

UK GOVERNMENT RESPONSE TO PRELIMINARY REPORT OF THE COMMISSION'S SECTOR INQUIRY

Introduction

As the UK increasingly becomes a net importer of energy, the interaction of the UK's liberalised energy market with the, in most cases, less liberalised energy markets in the rest of the EU is of increasing political importance. It is clear that much remains to be done before energy markets in Europe function properly. Achieving well functioning EU energy markets is essential for the UK as it has a direct link with the prices UK consumers pay for their energy. As set out recently in the Commission's Green Paper on a European Strategy for Sustainable, Competitive and Secure Energy, only when a fully competitive internal energy market is established will EU citizens and businesses enjoy all the benefits of security of supply and lower prices. The UK Government therefore welcomes the sector inquiry being undertaken by the Commission which has identified obstacles to the development of competitive EU energy markets.

Market defects identified

The preliminary report highlighted five areas of market malfunctioning:

- High degree of market concentration
- Vertical foreclosure e.g. vertical integration being used as a barrier to new entrants.
- Lack of market integration, e.g. energy markets remain national
- Lack of transparency
- Lack of well functioning and transparent market mechanisms for setting prices

There is a large degree of overlap between these areas and the potential barriers to competition listed in the conclusions agreed at the Energy Council in December 2005 during the UK Presidency. We therefore believe that the Commission has correctly identified the areas where remedial action needs to be taken.

Priority areas for action

The Commission has set itself a vast agenda and will need to focus remedial action on the most significant obstacles and market defects identified at the same time. The UK believes that the following issues should be addressed as a matter of priority since they present the greatest threat to the opening up of EU energy markets to competition. These issues are to a large extent already covered by the provisions of the existing legislation. With full implementation in both the letter and spirit, many of the obstacles to better functioning of energy markets could be removed. Enforcement of compliance with the Directives and Regulations is therefore a top priority, alongside the continued rigorous application and enforcement of competition law in the energy sector.

Unbundling

Effective unbundling of network businesses is essential if there is to be fair and non-discriminatory access to the network for all system users. Without this access, the incumbent operators of networks and storage can favour their own affiliates and thereby prevent the entry of new competitors. Moreover, proper separation should also deliver greater data transparency and confidence in the operation of the market, leading to lower prices. A study carried out in the UK has demonstrated that where the Transmission System Operator has been successfully unbundled, gas prices have fallen by around 15%.

Legal unbundling as laid down in the 2003 Directives can be effective if rigorously regulated by the national regulatory authorities. However, the Commission has found that unbundling is generally inadequate. Member States must take urgent action to ensure that the existing unbundling provisions are implemented in a manner which guarantees independent network operation; otherwise, ownership unbundling will need to be considered.

Transparency

Market players must have equal access to accurate, timely and comprehensive information, for example on capacity available in networks, and in gas storage. Without this, there can be no level playing field and new market entry will be difficult if not impossible. Greater transparency will increase confidence in price signals which are so important in trading and investment decisions, and will increase effective utilisation of energy infrastructure. Much more information could be released to the market under existing legislation, for example the Gas Regulation.

The Commission reported a serious lack of reliable and timely information on both the electricity and gas markets, which suggests that the existing legislation is not being enforced. Determined action by the Commission and regulatory authorities to enforce the existing obligations could bring about a significant and rapid improvement in the situation. However, the existing transparency requirements are not sufficient and further obligations will be necessary to ensure a level playing field.

Access to networks and gas /and electricity supplies

The Commission has found that the network of long-term contracts between gas producers and incumbent gas importers makes it difficult for new entrants to access gas on upstream markets and the low level of liquidity on traded markets limits their access to downstream gas and electricity. In the gas market, new entrants find it very difficult to secure transit capacity on key routes and access to gas in store. Pre-liberalisation contracts give long-term control of these facilities to the incumbents. This situation is made worse by ineffective congestion management mechanisms which can make it hard to secure even small volumes of short-term, interruptible capacity. And even when there is new capacity, most of it ends up in the hands of the incumbents. In electricity, there is insufficient interconnector capacity and long-term capacity reservations predating liberalisation, which limits access for new entrants. Moreover, congestion management mechanisms are inefficient and there is a lack of adequate incentives to invest in additional capacity.

Competition cannot develop if new entrants do not have information on unused capacity in pipelines and grids and, in gas storage, if non-discriminatory mechanisms are not in place to allow them to access this capacity. It is imperative that use it or lose obligations be imposed on system operators. Unbundled system operators, properly regulated, should in any case have the incentive to maximise the use of available capacity. So it is clear that the lack of transparency and inadequate unbundling are exacerbating the difficulties new entrants have in accessing essential infrastructure. The terms of long term contracts and the way in which new long term contracts are awarded must be rigorously monitored by regulatory authorities to ensure that no anti-competitive effects ensue. And the Commission must make it clear that legacy contracts are not exempt from the access provisions of the Directives. However, it must be acknowledged that long term contracts can play an important and legitimate role in underpinning investment in infrastructure. Doubts about the validity of long term contracts may therefore deter much-needed investment. It would therefore be helpful if the Commission could issue guidance on long term contracts to dispel the uncertainty which currently exists in the market.

Concentration

The Commission report highlighted that both gas and electricity markets retain the high level of concentration of the pre-liberalisation period, with the incumbents dominant in their traditional markets. Wholesale trade has been slow to develop with little new entry in retail markets which limits consumer choice and reduces competitive pressure. Incumbents largely control upstream gas imports and/or gas production and trade only a small proportion of their gas on hubs. Dominant electricity generators have the scope to raise prices on power exchanges. These findings confirm the UK's view that even with full implementation of the existing legislation, new entrants will find it difficult to enter many EU markets because of the dominance of the incumbents.

The UK fully supports the Commission's intention to scrutinise meticulously future mergers and be vigilant in its control of state aid. Any mergers that are allowed to go through should be subject to appropriate remedial concessions and other measures to avoid any anti-competitive outcomes. The rigorous application and enforcement of Community competition law will play a key role in the future development of the European energy market, and the sector inquiry can play a key role in establishing the most efficient remedies given the current market environment. We therefore welcome the Commission's statement that it will launch individual anti-trust investigations where it suspects violation of the competition rules.

Way forward

The UK suffered some very high prices this past winter, particularly in November 2005, with flows through the UK-Belgium gas interconnector averaging only 60% of total capacity. It has been estimated that the annual cost to the EU of gas prices remaining linked to the price of oil is £40 bn. This indicates that the price benefits to EU consumers of introducing gas-to-gas competition are likely to be significant. It is therefore important to the UK and to the EU as a whole that significant improvement in the functioning of EU energy markets is achieved.

The situation could be eased considerably if greater transparency were to be achieved in EU energy markets, with a greater political commitment to openness. More information freely obtainable by all market players could significantly reduce the anxiety factor which has made gas prices higher this past winter than they need have been and help provide a more stable framework for investment. However, further transparency obligations will be necessary to ensure a level playing field. The UK therefore urges the Commission to strengthen the transparency requirements as soon as possible.

Another area where further legislation may be necessary relates to powers of regulators. There are very great disparities in regulators' powers at present so, even with the fullest cooperation, they are not able to carry out their tasks effectively and in a coherent manner. Regulators' should be independent of Government, with powers to monitor and regulate competition in all the areas which impact on the operation of the national and, where appropriate, regional market, be able to impose penalties for non-compliance with the rules, and have sufficient resources to fulfil their functions. Moreover, consideration needs to be given to the powers that regulators may require to establish functioning and effective regional markets as a step towards establishing a single EU energy market. To help encourage further market integration, regulators need improved methods of coordination to help achieve a more consistent approach on cross-border issues, as has been achieved in the area of Financial Services. A key factor in the successful development of regional markets is the existence of a regulatory framework which provides investors in cross-border infrastructure with sufficient regulatory certainty and coherence. National regulators therefore need to be able to take account of the interests of consumers in a wider area than their national markets and to share information with other national regulators.

Conclusion

The UK Government welcomes the sector inquiry being undertaken by the Commission and believes that the Commission has correctly identified the areas where remedial action needs to be taken. We believe that the issues to be addressed as a matter of priority are: unbundling, transparency, access to networks and gas and electricity supplies, concentration. Many of these issues are already covered by the provisions of the existing legislation so **enforcement of compliance with the Directives and Regulations is a top priority.**

Member States must take urgent action to ensure that the **existing unbundling provisions are implemented in a manner which guarantees independent network operation**, otherwise ownership unbundling will need to be considered. The existing **transparency obligations must be enforced by regulatory authorities, but further transparency obligations will be necessary to ensure a level playing field.** New entrants must have **information on unused capacity in pipelines and grids** and non-discriminatory mechanisms must be in place to allow them to access this capacity, for example it is **imperative that use it or lose obligations be imposed on system operators.**

The **terms of long term contracts and the way in which new long term contracts are awarded must be rigorously monitored** by regulatory authorities to ensure that

no anti-competitive effects ensue. And the Commission must make it clear **that legacy contracts are not exempt from the access provisions of the Directives.** However, long term contracts can play an important role in underpinning investment in infrastructure and doubts about the validity of long term contracts may deter much-needed investment. It would therefore be helpful if the Commission could issue **guidance on long term contracts** to dispel the uncertainty which currently exists in the market. The UK fully supports the Commission's intention to **scrutinise meticulously future mergers and be vigilant in its control of state aid.** We also welcome the Commission's statement that it will launch individual anti-trust investigations where it suspects violation of the competition rules.

Regulators' powers should be increased to the level of the highest, based on independence from national governments. Consideration also needs to be given to the **powers that regulators may require to establish functioning and effective regional markets** as a step towards establishing a single EU energy market.

In addition, the Commission must ensure that the **information, analysis and remedies from the sector inquiry play an integral part in the development of an Energy Policy for Europe,** in line with the Commission's Green Paper and conclusions of the Spring European Council. Achieving a competitive and efficiently functioning Single Market is an essential prerequisite to the achievement of Europe's wider Energy policy aims.

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