months at the steering wheel of the Union. The Commission fully supports this drive from the presidency.

This Spanish approach is all the more convincing coming from a country, which is at the forefront of energy liberalisation, with such welcome initiatives as:

- The gas release programs[1],
- The design of an Iberian electricity market covering Spain and Portugal,

[1] Gas purchased under long-term contracts from producers by incumbents is transferred to interested wholesalers (for further information, see "Discussion document on long-term contracts, gas release programmes and the availability of multiple gas suppliers" produced in the context of the Madrid Forum of January 2002.

and

- Last but not least, the clear calendar for full opening of Spanish energy markets, well ahead of the timetable foreseen by the existing Directives.

All of these national initiatives fit perfectly well into the objective of energy liberalisation: moving from 15 monopolised markets to a single competitive EC energy market with effective consumer choice.

Three common lines of action can be identified when looking carefully at the way energy Directives[2] are drafted and antitrust rules implemented:

1 Guaranteeing free consumer choice

2 Looking after open access to energy networks constituting natural monopolies

3 Warranting free supply competition

[2] Electricity Directive 96/62/EC and Gas Directive 98/30/EC

My presentation will hence be target-driven: I'll endeavour to show how the Commission uses the range of available complementary instruments, to bring emerging energy markets from adolescence to maturity.

2. The tools

The main tools available are liberalisation Directives and antitrust rules. Let me start by briefly summing up the main characteristics of the existing energy Directives.

2.1 Liberalisation

It has indeed been acknowledged politically, from the very start of the process, that for the liberalisation of the energy sector to be a success, the opening-up of the national markets had to be accompanied by harmonisation measures. Effective competition could not be achieved in this area exclusively by means of case law and individual Commission decisions applying antitrust law.

In this perspective, the line of both existing harmonisation Directives on gas and electricity has been, in essence, to realise

a gradual market opening, with consumer choice limited, in a first stage to so-called “eligible customers”. Such staged process, of course, includes the side effect of uneven market opening, as all Member States do not proceed according to the same pace.

Fortunately, a majority of Member States has decided to go further than strictly required by Directives.

This has already produced positive results in practice. Indeed, at EC level, an average of 66 % of electricity demand and 79 % of gas has already been legally freed, creating a vast amount of Community-wide competition. In Spain, 54 % of the electricity and 72 % of the gas markets have legally already been opened up.

This state of affairs constitutes an incentive for the Commission also to proceed with further liberalisation. This is being done essentially by means of two proposals: on the one hand, the so-called “Acceleration Directive” covering both gas and electricity and, on the other hand, the Regulation on cross-border

electricity trades. This process, initiated in March 2001 under the forceful leadership of our Vice-president, Loyola de Palacio, will hopefully be approved during next month's Barcelona Council.

What do these proposals foresee?

A. Acceleration Directive

Let me start with the Acceleration Directive, which includes both quantitative and qualitative aspects. As far as the quantitative aspects are concerned, the proposal foresees to realise full market opening for industrial customers by 2003 in electricity and by 2004 in the gas sector. Full market opening for all final consumers would be achieved in 2005. As far as the qualitative aspects are concerned, the menu reads as follows: reinforcement of the regulated third party access regime (TPA) as a starter and reinforcement of unbundling rules - imposing full legal unbundling on transmission and significant distribution companies - as the main course. The "dessert" will

consist of the mandatory designation of an independent body looking after the sector.

B. Regulation on cross-border electricity trading

As the market opening for electricity has already progressed further than for gas, the need for a more precise framework relating to network access has indeed been felt[3].

C. Rationale of the proposals

But what is the rationale behind these proposals of a technical nature?

A first reason lies in the fact that full market opening from the beginning serves consumers better than phased introduction of competition, with its inherent risk of consumer frustration and loss of confidence in the liberalisation process due to remaining obstacles. Moreover, you are well aware in Spain that uneven market opening may lead to distortions of the level playing field

[3] Energy experts are currently discussing 3 main topics: 1) the establishment of a compensation mechanism between transmission undertakings for cross-border flows of electricity 2) the definition of harmonised principles for cross-border transmission tariffs and 3) rules on the allocation of available interconnector capacity between national transmission systems.

on energy markets. I'll come back to this subject in a few minutes.

Let me conclude this very brief description of the state of play of harmonisation measures by recalling that if the political discussions about the Acceleration Directive at Council level were stalled for a reason or another, the Commission would still have the possibility itself to adopt a Directive on the basis of Article 86§3 EC Treaty.

May I recall to you that the Commission has done so previously in the telecommunications sector. As you know, the Stockholm Council explicitly mandated the Commission to prepare itself for this hypothesis.

Do not believe however that this is the only task DG Competition is working on at present: our main mission in the area of energy is applying competition law – cartel provisions, provisions against abuses of dominant position, as well as state aid[4] and merger control - to the energy sector.

[4] This topic is not addressed in this speech.

2.2 Antitrust policy

Allow me to try to demonstrate how the different antitrust instruments interact and reinforce each other in achieving the three common lines of action mentioned above: free consumer choice; open access to networks and free supply competition.

A. Guaranteeing free consumer choice by challenging consumer lock-in

For decades it has been a traditional practice of electricity and gas suppliers to conclude exclusive long-term contracts with their customers. Such contracts can have the effect of a private barrier to free choice of customers, especially when the supplier concerned enjoys market power or when the entire demand-side is covered by such arrangements, leading to a foreclosure of the market. When all demand is exclusively linked to the dominant energy supplier for long years, competition from actual and potential competitors is impeded substantially.

Let me immediately deny though the commonly heard criticism that we would be opposed to all long-term supply contracts,

thereby threatening security of supply. The Commission is indeed aware of the importance of security of supply. This does not inhibit her from expressing concerns about contracts entered into by dominant undertakings, which tie in important customers on an exclusive basis. The clearest example of our balanced approach in this regard comes from Spain. I refer to the Gas Natural/Endesa case**,** successfully closed by the Commission in 2000[5].

In this case, the former Spanish gas monopolist Gas Natural had concluded a long-term gas supply contract with the leading electricity generator Endesa, which covered all its gas requirements for the foreseeable future and prohibited Endesa from reselling the gas it had obtained. Endesa was hence inhibited from entering the gas market and potential entrants were loosing one of their most attractive clients. In close co-operation with the Commission, Gas Natural and Endesa accepted to modify their agreement, both in terms of volume

[5] IP/00/297 and Fernandez Salas, "long term supply agreements in the context of gas liberalisation: Commission closes investigation of Gas Natural", Competition Newsletter 2000, Issue 2, p. 55 et seq.

and duration. The use-restriction-clause imposed on Endesa was also deleted.

Before turning to the next topic of access to networks, I should underline that DG Competition intends vigorously to pursue exclusionary conduct towards eligible customers, whenever this would be brought to its attention.

B. Looking after open access to monopolised networks

The existence of long-term contracts is not the only specificity of energy markets affecting competition. Another specificity is that gas and electricity are delivered through energy-transmitting networks (gas pipelines or transmission grids) connecting suppliers with their customers. These networks tend to constitute natural monopolies. Open access to such networks is hence essential to enable free supply competition and free customer choice. The so-called "interconnectors" linking distinct national gas or electricity networks create a particular type of such network problems.

The prerequisite to achieve access to networks lies in the obligation, for Member States, imposed by the energy Directives, to open existing networks for interested supplier and eligible customers. The keyword is third party access (TPA). Most countries have opted for so-called regulated third-party access (TPA) based on published tariffs, although a few[6], including Germany, have chosen for the system of negotiated access. You know that the latter should normally disappear if the Acceleration Directive is adopted in its present form.

Whatever of those two systems is selected, third party access creates conflicts of interest for vertically integrated incumbents involved both in energy transmission and trading. Such companies will, in reality, have the tendency to consider alternative energy suppliers not as customers, but as competitors of their trading activities. This is why both the gas and electricity Directives impose on Member States to unbundle

[6] Germany as far as electricity is concerned. As far as gas is concerned, Germany and Austria have a clear negotiated TPA, and the Netherlands, have a hybrid system, with certain characteristics of negotiated TPA.

the activities of such undertakings by means of separation of accounts and separation of management[7].

Fortunately, most Member States - including Spain - have gone further than required by imposing full legal or ownership separation of vertically integrated energy companies.

Now that the "access scene" is set, let me focus on two particular network issues that the Commission encounters most frequently: transmission tarification and congestion management.

a) Transmission tarification

Non-discriminatory access tariffs have been promoted, amongst others, through the creation of regulatory Florence and Madrid fora and by application of antitrust law.

Moreover, during the latest Madrid forum held earlier this month, "Guidelines for Good Practice" on third party access were agreed by the gas industry providing, amongst others, that in order to avoid conflicts of interest, system operators should

[7] The latter only in the context of the electricity Directive.

be sufficiently functionally independent from the supply business[8].

Due to its technical complexity, transmission tarification has, at this stage, rather been a regulatory than an antitrust issue.

However, the extent of regulatory intervention in this area does not inhibit the application of competition law. Under this regime, different concepts are used to check the appropriateness of access tariffs: discrimination, cost reflectiveness and comparison with neighbouring markets (comparative market principle). DG Competition, for instance, obtained in the context of the German electricity merger between VEBA and VIAG to form EON, that the distance component (so-called "t-component"), which was not discriminatory, was largely removed from the transmission tariffs[9].

[8] MEMO/02/27 of 14th of February 2002.
[9] IP/00/613

b) Congestion management

Transmission tarification does not however constitute the last hurdle of the steeple-chase imposed on new entrants in energy markets. Indeed, most energy networks, especially in the electricity sector, have been built, at the time, purely to serve national markets. With market opening and cross-border trades increasing in order to realise price arbitrages, the networks, and especially the interconnectors linking those networks, do not always have sufficient capacity to handle new cross-border transactions. Many electricity lines connecting different grids have therefore quickly become congested.

The Commission's antitrust services focus their attention on access problems to such cross-border interconnectors, especially because in 7 out of 15 Member States there exists a dominant electricity producer and supplier. In such situations, it is crucial to guarantee the possibility of import competition by offering effective access to cross-border interconnectors.

DG Competition focuses on two main issues relating to congested interconnectors: the way in which available capacity is allocated and long-term reservation contracts on interconnectors.

The first issue concerns the way scarce capacity on interconnectors is allocated by the incumbent operators, especially when the latter is still vertically integrated, in other words when it is also active itself in energy trading or supplying. The allocation of interconnector capacity on the basis of the "first come, first served" principle, for instance, lacks transparency and significantly increases the risk of discrimination by vertically integrated network operators. Hence the importance of achieving full legal unbundling in this area, as suggested by the draft Acceleration Directive.

Secondly, congestion is at some borders further aggravated by the transmission capacity being permanently reserved for historical large import contracts concluded before liberalisation. DG Competition is hence investigating currently the import

contracts and capacity reservations which incumbent operators enjoy at some of Europe's most congested borders, as they are considered to have a substantial foreclosure effect[10].

The recent settlement reached by the Commission and Thyssengas in the Marathon case offers an example of action of DG Competition in the area of access to gas networks[11]. Indeed after having refused access to its network to Norwegian gas, Thyssengas offered commitments for granting access to its pipelines, including improvements to balancing, trade in capacity rights, congestion management, transparency and handling of access requests. The "Use-it-or-loose-it" principle was also introduced by this company, which should significantly reduce the risk of congestion on the gas pipelines concerned.

Another striking example of effective enforcement of competition rules is provided by the acquisition of Hidrocantabrico by Grupo Villar Mir and EnBW (EDF)[12]. In

[10] Important achievements have already been obtained in this area on submarine electricity lines linking, on the one hand the UK and France and, on the other hand, Norway and Germany. IP/01/30 and IP/01/341.

[11] IP/01/1641

[12] IP/01/1320

this merger case, EDF and the operator of the French electricity grid, RTE, undertook to substantially increase the commercial capacity up to about 4000 MW on the interconnector between France and Spain. Thus, they created the conditions for greater electricity trade to and from Spain, to the benefit of Spanish customers.

Regulatory and antitrust involvement are however insufficient to develop the interconnection level between Member States. The European network infrastructure indeed has to be substantially improved to allow trade to grow and import competition to become even more effective. The "Energy Infrastructure Package", adopted by the Commission in December 2001, intends, in this perspective, to provide political and financial support for building additional interconnectors[13]. This initiative should improve interconnector capacity and fight congestion and bottlenecks, by facilitating market entry from neighbouring networks. Both security of supply and import competition would

[13] IP/01/1890

hence be ensured. Here again, the electricity connections between Spain/France have been identified as a "critical bottleneck".

This allows me to underline the coherent nature of EC regulatory, antitrust and structural policies. Their combined effect should, at least in the medium term, facilitate the emergence of more competition in energy markets in Europe.

Having dealt with measures intending to enable customer's choice and open access to networks, I now turn to the third and last line of action of the Commission in the area of energy liberalisation, the support to supply competition.

C. Guaranteeing free supply competition

The energy Directives have created the basic legal framework for achieving competitive supply markets especially by abolishing import and export monopoly rights.

The fundamental legal prerequisites for supply-side competition between incumbent operators and new market entrants have thus

been created. Continued high concentration rates or even monopolisation of markets remain nevertheless one of the main reasons for the slower progress in gas liberalisation in certain Member States. Indeed, the existing monopolistic supply situation in many Member States cannot evolve overnight into a competitive market structure, unless structural measures such as the beneficial Spanish gas release programmes are put into place.

One of the ways in which DG Competition has been trying to improve supply competition is by challenging joint marketing agreements of gas producers. Amongst others, it obtained from a series of gas companies who were jointly exploring the Irish Corrib gas fields, that they would market the explored gas separately from one another, instead of jointly, as originally intended. This will help creating a healthy gas supply structure on the Irish market[14]. In this very same perspective, the joint sales cartel practised by the Norwegian gas producers in the past

[14] IP/01/578

- fixing both prices and quantities sold - are being challenged at present in the context of the so-called GFU case[15]. The Commission has welcomed the announcement by the Norwegian government no longer to support these joint sales. Equally, the territorial sales restriction clauses (destination clauses) identified in a series of gas contracts are also being challenged in this perspective, as they inhibit EC importers to resell in neighbouring territories, thereby erecting artificial barriers to import competition.

Such cases are crucial, as the success of gas liberalisation depends to a significant extent on the conversion of the gas column into a supply chain where each operator is free to compete at all levels of the chain throughout the Community.

Increased competition on supply markets, may, in turn, lead to innovation, cost reductions, cutback of inefficiencies and, in some instances, to mergers and acquisitions, which will again fall under the scrutiny of either national or EC merger control. Indeed some undertakings may consider they can only live up to

[15] IP/01/830

the challenges of liberalisation by co-operating with other companies.

Through merger review, the Commission can contribute to improving supply competition as evidenced by the VEBA/VIAG (EON) and EDF/EnBW merger cases affecting the German and French markets. In the first case, VEAG, a former joint venture of the merging parties was separated from the parent companies to create a new independent competitor on the German market. In the second case, EDF offered to organise auctions for access to "virtual power plants" and cut its links with the Compagnie nationale du Rhône (CNR) in order to get its acquisition approved. This again created new independent operators on the previously monopolised market.

Being in Madrid, I take the opportunity to underline that the Commission welcomes action taken by the Spanish competition authority in a series of national merger cases involving, amongst others Endesa/Iberdrola (2001) and Fenosa/Hidrocantabrico (2000). I think this forceful action of your national authority has

had a decisive impact in maintaining a level playing field on the Spanish electricity supply market.

In Brussels, most recent merger cases in the energy area have been rather uncontroversial and have been dealt with under a simplified procedure, as for instance in the Spanish Endesa Energia/Spinveste case[16]. But a few days ago, the restructuring of Hidrocantabrico between existing shareholders leading to a change of control within that undertaking has been notified and will be examined with due care.

Some previous energy mergers have given rise to another controversial issue. I am thinking of the acquisition by Fiat, EDF and a series of Italian banks through a vehicle named Italenergia, of the Italian Montedison group, active amongst others in electricity supply. You are aware that originally, the acquisition was set up by EDF. But the Italian authorities adopted a decree limiting the voting rights of electricity and gas incumbents from other Member States in companies like

[16] Endesa Energia/Spinveste/Ecocicloendesa-Energia (M.2668)

Montedison. Accordingly EDF's voting rights in Italenergia were limited to 2% and Fiat was considered to have acquired sole control of Montedison. In these circumstances, the Commission approved the acquisition[17]. This case leads me to the next and last issue I would like to address: golden shares held by States in core national industries.

2.3 Freedom of investment and free movement of capital with special attention to the golden shares issue

This topic leads us back to the internal market rules mentioned in my introduction. Such measures could indeed constitute restrictions on intra-Community investments that fall under the scope of the EC Treaty rules on freedom of establishment and free capital movements (Articles 43 and 56 EC Treaty). Contestable under these provisions are two types of rules: 1) golden shares held by State authorities granting them special rights as regards management of a company or transfer of shares or ownership of such company and 2) any kind of administrative procedure requiring from a buyer to obtain prior authorisation

[17] IP/01/1229

from the government before acquiring such companies, generally considered to be of "national interest", whatever that term may mean today.

Already in 1997, the Commission issued a Communication on this topic[18]. It provided that measures restricting EC investment are acceptable subject to stringent conditions. In June 2001, a series of acquisitions by EDF lead to a large debate, which prompted the Commission to confirm its 1997 approach by stating its willingness to tackle cross-border restrictions[19]. The Commission again stressed the need to address unequal market opening by 1) accurately applying competition rules 2) ensuring proper implementation of existing energy Directives and 3) rapidly adopting the Acceleration Directive.

This is illustrated by DG Competition's approach in the Montedison case. Indeed the Commission approved the acquisition of Montedison by Fiat/Italenergia on the condition that if the Italian decree restricting EDF's investment were to be

[18] OJ C 220/15 of 19th of July 1997
[19] IP/01/872

found in contradiction with Treaty provisions on free investment and free movement of capital, prompting an increase of EDF's voting rights in Montedison, the case would have to be re-notified and re-assessed as to its compatibility with the common market.

Let me close this topic by mentioning the fact that the Commission referred Spain to the Court of Justice for adopting an authorisation procedure for the acquisition of more than 10 % in companies of "national interest" including Repsol (oil/energy) and Endesa (electricity) [20]. This case, as well as a series of other cases involving golden shares, are still pending in Luxembourg. The judgements are expected in the first half of this year. More Commission action can hence be anticipated in this area as from next summer.

[20] IP/00/715

3. Conclusion

I come to the conclusion of this bird's eye view on emerging competition in the European energy markets by underlining once more the coherent and integrated action of the different Commission services to guarantee competition at all levels of the energy supply chain. Certainly, some uncertainties still remain. But this is build into the nature of a progressive liberalisation, with difficulties becoming more perceptible the more the process moves ahead.

It is the Commissions' conviction that the energy liberalisation process has been launched successfully and is yet irreversible. As a consequence, positive price developments have been experienced in a number of Member States, especially in the electricity sector.

Energy liberalisation continues to be high on the political agenda, not least thanks to the special interest the Spanish Presidency is devoting to this topic. It should become one of the main issues of the Barcelona Council on 15th and 16th of March

2002. I look forward to the adoption of the Acceleration Directive, which should help resolving the serious competition concerns related to unequal market opening, a particularly obvious concern in Spain.

In the meanwhile, DG Competition will keep on forcefully pursuing the infringements of antitrust law where they appear. And as I have already pointed out, in fulfilment of the mandate of the Stockholm Council, the Commission keeps the possibility to adopt a Directive on the basis of Article 86 of the EC Treaty**,** were the liberalisation process to be unduly stalled.

My personal conviction is that the joint effect of both national and European regulatory measures and antitrust procedures, combined with the appropriate EC structural measures being currently implemented should soon improve the situation on energy markets. Let me finish by stating that energy consumers should be both proactive and patient: their support is needed to help transforming the energy industry characterised by large

sunk costs, but such liberalisation is not a short-term project: it requires the determination and motivation of marathon runners.

Thank you for granting me your attention.