

SPEECH

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The Liberalisation of EU Energy Markets

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Ladies and Gentlemen,

Hegel famously wrote that “*nations and governments have never learned anything from history, or acted upon any lessons they might have drawn from it*”.¹ This may have been the origin of Marx’s aphorism that history repeats itself, the first time as tragedy, the second as farce. Looking at the liberalisation of network industries over the past twenty years, one wonders what Marx or Hegel would have made of history repeating itself the third and the fourth time.

In telecoms, posts, gas, electricity, water, we have struggled, continue to struggle and likely will continue to struggle with the same problems with which Michael Beesley struggled. Do we want a publicly owned company carrying out public service tasks? If so, getting the best service at the best price requires complex evaluation mechanisms such as shadow pricing. Or do we want a liberalised environment where markets are left to their work? If so, we will need continued regulation of access and pricing of the natural monopoly areas – and some mechanism for determining what those areas are.

Of course, if Marx had been right about the labour theory of value, access pricing would be a rather easier exercise. And if Schumpeter – with whom Beesley had rather more sympathy – had been right about the gale of creative destruction perennially undermining monopoly,² then we would have nothing to worry about in the first place. Sadly reality is not quite so simple.

Beesley fully appreciated the limits of academic theorising, the extent to which the “*great elaboration*” of modern industrial economics was sometimes of

¹ GWF Hegel, Lectures on the Philosophy of World History, Introduction, 1830

² JA Schumpeter, *Capitalism, Socialism and Democracy*, 1942

“*small actual assistance in our problem*”³ of regulating the “*half-world of potential overlap*”⁴ between incumbents and entrants.

That half-world to which he referred is not constant. In telecoms, the wired and wireless revolutions mean that little remains of the natural monopolies of the last century. In the water industry, by contrast, multiple sources of supply and distribution remain a pipe dream. The energy sector is somewhere between these two extremes. But in all of these areas, history shows us that the concerns are essentially the same:

- how to identify and separate natural monopoly interests from those open to competition;
- for the natural monopoly elements that remain (if any), how to regulate them;
- for those areas open to competition, how to enable competition to emerge against what is usually a dominant incumbent.

On this last point, Beesley, writing with Stephen Littlechild, suggested a focus on “*facilitating the entry of new competitors, including the entry of existing competitors into new parts of the market*”⁵ advocating a three step approach of (i) focussing on likely patterns of entry, (ii) identifying options which are open to the regulator, and finally (iii) choosing options which are likely to have the greatest positive impact on entry.

This is the process we have been going through in the energy sector for ten years, and which we are going through again with the energy sector inquiry. In

³ Michael Beesley, *Abuse of Monopoly Power*, in *Regulating Utilities: The Way Forward*, at p 140.

⁴ *Ibid.*

⁵ Michael Beesley and Stephen Littlechild "The regulation of privatized monopolies in the United Kingdom." in *Privatization, regulation and deregulation*. London: Routledge, 2nd edition, pp.58-83

the next months the European Commission will make further proposals as to how it sees the structure of the sector, and how it sees the relationship between market forces, regulation, and the competition rules. As Peter Freeman wrote a few weeks ago,⁶ portraying the relationship between regulation and the competition rules as the difference between ex post and ex ante control is rather simplistic. Competition policy can inform not only the question of whether regulation is needed, but – more effectively – the question of what form that regulation should take.

The Commission's experience in the telecommunications sector shows that we can improve sector specific regulation if we base it on solid competition law principles of market power and foreclosure. We can also help the sector to move along the path towards the withdrawal of regulation if it is no longer needed. But in energy, that tinkering with the structure of the regulatory system may well not be enough. As Commissioner Kroes has already indicated, requiring structural change on the markets may be a necessary step if we want the markets to work.

We need well-functioning markets that can send the right signals to investors and policy makers. For more than ten years, liberalisation of EU energy markets has been on the agenda. Two waves of liberalisation Directives have addressed the inefficient monopolised energy markets. There is no doubt that some progress has been made, but we do not yet have a single, competitive European energy market. It is not well equipped to cope with current challenges of providing secure supply to match growing demand; it is even less well equipped to cope with future (near-future) challenges such as climate change.

The Commission's Green Paper on Energy, from last spring, identifies sustainability, competitiveness and security of supply as the three main

⁶ Peter Freeman, *Regulation and Competition – Chalk and Cheese? The Role of the Competition*

objectives for Europe's energy policy. It also underlines the need for a competitive energy market to achieve this. A High Level Group on competitiveness, energy and environment is currently working on finding a balance between these three essential policy objectives.

Competition policy in the energy field aims at ensuring a secure flow of energy, in particular electricity and gas, at competitive prices to EU's households and businesses. An open and competitive single EU market should also contribute to a secure provision of energy in the future, as it will make the European market attractive for a range of external suppliers from different energy sources. Moreover, such a market will also be open to new energy mixes, and will play a major role in developing and deploying new environmentally friendly technologies.

As most of you will know, the Commission launched its sector inquiry into the gas and electricity markets in June 2005. Its purpose is to identify market malfunctioning and determine which are the main barriers to competition. It should provide an empirical base, permitting us to identify the relevant remedies that could help to radically improve the functioning of energy markets.

We have gathered considerable information, after sending several thousand questionnaires, in order to identify possible restrictions or distortions of competition.

In February a Preliminary Report was presented at a public event, highlighting a number of worrying market distortions. This was followed by a two month consultation period, during which we have received many valuable contributions.

The Final Report of the Sector Inquiry will be adopted around the end of the year, together with the strategic EU energy review and Energy Package. This process is can be expected to lead to concrete new proposals, including, where necessary, further liberalisation measures.

I assume that you are also familiar with the five main findings of the inquiry:

- First, there is too much market concentration. Incumbents often retain a firm control of the liberalised markets, with little new entry. This creates scope for incumbents to raise prices.

Wholesale trade has been slow to develop in gas, and incumbents largely control up-stream gas imports and domestic production.

In electricity, incumbent operators' market power is demonstrated in the first place by their control over the generation assets. Control over generation assets gives incumbents scope to exercise market power in two ways: One way is to withdraw capacity. Another way would be to charge higher tariffs when the operator knows that its plants are indispensable to meet demand.

- Second, new entrants are largely foreclosed from the markets, preventing them from offering their services to the consumer. Incumbents are often vertically integrated, acting at several levels of the supply chain. They demonstrate little or no interest in trading with new entrants. Markets are characterized by long-term contracts and a lack of liquidity, so there is a lack of available gas and electricity that could be acquired by alternative providers.

A huge problem is the strong link that often still exists between the incumbent wholesalers and the network companies, as well as gas storage facilities. Respondents to our Inquiry point to inadequate unbundling between incumbent wholesalers and network companies as an important

obstacle to entry, and allege discriminatory treatment. The lack of infrastructure investment or delaying tactics by vertically integrated supply companies are also a serious source of concern. As a consequence, incumbents remain dominant at all stages of the supply chain, and the markets remain closed to competition.

- Third, there is very little cross-border integration. Both gas and electricity markets are still largely national, and incumbents seem to have limited interest in going out and competing on their neighbours' territory.

For gas, it is difficult to secure transit capacity on key routes. We have looked at the state of access to transit on two main axes of gas flows in continental Europe: North-South and East-West. In both cases, capacity rights were completely sold out for periods exceeding 10 years - more often than not to national incumbents or their affiliates. At the moment, it would not be possible for a new entrant, even if it did manage to purchase gas in Russia or Norway to transport it across Europe to a customer.

The lack of market integration is a serious concern in electricity, as market entry through construction of new power plants is relatively slow. Imports are hindered through long-term capacity reservations and insufficient interconnector capacity. Many interconnectors are increasingly congested, and some are congested 100% of the time.

- Fourth, there is a patent lack of transparency. This represents a serious barrier to entry. It undermines confidence in trading and wholesale prices, reduces the liquidity of the markets, and stops market participants from making informed choices.
- Fifth, there is a lack of confidence that prices on spot and forward wholesale markets are the result of fair competition. We have seen dramatic gas price

increases over the past couple of years. There are, no doubt, several causes of this. But one of them may be anti-competitive practices.

The Final Report of the inquiry will integrate the comments from the public consultation, which tend to confirm our preliminary findings. It will also include further analyses of the downstream markets, as well as the functioning of gas and electricity balancing markets, LNG-markets and power exchanges.

In order to remedy the identified problems, the Commission is pursuing infringements of Community competition law in the sector with all the instruments at our disposal. In other words, antitrust control (meaning pursuing restrictive agreements and abuses of dominant positions), merger control and state aid control.

The findings of the Sector Inquiry enable the Commission to focus its enforcement action on the most serious concerns as identified in the report. They also make it easier for the Commission to identify efficient remedies that can resolve the specific competition problems in individual cases.

Based on the findings of the Sector Inquiry, specific competition law investigations were initiated in a number of areas well ahead of the completion of the Inquiry. As part of these investigations, the Commission carried out several unannounced inspections in May, at the premises of gas and electricity companies in six Member States (Germany, France, Belgium, Italy, Austria and Hungary). These investigations were carefully selected on the basis of the priority problem areas identified in the Sector Inquiry.

Key problems on the market include various practices that prevent new entry and limit customer choice. These foreclosure problems at different levels of the supply chain constitute important aspects of several of the ongoing antitrust cases. This includes tying of markets by long-term downstream contracts, as

well as access to infrastructure capacity, such as transmission networks and storage facilities (capacity hoarding).

The concentration of gas import contracts in the hand of a few incumbents is another main reason why competition at the subsequent level of trade does not take off. Whilst this does not put into question existing and future upstream contracts, it requires attention with respect to the effects for the downstream markets.

Concerted practices between incumbents are another of the priorities of our antitrust enforcement action.

The Commission applies the European competition rules in close cooperation with national competition authorities within the framework of the European Competition Network. And we count on national competition authorities, in cooperation with energy regulators, to act decisively at Member State level.

As part of the ongoing enforcement action in the energy sector, I would, therefore, like to highlight several recent decisions from national authorities, which exemplify the problems we encounter in the sector.

An important case in relation to foreclosure of downstream markets, is the decision of the German competition authority against long term gas supply contracts concluded by EON Ruhrgas for the German market. Another significant case is the decision of the Italian antitrust authority against the delaying tactics of ENI to expand an important import pipeline, which well exemplifies the risks of having vertically integrated supply companies. A third example is the Czech competition authority's decision against RWE Transgas for having favoured its own local distribution affiliates at the expense of other distribution companies not belonging to the RWE group.

Persistent concentration is a core problem in the markets. So there can be no alternative to meticulous scrutiny of future merger operations. We are promoting competition between companies looking to become EU-wide competitors, rather than dominant national players.

While each merger case is assessed on its own merits, the Sector Inquiry helps to identify the most relevant criteria and the most efficient remedies in the given market environment. The findings of the Inquiry have been taken into account in several recent merger cases in the energy sector.

As an example, in the recent E.ON/MOL case, the competition problems we identified with the merger in both gas (strengthening of wholesale position; foreclosure of retail gas competitors) and electricity (input foreclosure of gas-fired power competitors) led us to the remedies of structural unbundling – reducing scope for foreclosure – and gas release, to increase liquidity and encourage entry into the Hungarian market.

Furthermore, we will continue to be very vigilant in the field of state aid control, as the sector moves into a period of major investments. There is a close coordination between antitrust and State aid action, since certain energy schemes involving State resources also can have important foreclosure effects on competitors.

However, competition law cannot by itself open markets and resolve all the shortcomings identified by the Sector Inquiry. In order to achieve this, it is necessary to complement the competition enforcement through an improved legal framework.

The Sector Inquiry has enabled us to identify several priority areas for regulatory measures. We are now in the process of formulating concrete suggestions to be presented together with our Final Report. Without prejudging

the outcome of this work, I would like to give you some examples of areas that I consider should be improved.

Transparency is an obvious candidate for improvement. In most electricity and gas markets in the EU, it is the incumbents that have a decent access to information, while new entrants, customers, and sometimes even regulators, are fumbling in the dark. To ensure a level playing-field, it is essential that all market participants have equal access to relevant market information.

In gas, progress is being made through the recent entry into force of new transparency requirements in the Gas Regulation, and work is under way for specific Commission guidance. For electricity, there is widespread recognition of the need for improvement, and I hope that the current discussions can move from debate to adoption as quickly as possible.

However, transparency is not enough to create integrated energy markets.

The Commission has proposed, and EU Member States have agreed, that there should be a single European network for gas and electricity from the perspective of the network user. Considering that the Inquiry has pointed to an absence of cross-border integration, there is a need for further harmonisation of market design.

This will require improved technical rules, especially those network issues that have an impact on cross-border trade, as well as an improved cooperation between network operators across national borders.

In order to achieve any substantial progress in this field, it is also essential to improve regulatory cross-border coordination. An immediate improvement would be the strengthening of national regulators through increased harmonised powers and independence. A system of close cooperation and coordination would also need to be set up, in order to ensure coherence and to guarantee that

cross-border aspects are taken fully into account. We will reflect on how this work can best be coordinated at European level.

An issue that is likely to be at the heart of the coming discussions is unbundling. There are currently systemic conflicts of interest resulting from the vertical integration of the energy giants. The Sector Inquiry has proven that the current level of unbundling is clearly insufficient. Respondents tell us that network companies still favour their own supply or generation businesses. And there is evidence that investments are based on what is good for the integrated company, rather than on efficiency gains for the network company.

We need to ensure a structural unbundling that removes the opportunities for discriminating against competing suppliers, and which provides the proper incentives to invest in the network.

To conclude, I believe that our Sector Inquiry presents ample evidence in relation to the many problems that are obstructing the creation of a well-functioning, integrated European energy market. Whereas we all had our own ideas as to the causes and the degree of shortcomings on the markets, the Sector Inquiry now provides us with hard facts.

DG Competition has already initiated significant action under the competition rules, but we obviously cannot deliver all the necessary changes.

As I mentioned, the Final Report will be adopted in about two months time, at the same time as the Commission's strategic energy review. These documents will provide the basis upon which the Spring European Council can formulate our future energy policy.

It is essential that the opportunity is taken for the kind of decisive action that can help deliver competitive energy markets - action that will help us ensure our goals of sustainability, competitiveness and security of supply. Not acting today

would mean putting our heads in the sand and betraying the trust that has been bestowed in us.

Ladies and Gentlemen, thank you for your attention.