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Energy Competition Policy—Short Overview

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Thank you for the opportunity to give a short overview on the current status of application of EU competition rules to the energy sector before we enter into the debate.

Let me touch during these remarks on three topics:

- The new approach: Sector Inquiry instead of piecemeal dealing with cases
- The deficiencies in competition that we still find in the European energy market
- The new combination of the application of competition law and regulation that we will need to address systemic competition issues in the sector

Firstly, Sector Inquiry instead of a piecemeal approach

As will be well known to everyone in this room, the European energy market has moved through three stages of liberalisation:

- The first EU electricity & gas liberalisation package was adopted in 1996 (for electricity) and 1998 (for gas),
- The breakthrough towards a competitive energy market came with the second liberalisation package in 2003,

- As everybody here will know, that package set the deadline for full liberalisation on 1 July 2007, with minor derogations for some Member States for additional transition periods.

In parallel, we have seen major case lines developing. Important as they have been in setting major principles (notably the GFU case, the Nordic gas supply cartel; the Marathon case line, on access to gas pipelines; the Gazprom line of cases, on territorial restrictions and market partitioning), it was felt that a piecemeal approach would not allow us to deal with the sector in a comprehensive manner under competition law. It was therefore decided to activate Art 17 of Regulation 1/2003: the launch of a comprehensive sector inquiry under the EU's competition powers (in parallel with an inquiry into the financial sector).

The European Commission therefore carried out, under its competition law powers, an in depth investigation of competitive conditions in the EU electricity and gas market, in the run up to full liberalisation.

Secondly, the findings: deficiencies in the competitive structure

We sent 3000 questionnaires to the sector, both gas and electricity. A Preliminary Report on the findings was published in February 2006, and is available at

http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/energy/

We have found five main competition problems that hinder the competitive development of the energy market:

- Market concentration
- Vertical foreclosure
- Lack of EU-wide market integration
- Lack of transparency
- Deficient price formation mechanisms

I will not go into any details on these barriers but refer you to the published report. This list of barriers can serve as a checklist against which to measure progress in energy markets in the Union. In essence, these barriers have led to substantial underinvestment particularly in trans-border energy links in the Union, and an endemic lack of diversification in our outside supply relationships particularly in gas, with a consequential enhanced risk for security of supply. And they have led to a chronic lack of liquidity in the newly created wholesale markets which are the basis for bringing the advantages of liberalisation and choice to the consumer.

Let me just illustrate some of the key findings.

Gas:

Gas infrastructure remains mostly owned by incumbents and is not sufficiently unbundled. Long term capacity reservations in transit pipelines and storage block new market entry and new investment—hardly any capacity is available in the short term.

A closer look at our main gas supply routes confirms this. On the East / West axis there is minimal unsold capacity available for at least the next ten years.

Electricity:

Many market participants complain about inadequate unbundling of network and supply activities. There is a substantial lack at TSO level of grid connection for new power plants, interconnector capacity, and transparency.

Competition from imports is insufficient to erode market power of incumbents. More interconnector capacity is needed, as demonstrated at a number of important links in the Union. Many interconnectors are chronically congested. Long term capacity reservations reduce the capacity available for new entrants.

Thirdly, consequences for the competition approach

We have therefore found three major systemic deficiencies in competition in the sector:

- The structural deficiency: systemic conflict of interest through insufficient unbundling of generation, supply and networks. We are faced with a structural incitation to leverage market power, to discriminate and to foreclose competitors
- The regulatory deficiency: we find a persistent regulatory gap particularly where borders are crossed. The regulatory systems in place have loose ends which do not meet.

- The deficiency in liquidity, both in electricity and gas wholesale markets. The liquidity is lacking that would allow our markets to function in a competitive manner.

Looking at these findings, three consequences come to mind:

- The application of competition law will be important but it will have to be applied in parallel with regulatory change. The role of competition law and regulation is complementary, as it was during the telecommunications liberalisation exercise of the past decade when a fine balance was worked out between the role of competition rules and regulatory instruments which ultimately led to the Electronic Communications Framework of 2003;
- Competition law must be applied in the context of the liberalising market. It cannot make up for a lack of regulatory reform but remedies must take current market deficiencies into account, both in antitrust and mergers;
- Remedies in the sector must be forward looking, both in merger and antitrust. We are used to a forward looking analysis under the merger regulation. We will have to become used to doing this under antitrust. A major change brought by Regulation 1/2003 is a new forward looking and structural orientation - both waiting to be used. Recent settlements under Article 9 have shown this new orientation.

I believe, the new approach is seen clearest in recent merger cases. The intense scrutiny of mergers is at the centre of attention, as we

witness a massive restructuring of the gas and electricity markets in Europe.

We have seen a series of recent EU decisions in this area:

- The EDP/GDP Decision (December 2004, Portugal).
Prohibition of the planned acquisition of the Portuguese gas incumbent by the country's electricity incumbent (jointly with ENI);
- The EON/MOL Decision (December 2005, Hungary).
Clearance with remedies concerning the acquisition of the gas wholesale business of the country's gas incumbent by German EON;
- The DONG Decision (February 2006, Denmark). Clearance with remedies concerning the acquisition of major electricity companies by the country's gas incumbent; and
- The EON / Endesa bid (April 2006, Spain). Clearance concerning the planned takeover by EON of one of the two major electricity companies in Spain.

And as you will know, other major mergers are still being scrutinised under the EU merger regulation but are not yet in the public domain.

I will pass over the details of these Decisions. Let me just mention EON / MOL in more detail.

The acquisition by EON, the major German gas and electricity company, in Hungary of the wholesale gas business of MOL (the

Hungarian gas incumbent) was approved, but subject to strict conditions. Two sets of remedies were required:

- Structural: ownership unbundling of the control of the infrastructure network,
- behavioural: a commitment to a very substantial gas and contract release programme, in order to generate liquidity in the market and to avoid market foreclosure in the Hungarian gas market.

Instead of going into further detail, let me turn to the more general lines set by these recent decisions. EU merger control is supports restructuring but will not admit monopolisation of markets and customer exploitation. It will see that both large and small Member States follow the same rules. It cannot be that large Member States escape scrutiny when the smaller Member States comply.

We must look carefully in all cases at effective unbundling of infrastructure and supply, and at ensuring sufficient liquidity. The latter means that we have also to look at the upstream situation.

Or to say it in other words: open upstream access to both gas and electricity supply facilitates open downstream markets—and this means consumer benefits. Our ultimate remedies must be structural, in order to reach lasting change. We must design remedies to be strictly merger specific but we cannot close our eyes to the context of markets and regulation, in order to make those remedies efficient. We believe that the Court will support us in this more holistic approach.

Let me conclude these short introductory remarks with a few remarks on the general environment of the sector which we should keep in mind.

The context is set out by the European Commission in its March Green Paper and largely endorsed by the EU Heads of States at the European Council under Austrian Presidency the same month.

The Green Paper (“A European Strategy for Sustainable, Competitive and Secure Energy”, 8 March 2006) sets out as main energy policy goals:

- Open energy markets
- Security of supply
- Environmental goals, the Kyoto process.

As a consequence, when applying competition law and in particular the antitrust rules, we will concentrate on anticompetitive conduct and structures which hinder the liberalisation of the electricity and gas markets by 1 July 2007 from having its full effect. This means that we will have to combat anti-competitive practices particularly in areas which promise the most rapid effect on market opening:

- Anti-competitive practices concerning tying of downstream markets—which hinder new entrants from supplying customers in the newly liberalized markets,
- Anti-competitive practices concerning access to capacity on pipelines, gas storage and interconnectors,

- Market partitioning / territorial restrictions in supply contracts, or provisions with equivalent effect,
- Other anti-competitive and exclusionary conduct, such as impeding customer switching.

Let me here come back to the broader supply perspective. The Green Paper aims at widening the EU's energy market, in line with the EU European Neighborhood policy and its Action Plans—progressively creating a common regulatory space around Europe. This “would create a predictable and transparent market to stimulate investment and growth, as well as security of supply, for the EU and its neighbours”.

This also applies to the EU's largest partner in the energy field, Russia. The EU Presidency and the Commission have set out that the EU and Russia “are, and must remain, in a position of mutually beneficial interdependence.” As you will know, the issue has been on the agenda of the meeting between the EU Heads of State at Lahti last week where they discussed the Energy Charter with the Russian president. As the Commission has stated on various occasions, Third Country energy companies entering the EU will be screened under EU competition law no differently from EU enterprises, as regards impact on the competitive market structure. But this also means that one will have to take into account both the position in the upstream 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 also in upstream supply markets would facilitate such a competition analysis.

This leads me back to the checklist established by the Sector Inquiry. We will have to measure progress against the deficiencies which we have found. We have to overcome the effects of market concentration, of vertical foreclosure, of lack of market integration, of lack of transparency and of the deficient price formation mechanisms with which we are faced.

We will look intensely at actual customer switching or any anticompetitive practices that may hinder customer choice. Liberalisation gives rights to customers which we must allow them to exercise. We will also have to take a careful look at regulated tariffs wherever they persist or are introduced. Good intentions in the short term may prevent the effective entry of competitors—and therefore undermine longer term advantages for the very customers those tariff schemes pretend to protect.

And we will have to look very closely at the Gordian knot that currently hinders the effective working of competitive energy markets in both gas and electricity: the systemic conflict of interest generated by joint ownership of generation, supply and networks—or, to say it in other words, the systemic insufficient unbundling that we have found in the sector inquiry in the market place. This systemic core problem in the energy market leads to an undue advantage for the incumbent and to systemic unfair conditions for competitors, and it leads to flawed investment signals for the development of the network infrastructure. Inevitably, this issue will be on the agenda as we progress towards the completion of the Inquiry.

Both the Strategic Energy Review, based on the Green Paper consultation and the final report on the Sector Inquiry are due by the end of this year. I believe we are moving to a critical stage for

making liberalisation work fully —and this means giving a sound and sustainable basis for resolving Europe's energy problems. We should keep this in mind when we discuss the combined application of antitrust, merger control and state aids to the sector.