



**EUROPEAN COMMISSION**

Competition DG

Energy, Basic Industries, Chemicals and Pharmaceuticals  
**Energy, Water**

# **PRELIMINARY REPORT EXECUTIVE SUMMARY**

## **Sector Inquiry under Art 17 Regulation 1/2003 on the gas and electricity markets**

**16 FEBRUARY 2006**

## EXECUTIVE SUMMARY

### Introduction

Following further analysis of the data gathered in the Energy Sector Inquiry, the Preliminary Report confirms the initial findings presented in the Issues Paper<sup>1</sup> (November 2005). The five main barriers to a fully functioning internal energy market are:

- (1) Market concentration
- (2) Vertical foreclosure
- (3) Lack of market integration
- (4) Lack of transparency
- (5) Price formation

The Inquiry was launched in June 2005 and is a competition investigation based on Article 17 of Regulation 1/2003, which assesses the competition conditions on European gas and electricity markets and examines whether current indications of market malfunctioning result from breaches of competition law. The overall objective of the Inquiry is to address the barriers currently impeding the development of a fully functioning open and competitive EU-wide energy market by 1st July 2007.

The wider context has been set out in the Commission's Communication to the 2006 Spring European Council<sup>2</sup> concerning the renewed Growth and Jobs strategy. This puts the creation of an efficient and integrated energy policy at the heart of the Commission's priorities. This context will be further developed in the Green Paper on an integrated European Energy Policy that the Commission has announced will be submitted in early March.

Both the European consumer and European industry<sup>3</sup> are heavily dependent on the secure and reliable provision of energy at competitive and fair prices. Also, the achievement of the Union's goals for the environment are heavily linked to the reduction of greenhouse gases in the energy sector and the achievement of the Kyoto commitments.

The main findings of the Inquiry to date are summarised below for the gas and electricity markets.

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<sup>1</sup> [www.europa.eu.int/comm/competition/antitrust/others/sector\\_inquiries/energy/issues\\_paper15112005.pdf](http://www.europa.eu.int/comm/competition/antitrust/others/sector_inquiries/energy/issues_paper15112005.pdf)

<sup>2</sup> Time to move up a gear - Annual Progress on Growth and Jobs, 25 January 2006

<sup>3</sup> See Implementing the Community Lisbon Programme: a policy framework to strengthen EU manufacturing - towards a more integrated approach for industrial policy, Communication from the Commission, 5 October 2005. The Communication has led inter alia to the setting up of a High Level Group on Competitiveness, Energy and the Environment which will take up its work by the end of February 2006.

## **The Findings - Gas Markets:**

### **Market concentration:**

**At the wholesale level, markets generally maintain the high level of concentration of the pre-liberalisation period.** Wholesale trade has been slow to develop, and the incumbents remain dominant on their traditional markets, by largely controlling up-stream gas imports and/or gas production. Incumbents trade only a small proportion of their gas on hubs. With little new entry in retail markets, customer choice is limited and competitive pressure reduced. The overall picture for potential new entrants is one of dependency on vertically integrated incumbents for services throughout the supply chain.

### **Vertical foreclosure:**

**Lack of liquidity and limited access to infrastructure prevent new entrant suppliers from offering their services to the consumer.** The network of long term supply contracts between gas producers and incumbent importers, makes it very difficult for new entrants to access gas on the upstream markets. Additionally, certain features of these contracts limit incentives for incumbents to provide liquidity on traded markets. Gas infrastructure (networks and storage) is to a large extent owned by the incumbent gas importers, and the insufficient separation of this infrastructure from supply functions results in insufficient market opening. Despite EU rules on third party access and legal/functional unbundling, new entrants often lack effective access to networks, the operators of which are alleged to favour their own affiliates.

### **Market integration:**

**Cross-border sales do not presently exert any significant competitive pressure.** Incumbents rarely enter other national markets as competitors and available capacity on cross-border import pipelines is limited. New entrants are unable to secure transit capacity on key routes. The primary capacity on transit pipelines is controlled by incumbents based on legacy contracts that derogate from normal third party access rules. This is reinforced by ineffective congestion management mechanisms, which can make it hard to secure even small volumes of short-term, interruptible capacity on the secondary market. In most cases, new entrants have not even secured capacity when there have been expansions of transit pipeline capacity.

### **Transparency:**

**There is a lack of reliable and timely information on the markets - normally the lifeblood of healthy competition.** Network users request more transparency on access to networks, transit capacity and storage, going beyond the current minimum requirements set by EU legislation. To ensure a level playing field, users require information to be made available on an equal footing. Confidentiality rules also undermine effective transparency when given too wide an interpretation.

### **Price formation:**

**More effective and transparent price formation is needed in order to deliver the full advantages of market opening to consumers.** Gas import contracts use price indices

that are linked to oil products and recent price increases have, therefore, closely followed developments in oil markets. This results in wholesale prices that fail to react to changes in the supply and demand for gas. No clear trend towards more market based pricing mechanisms can be observed in long-term import contracts. Gas prices on existing gas hubs have also been rising recently, and ensuring liquidity is crucial to improving confidence in price formation on gas hubs. Even when different producers are selling from the same field, the contracts generally contain the same price index and often even the same actual price.

## **The Findings - Electricity Markets:**

### **Market concentration:**

**Most wholesale markets remain national in scope with high levels of concentration in generation, which gives scope for exercising market power.** Sales on spot markets generally reflect the level of concentration in generation, unlike those for trading in forward markets which show less concentration. However, caution is needed in assessing market power in electricity markets only on the basis of market shares. Analysis of trading in power exchanges shows that, in a number of them, generators have the scope to raise prices, a concern also expressed in the inquiry by many customers. Analysis of generation portfolios also shows that the main generators have the ability to withdraw capacities to raise prices. Further assessment will be needed in order to determine whether operators have unduly used these possibilities to raise prices.

### **Vertical foreclosure:**

**Vertical integration of generation, supply and network activities has remained a dominant feature in many electricity markets.** Vertical integration of generation and retail reduces the incentives to trade on wholesale markets. Low levels of liquidity are an entry barrier. The strong links between supply and network companies reduces the economic incentives for the network operators to grant access to third parties. Many respondents are highly critical of the efficiency of existing unbundling obligations, believing that discrimination in favour of affiliates continues, and calling for stricter measures.

### **Market integration:**

**The low level of cross-border trade is insufficient to exert pressure on (dominant) generators in national markets.** Integration is hampered by insufficient interconnector capacity and long-term capacity reservations predating the liberalisation. Improving access to interconnectors requires better methods of congestion management. There is also a lack of adequate incentives to invest in additional capacity to eliminate long-established bottlenecks. Different market designs hamper market integration.

### **Transparency:**

**There is a serious lack of transparency in the electricity wholesale markets that is widely recognised by the sector.** Improved transparency would minimise risks for market players and so reduce entry barriers to generation and supply markets, provide a

level playing field, and improve trust in the wholesale markets and confidence in its price signals. More than 80 percent of market participants are not content with the current levels of transparency. Users request more information on technical availability of inter-connectors and transmission networks, on generation, on balancing and reserve power, and on load. Rules on proper market conduct and supervision differ significantly between Member States, as there is little harmonisation at EU level of the transparency requirements in electricity markets.

### **Price formation:**

**Price formation is complex, and many users have limited trust in the price formation mechanisms.** Fuel price increases in marginal plants certainly play a role in recent electricity price developments. Gas prices have significantly increased but coal prices have remained relatively stable. Analysts cannot yet agree on the extent to which the EU emissions trading scheme has affected electricity prices. The co-existence of regulated and free market prices on several national markets has an adverse effect on the development of competitive markets. In a number of Member States, special measures to reduce electricity costs for large energy intensive users have also been considered, although compatibility with antitrust and state aid rules provides limits to lowering prices by such schemes.

### **Way forward**

In the Issues Paper the Commission services had announced that they would discuss and propose any necessary *structural, regulatory and competition law based remedies*, once the assessment of the findings of the Inquiry and the parallel reviews of implementation of the Liberalisation Directives had been concluded. It is therefore **too early to draw conclusions** at this stage and comments are solicited during the forthcoming two months consultation period following the publication of the report and the **wider debate in the context of the forthcoming Green Paper**, which will allow the Commission to reach conclusions at the end of 2006. Nevertheless, from the point of view of the Commission services a number of preliminary remarks can be made now.

### **Competition law**

The Commission is pursuing infringements of Community competition law in the sector wherever the Community interest so requires, in accordance with the regulations in place and in close cooperation with National Competition Authorities. Even before the completion of the Inquiry, the current findings will help to carry forward procedures with full knowledge of the market environment and to orient priorities towards the most serious problem areas.

(1) *Market Concentration* has been identified as the major problem and this makes the Community's action under the merger regulation essential. While each merger case is assessed according to its specific characteristics, the Inquiry helps to identify the most relevant criteria and the most efficient remedies in the given market environment.

(2) *Vertical foreclosure: Tying of downstream markets.* The Inquiry has confirmed that foreclosure of the market by long-term downstream contracts is an immediate priority for review of case situations under competition law. During the forthcoming phase of the Inquiry, the data collected will be further screened and any foreclosure effect closely analysed.

(3) *Market integration: access to capacity on pipelines, gas storage and on interconnectors* has been found to be a major stumbling block towards more market integration and should be the other immediate priority for review in terms of anti-competitive conduct.

The findings indicate that the use of market partitioning clauses continues in a number of Member States. This will need further attention during the final phase of the Inquiry.

Besides these priority actions focusing on market concentration, downstream market foreclosure, and market integration, other case situations of anti-competitive and exclusionary conduct deserve immediate attention, such as inhibiting customers from switching suppliers.

The issuance of guidance on the application of Articles 81 and 82 EC to various practices in the sector may be envisaged. The Commission welcomes comments on the need for such guidance during the consultation.

## **Regulatory**

The Commission has undertaken to review on a Member State by Member State basis the implementation of the gas and electricity liberalisation directives during 2006, and to submit proposals by the end of the year<sup>4</sup>.

While more time will, therefore, be needed to reach conclusions in this field, from a competition perspective a number of issues already seem to emerge from the preliminary findings.

(1) A main finding is that *transparency* is insufficient in the sector. There seems to be broad consensus that this issue should be addressed by strengthening transparency obligations, be it under regulation or under competition law.

(2) There are substantial indications that the remaining “*grandfathering rights*”<sup>5</sup> seriously impede effective entry of competitors and therefore undermine the pro-competitive operation of the market.

(3) Whilst progress has been made in fixing common rules regarding the interconnectors between national grids, much more needs to be done. While there are a number of schemes between national regulators in place or being set up concerning coordination in this area, the findings suggest that purely voluntary cooperation schemes between

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<sup>4</sup> Commission Report on Progress in Creating the Internal Gas and Electricity Market, 15 November 2005

<sup>5</sup> Capacity rights stemming from pre-liberalisation monopoly contracts.

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regulators are unlikely to provide the investment certainty and regulatory protection that is needed to develop international pipelines and interconnectors in a stable environment and keep them open.

There are a number of other regulatory issues that have been raised by both market participants and regulators and which will have to be further considered during the ongoing reviews of the implementation of regulation in the sector. It seems that in a number of Member States, the powers of national regulators should be increased in a number of areas. For example, one area appears to be the surveillance of the conditions and prices for Third Party Access for competitors in order to make pro-competitive markets work and allow consumers to benefit.

### **Issues under review**

There are a number of issues on which it would be premature to take position at the current stage of the assessment but on which comments are solicited:

- the price setting practices on electricity wholesale markets including power exchanges
- the competitive assessment of the gas / oil price linkage in many contracts
- the exemption from Third Party Access provisions in the gas directive (in cases of new investment in pipelines, storage and LNG terminals)
- a possible more generalised use of gas and electricity release programmes under regulation, in order to reduce the effect of concentration in the upstream supply level and inject liquidity into the market, as well as other measures reducing the effects of concentration,
- further measures to reduce upstream supply concentration, and
- the impact of the Emission Trading System (ETS) on prices in the electricity market. The Emission Trading System is central to a cost effective attainment of the Kyoto green house gas reduction goals and therefore must be seen in a wider policy context. The Commission has committed to undertake a review of the functioning of the scheme before the end of the year.

### **Structural**

While the measures and issues set out above and submitted for consultation would address a number of the key problems found at this stage of the Inquiry, the findings of the inquiry suggest more and more strongly that a real breakthrough towards effective competition in the gas and electricity markets by 1st July 2007 will not be possible unless the root causes of the market malfunctioning are addressed. The market structure suffers from a systemic conflicts of interest resulting from the vertical integration, in many cases, of the supply, transport and distribution level.

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This situation dates from the pre-liberalisation period and prevents the advantages of an efficient competitive market reaching the final consumer in a meaningful manner. It makes the Community's energy system less receptive to the introduction of new forms of energy such as renewables due to the stake holders' interest at all three levels of the value chain; and it prevents an effective diversification of supply, which is an indispensable element towards more security of supply.

The provisions of the second electricity and gas Directives on unbundling need to be fully implemented, not just in their letter but also in their spirit. If real progress in this respect does not develop and a true level playing field result, further measures such as **full structural unbundling** (i.e. separation on the supply and retail business from monopoly infrastructures) should be considered.

Comments on this issue are also welcome during the consultation period.

### **Conclusion**

The overall objective of the Inquiry was to identify the barriers currently impeding the development of a fully functioning open and competitive EU wide energy market as a basis for fairer prices for the final consumer, more efficient allocation and use of resources and supply, more openness for renewable energies and an economically sustainable basis for security of supply.

At this stage of the preliminary findings, the overall conclusion is that the main problem areas identified in the Issues Paper have been confirmed. Comments are solicited on these problems and the further considerations submitted in this Preliminary Report before 1st May 2006 and should be sent to [comp-energy-sector-inquiry@cec.eu.int](mailto:comp-energy-sector-inquiry@cec.eu.int). Taking account of comments received and the further assessment of data, the Final Report on the Inquiry will be published at the end of 2006.

**A complete version of the Preliminary Report is available**

**[http://europa.eu.int/comm/competition/antitrust/others/sector\\_inquiries/energy/](http://europa.eu.int/comm/competition/antitrust/others/sector_inquiries/energy/)**