

Mr H Ungerer
Directorate B
Directorate-General for Competition
European Commission

26 April 2006

Dear Mr Ungerer

Energy Sector Inquiry – Draft Preliminary Report

Thank you for the opportunity to comment on the report by DG Competition on the Energy Sector Inquiry, published on 14 February 2006. British Energy is the largest electricity generator in the UK, producing around one fifth of the country's electricity. We are also a major supplier of electricity to the industrial and commercial sector. Our comments primarily relate to the electricity market although as gas and power markets become increasingly correlated, we are also concerned about proper functioning of the European gas markets.

Market Concentration

- Excessive market concentration is not a particular issue for the UK market currently, although the competition authorities at both the national and European level need to continue to be vigilant as the trend towards consolidation continues. This is particularly important if market integration at the European level does not proceed as envisaged by the Commission.
- The presence of national champions with the potential for abuse of dominant positions in certain continental markets mitigates against proper functioning of these markets – in particular it creates barriers to entry. The fact that these national champions are also largely free to compete in other competitive markets across the EU also potentially distorts wider competition. The Commission should therefore look carefully at any pan-EU M&A activity by such groups with a view to securing reciprocity of treatment / access to markets.
- Efforts need to continue to increase the size of the market, i.e. through greater market integration at the regional and European level, as a means of addressing the problem of excessive market concentration.

Vertical Foreclosure

- The recent decline in liquidity in the wholesale electricity and gas markets in the UK and failure of liquidity to develop in other fledgling continental markets is a concern to

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us. Vertical integration of generation and supply is undoubtedly a major factor in suppressing liquidity and measures need to be considered which incentivise market-place trading.

- It is not yet clear whether further measures to require full structural unbundling of monopoly network activities from competitive generation and supply are necessary. The first step must be to ensure that existing EU requirements for legal separation are enforced. Progress in this area needs to be monitored closely to ensure that progress is being made by member states. The Commission needs to be prepared to take action if this proves necessary.

Market Integration

- The extent of market integration depends in part on the level of physical interconnection. However, we do not support the setting of arbitrary targets for the percentage of interconnection required irrespective of physical or other barriers to such interconnection as this could be hugely expensive and potentially inefficient.
- The issue of how new interconnections should be financed is critical – there is unlikely to be significant expansion of interconnection on an unregulated basis, and if interconnections are justified as part of a regulated asset base, then the economic benefits to consumers must be shown to outweigh the costs.
- Regulatory action to facilitate cross border trade through harmonising legal and other requirements in physical or financial products could also assist in promoting market integration. Greater co-operation and co-ordination between national regulatory bodies should be encouraged to assist in this process.

Transparency

- For EU energy markets to function properly there needs to be a significant improvement in the quality and transparency of information provided to market participants. This is particularly important for TSOs, where guidelines on minimum standards and best practice regarding network utilisation, generator availability and demand need to be provided.
- It is also important that information on other key parameters is provided in a timely and transparent manner to the market. This includes issues like progress against emissions targets by Member States, as discussed below.

Price Formation

- We believe that there are fundamental issues to be addressed regarding price formation in the continental gas markets, and hence in the UK gas and power markets which are increasingly correlated with continental gas. We do not believe

that market fundamentals require there to be a link between the price in gas contracts and oil prices as there is limited opportunity for fuel substitution and production costs are not generally linked.

- Long term contracts are an important element of a well functioning and stable competitive market. However, action may be justified if these contracts prevent access to networks by third parties and thereby hinder the development of the market.

EU ETS

- We support the EU Emissions Trading Scheme as a market-based mechanism to put a real price on carbon dioxide emissions as one of the key enablers for a lower carbon EU. However, for the electricity and gas markets to function properly, it is essential that the price signal for carbon is longer-term so that it can be properly reflected in investment decisions. The situation for the EU ETS post-2012 therefore needs to be clarified as a priority as soon as possible.
- The importance of transparency in this market has also been highlighted by the recent sharp price moves triggered by unexpected, ad hoc announcements of actual 2005 emissions by certain Member States. This sort of behaviour, and the resultant volatility of prices, is in danger of undermining confidence and liquidity in what is still a fledgling carbon market.
- The Commission should therefore consider the need for all Member States to provide regular and detailed interim updates on their progress against their targets. This would help ensure that all market participants had the necessary information to inform their trading decisions; it would also serve to increase confidence that the targets themselves – and the Member States' submissions that underpinned them – are genuine, credible and realistic. This is particularly important as we move towards resetting targets for 2008-2012.

If you have any questions regarding this, please do not hesitate to contact me.

Yours sincerely



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