SPEECH

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Opening Remarks to the Energy Day 2006

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Ladies and Gentlemen,

I am very pleased to welcome you to today's meeting. Energy is at the top of the EU agenda. The challenges we face are well known, and I am convinced that we must address them through well functioning competitive markets.

Further improvement of market functioning, however, will require the use of both competition and regulatory powers. This requires close co-operation between the regulators and the competition authorities – in the Commission as well as in the Member States – and so it is a great pleasure to see you all here today.

I. The context

The challenges we face are well known: sustainability, security of supply and competitiveness.

Sustainability is probably the greatest challenge.

The recent Stern report states that "the scientific evidence is now overwhelming: climate change is a serious global threat, and it demands an urgent global response". The report estimates that if no action is taken there would be a better than even chance that temperatures would rise more than 5°C, which is equivalent to the change in temperatures from the last ice age to today. The report estimates that unless we act the costs and risks of climate change will be equivalent to losing between 5 and 20 percent of GDP each year. Furthermore, stabilisation – at whatever level – will ultimately require annual emissions to be 80 percent below current levels; and should be at least 25 percent below current levels by 2050.

Investments in the energy sector have an exceedingly long life, with 50 years for generation plants being quite possible. With the current high prices and shortage of capacity, we are at the start of an important investment cycle. The choices made in the next 10 to 20 years will therefore have a profound impact on climate in the second half of this century and the next. It is therefore essential that we ensure that the energy markets provide the correct investment signals, encouraging improvements to the networks, efficient electricity generation, and in particular greater energy efficiency.

Security of supply, or maybe more accurately reliability of supply, is essential.

Our society could not function without reliable supplies of energy, in particular electricity. Earlier this month we had a major blackout, apparently due to a single problem near Hamburg, which spread within seconds over large parts of the EU from the Baltic to the Adriatic. The TSOs appear to have reacted quickly and appropriately to the problem and were able to get the lights back on within about half an hour. But this event clearly demonstrates the need for investment in the networks, particularly in the interconnectors between TSO regions. One can also ask whether it is appropriate for operation of an integrated network to be based on a system of voluntary co-operation between TSOs when events in one region have such an immediate and dramatic impact in other regions. In addition to reinforcing the networks and strengthening their governance, reliability of electricity supply requires investment in generation capacity. To encourage investment we should promote a larger, more liquid, more transparent electricity wholesale market, which in turn must be based on a stronger and better functioning network.

Improved reliability of gas supply requires, in addition to improved networks, a diversified portfolio of gas supply. The EU as a whole is well-placed in this respect, situated between the North Sea, North Africa, Russia and the Caucasus and with ready access to LNG, although some individual Member States are heavily dependent on individual suppliers. A number of LNG regasification plants are being built and pipeline connections with Russia, North Africa and the Caucasus are being strengthened, which should ensure that the EU will continue to have a well-balanced diversified portfolio of gas supply despite falling domestic production. These important investments would be strongly encouraged by the removal of barriers and bottlenecks in the EU gas market, whether contractual, physical or due to market structures.

In both the electricity and the gas sectors, improved reliability of supply will also require improved energy efficiency, both by end consumers and by electricity generators. This requires clear price signals, which brings me to the third challenge.

<u>To be competitive our economy, and in particular our manufacturing industry, requires competitively priced energy.</u>

The EU needs competitively priced energy to strengthen its economy and achieve its Lisbon targets. Large energy users are already complaining bitterly about energy prices. In some Member States regulated tariffs have been introduced or are being considered. In other cases, large energy users are calling for very long-term contracts in exchange for discounts. These measures are not, however, addressing the underlying problems and in both cases price signals are smothered, pressure on customers and suppliers to improve efficiency is reduced, and higher costs are passed on to the future. Both cases also raise important competition concerns. Regulated tariffs may involve State aid and risk eliminating competition. Long-term contracts give rise to foreclosure concerns.

A well-functioning single EU market in electricity and gas will be essential to meet these three challenges.

Markets encourage operational efficiency. For example, maintenance is scheduled at the least disruptive (and expensive) period; individual suppliers take appropriate "generate or buy decisions" which ensures that the most efficient plants are run; and cross-border interconnectors are operated appropriately to ensure maximum efficiency. Markets also encourage appropriate investment decisions, particularly if combined with a clear long-term mechanism for taking into account the externalities linked to greenhouse gas emissions. Markets therefore allow and encourage the use of the best available technology, and lower the barriers to entry. Markets also encourage demand-side changes in behaviour, for example, encouraging consumption at non-peak periods rather than peak periods and encouraging energy efficiency. Markets finally help to spread the risks in a market to those most willing and best placed to take them on, and this decentralisation of decision makes the energy sector stronger than if all important decisions were taken by a single monopoly energy supplier.

II. Barriers to competition

Today we meet to discuss with you the results of the Commission's energy sector inquiry and what follow up action the Commission intends to take. You will recall that last year around this time we met to present and discuss with you the first results of this inquiry. Detailed results were then published in our preliminary report adopted in February of this year. The main barriers for effective competition identified in the preliminary report have not changed. These are

- market concentration,
- vertical foreclosure,
- lack of market integration,
- lack of transparency and
- price formation.

However, since the preliminary report was published we have been able to strengthen the analysis significantly.

First of all we have been able to analyse information that we did not have time to analyse before. In particular we have significantly reinforced our analysis of unbundling of TSOs within the chapters on vertical foreclosure of the markets.

We have also included additional chapters in the final report on downstream markets and balancing markets. Furthermore, we have launched two studies, one on the role of Liquid Natural Gas (LNG) in the EU gas markets and one on concentration and pricing in electricity markets. Chapters on both issues will be included in the final report. These issues will be presented in detail by my colleagues in a few minutes.

We also carried out a public consultation, which largely confirmed our analysis of the problems and called for urgent action in line with the ideas developed in the preliminary report. We received support from almost all the contributors with the notable exception of the vertically integrated ex-monopoly energy suppliers, many of which called for a continuation of the status quo in some form. Obviously we do not agree with this proposal.

III. Remedies:

Use of Competition Powers

Removing the identified barriers will require all our efforts using both competition powers and regulatory powers. We shall use our competition powers to address the problems of concentration, vertical foreclosure and market integration. These problems were the main focus of the inspections we carried out in May.

Concentration is one of the core problems in the energy markets, and meticulous scrutiny of future mergers is essential. The sector inquiry should help us to identify key issues quickly and to tailor any remedies to be as effective as possible, as we have achieved in the GDF-Suez case. However, mergers can also be pro-competitive, for example, in spreading best practice, encouraging cross-border trading and facilitating investment. So it is also important to ensure that mergers are not blocked unnecessarily. The Commission will therefore react firmly against any Member State measures that impose unnecessary barriers to cross-border mergers.

The second major priority for competition enforcement is tackling foreclosure stemming from vertical integration. Vertical foreclosure of markets with long term downstream contracts is an immediate priority for competition law and I therefore welcome the actions of the Bundeskartellamt on this issue. We are actively looking into the issue in our own case work and are confident that we can give appropriate guidance soon. We are also analysing a complaint on regulated tariffs which are claimed to favour vertically integrated generators and suppliers and penalise any suppliers without generation capacity or generators without supply arms.

The third priority is market integration. Hindering access to infrastructure (for example, interconnectors and storage) or deciding not to invest in new infrastructure can contribute to foreclosure of the markets. Market partitioning, for example agreements not to enter into each other's markets, is a hard-core violation of competition law and would be heavily penalised if proven.

Use of Regulatory Powers

However, competition law enforcement cannot by itself open markets and resolve all the shortcomings identified during the sector inquiry. We shall therefore make concrete suggestions on improvements to the regulatory framework when we publish the final report, possibly including transparency, harmonised regulatory powers, liquidity and unbundling.

The need for greater transparency is widely recognised and in October ERGEG proposed that there should be mandatory rules on transparency in the electricity markets. A group chaired by the Commission is currently examining in detail what should be published and how to implement these rules.

Europe also needs a substantial strengthening of the powers of regulators and enhanced European co-ordination to provide a transparent and non-discriminatory framework for competition to develop and investments to be made. Reinforced co-ordination between regulators, with a stronger role for Community oversight, particularly as regards cross-border issues, has to go hand in hand with the enhanced cooperation of network operators.

Increased liquidity is needed and at least in the short-term this will almost certainly require regulatory action of the type already taken in many Member States, such as release programmes.

The issue that has been most discussed so far is, of course, unbundling of vertically integrated network and supply operators. In the sector inquiry, but also during the recent inspections we found numerous examples that the current unbundling rules are inadequate and not respected by the incumbent operators.

As has been reported, two possibilities are being considered to address the issue: full ownership unbundling, where the network operator has no ownership links with suppliers or generators using their networks; or some sort of independent system operator (ISO). In my view only full ownership unbundling will provide network operators the necessary incentives to manage and invest in the network in an efficient manner without distorted influences of affiliated supply branches and without the need for detailed and burdensome regulation. Full ownership unbundling would probably also encourage the co-operation or even merger of neighbouring network operators given the clear synergies that would exist, and so would help the development of wider and deeper markets. As you all know I am in excellent company with this view. Commissioner Kroes has left little doubt as to her preferences. And we believe that there is a growing support for our view.

Whilst I do not want to exclude the ISO model outright – it seems to work under the special circumstances of Scotland - it would appear that the model has three major disadvantages compared to full ownership unbundling. First, it requires detailed regulation to avoid the leakage of information between the network operator and the asset owner, who is also the incumbent supplier in the region concerned. And it requires constant monitoring by the regulators, who might not have the resources to devote to this task. Secondly, the network operator might not have the power to direct investments where most needed as the asset owner will still try to block or at least delay the necessary investments if not in the interest of its affiliated supply branch. Thirdly, unless the ISO operates the networks of a number of asset owners (as is the case in Scotland), the ISO may not have the standing in practice to challenge the wishes of the asset owner even if in theory it has the power to do so.

IV. Next Steps

Our intention is to publish the final report on 10 January in parallel with the Strategic Energy Review and the other elements of the energy package being prepared by DG Transport and Energy. The Commission will adopt a Communication containing the main conclusions and messages and the detailed final report will be adopted as an annex to the Communication.

We shall now have a rapid presentation of the final report followed by a discussion. After lunch Mr Hilbrecht of DG Transport and Energy will present the Strategic Energy Review and progress report and chair the discussion.