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1 May 2006
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Case
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Public Consultation - Comments to Draft Preliminary Report on the Commission's ENERGY SECTOR INQUIRY

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Dear Sirs,

Reference is made to the Commission's Draft Preliminary Report on the Commission's inquiry into the energy sector published mid-February 2006 (the "Report").

In the Report the Commission invites the public to comment on the Report by 1 May 2006. Below please find the DONG group's comments to the Report including comments to some of the other issues currently under review by the Commission, cf. pp. 190-191 of the Report. The DONG group consist of DONG Energy A/S including its subsidiaries and control of the energy companies Energi E2, Elsam, Nesa, Frederiksberg Forsyning and Københavns Energi (electricity activities) ("DONG"). Please note that to the extent comments have already been put forward by various DONG entities as a response to the questionnaires sent out last summer, such comments will not be reiterated here.

DONG fully supports the purpose of the Commission's Energy Sector Inquiry.

Further, on 14 March 2006 the European Commission cleared the merger of the energy companies DONG, Energi E2, Elsam, Nesa, Frederiksberg Forsyning and Copenhagen Energy (electricity activities). In the merger clearance process said energy companies have been thoroughly investigated by the European Commission and the merger lead to undertakings on an agreement on the sale of power stations and wind power activities to the Swedish energy group Vattenfall to further enhance competition within the electricity sector. Within the gas sector competition will be further promoted through an undertaking on a gas release programme and sale of more than half of DONG's gas storage capacity.

The newly merged DONG operates on a highly competitive Nordic energy market. The Nordic countries have executed an ownership unbundling of transmission capacity within both the gas and the electricity sector. And the competition has been promoted with the establishment of Nord Pool - The Nordic Power Exchange in 1993.

Nord Pool is the world's only multinational exchange for trading electric power and it has in practice connected the electricity markets with a competitive price formation in Norway, Sweden, Finland and Denmark. Furthermore Germany and Denmark are connected with cross-border capacity and Germany thereby indirectly influencing the Nordic electricity market as well.

Nord Pool is a well-functioning market and further progress is achieved through increased customer confidence. The number of customers at the exchange is rising along with volumes being traded.

DONG supports the efforts taken by the Commission to increase openness, competition and transparency of the energy markets in EU. Specifically DONG supports harmonized EU regulation with regard to unbundling of grid assets to secure non-discriminatory grid-access. Common EU CO_2 regulation is also needed to secure equal terms of competition within the EU.

The efforts to secure competition should be accompanied with a deregulation of some sector specific regulation, which in spirit and practice limits the competition. For instance a tight and specific regulation of supply duty prices at a low level may de facto prevent new competitors to enter the market, as there is no business case for doing so.

1. Comments regarding Findings on the Gas Markets

1.1 General Remarks

The Commission outlines a number of concerns regarding the market for natural gas in EU, i.e.

- Market concentration
- Vertical foreclosure

- Market integration
- Transparency
- Price information

In general DONG does not find that these concerns are prevailing in Denmark; see our earlier responses to questionnaires related to the sector inquiry.

DONG has the following suggestions regarding measures to stimulate a well functioning internal gas market:

1.1.1 Regional network cooperation as a door opener for a pan-European solution

On the overall European level the basic rules etc. for the European TSOs are quite fragmented and unbalanced but in the Northern part of Europe the rules and terms and conditions have improved over recent years. This applies especially to Denmark (Energinet.dk), Northern Germany (BEB), the Netherlands (GTS) and UK (Transco). The network operators in these areas seem to have the same philosophy developing terms and conditions in a more customer/shipper friendly way although still focusing mainly on their "own" areas making international cross-border activities less seamless.

New regional fora and specific cooperation between Transmission System Operators ("TSO") in regional areas with some common features should supplement the current approach of pan-European discussions fora. This could lead to the establishment of coherent areas with improved market access, stimulate cross border activities and thereby create larger areas of competitive and integrated markets. Consequently, gas market at different speeds will appear, but when one international gas market area develops to the benefit of customers and consumers it will put more pressure on other neighbouring areas to develop as well. In other words, a regional network corporation will work as a door opener for a pan-European solution.

1.1.2 Proposals for harmonisation of network rules etc.

Based on the actual market situation and in its experience DONG finds that the following specific measures should be prioritised and developed as a basis for establishing common network codes etc.

Transparency

It is important that shippers have information from network operators on available capacity, tariffs, actual flows etc. in order to plan, manage and optimise the supply business.

Some network operators do not have public adequate information on capacities, tariffs and terms and conditions for the capacity availability and tariffs vary greatly even among TSOs/Storage System Operators ("SSO") even as regards companies from the same member state.

Therefore, network operators should publish information on capacity and tariffs in a harmonised and comparable form.

Functionality

For a properly functioning gas market a simple market model for customer switching is needed.

Many network operators do allow for third party access but have no rules, procedures and systems for customer data, customer identification, allocation etc. in place for end customer switching.

Consequently all network operators should be requested to establish standard mechanisms for switching customers from one supplier to another (market model).

Accessibility

Access to transportation and storage capacity is essential for shippers to supply acquired new customers with gas including the needed flexibility for so-called "full supply" etc.

Many network operators often have the entry and/or exit capacity fully booked by the existing suppliers (or if capacity is available network operators often only have interruptible capacity for new suppliers) and do not have rules for transfer of capacity not used when customer wants to shift to another supplier.

Network operators should be obliged to have rules securing release and transfer of non-used transportation and storage capacity.

Gas quality converting

Shippers should have access to markets with different gas qualities as gas with different qualities can be blended and converted to a uniform quality increasing liquidity.

Some markets have different qualities of gas constituting a market entry barrier for new suppliers as no rules for gas quality converting exist if the shippers only have gas in one quality available.

Network operators should offer shippers the possibility of converting gas qualities at fair terms and conditions.

Balancing

Shippers have to balance the volumes put into and taken out of the system, i.e. shippers must deliver a volume to the network that is equal to the volume taken out from the network by the shippers' customers.

Network operators have different - and often complicated - rules for balancing with substantial risks for shippers, as access to gas for balancing purposes is limited and costly. Some network operators have hourly balancing regimes and some have daily balancing regimes. Hourly balancing is a very tough and expensive obligation for shippers as customers and network operators are often not able to provide the required volume data information to the shippers.

Network operators should align balancing rules across markets and balancing should be daily, not hourly. Network operators should have access to some storage capacity to be able to provide shippers with gas for balancing on fair terms and conditions. Improvements in this regard can be achieved regardless of ownership structure; it is a matter of setting harmonized standards.

Allocation/matching between network operators

For shippers with cross border activities and/or activities in vertical markets with many operators to pass on the way to the customers it is important that the different network operators make agreements on allocation and matching of volumes.

In some gas markets there are limited inter-connection agreements between upstream and downstream system operators and often no matching and allocation rules exist.

Network operators should be obliged to agree on standard rules for allocation and matching of volumes between system operators.

1.2 Specific remarks

Para. (11): The claimed barriers for substitution to other fuels seem undocumented. In practice, the substitution possibilities are rather smooth for industry and electricity generation, whereas the switching costs for households might constitute a barrier.

The Commission overlooks the fact that the development of the natural gas market historically has been in competition with other fuels, mainly oil. I.e. natural gas has been penetrating on a market for other fuels used for the same purposes as natural gas.

Para (103): In relation to gas release programs attention should be drawn on two-way gas release programs as opposed to traditional one-way gas release programs. Whereas the traditional one-way gas release programs, i.e. where the gas is sold at an auction in return of payment in cash, provides more liquidity in one market, two-way gas releases, i.e. where the gas is sold at an auction in return of delivery of gas at another place, increases the liquidity and competition in two markets and at the same time facilitate access to gas in new markets for more market players. Therefore, two-way gas release will stimulate the overall competition and increase the overall level playing field on a European scale in line with the strategy of the Commission.

The Commission should use gas release programmes to a limited extent only, as a gas release program leads to expropriation of gas from long-term gas sales agreements between private parties. Prudent suppliers with delivery obligations towards end-consumers cannot rely on winning an auction for its supply. Hence, auction gas from release programs will tend to be "auxiliary gas" in the portfolio of prudent suppliers, and often exported away from the national market where it is meant to create larger liquidity.

Para (285): The graph (figure 37) is a good example of why both wholesalers and end customers prefer oil indexed prices as opposed to hub based prices: relative price stability, which from a financial point of view is a merit in any business.

1.3 Price Formation

On the issue of interplay between a regulated and a "free market" price the Report on p. 93 ff, para. 288, rightly points to some of the adverse effects of setting supply tariffs below the corresponding wholesale benchmark as this may lead to new suppliers not entering or being squeezed out of the market. In our experience the intense price regulation of the regulated supply tariffs allows only for small margins/marginal profits, which makes it less desirable for new suppliers to enter the market as the there is a tendency for all suppliers to converge toward the regulated supply tariff because this already is close to break-even. Consequently, the current enforcement of the legislation in place on regulated supply tariffs runs counter to the objective desired by the Commission, see also 2.4 below.

2. Comments regarding finding on the Electricity Markets

2.1 Market Power

DONG supports the Commission in its efforts to bring possible abuse of market power in electricity generation to an end. It is however important to distinguish between the existence of market power for a short period of time and abuse of the market power. The market for electricity generation has along with the liberalisation changed in a manner that may in some cases increase the likelihood of market power in shorter periods of time.

The overcapacity in electricity generation has been significantly reduced as only profitable investments are undertaken since the privatization and liberalisation of the energy sector.

Generation capacity is impeded as profit margins from electricity production ("green dark spread" and "clean spark spread" are not yet at sufficiently high levels to attract investors to electricity production). Recent investment projects seem profitable only thanks to subsidies. This fact combined with a rising consumption means that scarcity at peak periods is no longer a rare phenomenon and that scarcity must be accepted to some degree as it is a driver for new investments.

The Commission should pay attention to the fact that an important element of electricity supply is must-run production (run-of-river hydro plants, wind power, and to a large extent combined heat and power plants and nuclear plants) which depress market prices for shorter periods (in which case electricity buyers are in an attractive position). It is therefore important not only to focus on a small number of hours, when prices are high, but on the average annual prices and profits.

In para. (383) the Report states that "*it is however important to underline that having scope for influencing prices does not automatically mean that market power was abused in an anticompetitive manner, as many market participants claim*".

It is very important that the Report focus on improving the market mechanisms instead of imposing detailed regulation, price caps and other proposals that creates uncertainty about profitability of investments in production capacity.

It is true as the Report states that a high frequency of congestion on a certain border shows that trade and price equalization could have been even higher. However in the case of congestion, there is maximum competitive impact from the exporting area on the importing area. Congestion is also a sign of intense interaction – lack of congestion might be the sign of over-investment in transmission capacity.

2.2 Improving the market

DONG agrees with the need for more transparency. The lack of transparency is probably the main reason why many market participants perceive market malfunction and producer conspiracy. Reaching the Nordic level of transparency would be a major milestone for the European electricity market.

As in any other market, new investment is the major tool to avoid excessive prices. Focus should be on transparency, bottleneck relief, efficient cross-border regimes and maintaining a good investment climate.

In order to increase price convergence, major transmission investments are required. DONG is pleased that this important subject is raised in II.3.5 and would welcome increased focus on the required action and coordination from the TSOs.

2.3 Vertical Foreclosure

As regards vertical integration between generation and retail activities described in the Report on p. 135 ff where it is assumed that such integration may lead to a lack of liquidity in the wholesale market if the major producers to not trade or clear their production via the wholesale market or an exchange.

In the Nordic region Nord Pool has now for a number of years been setting the market price. Consequently, the quoted price on Nord Pool serves as a credible reference for setting the retail price, which in turn leads to a liquid market.

The Nord Pool set-up should be encouraged in less liquid markets.

DONG does not share the view that vertical integration between the supply and distribution system networks will per se restrict competition. In our opinion an efficiently enforced legal unbundling of the supplier and distribution company is sufficient in securing competition.

Currently, the electricity consumer and not the supplier enters into the transportation capacity contract. Thus, under the Danish set-up the electricity consumer enters into two separate contracts for his electricity purchase; one on the provision of transportation capacity from the Distribution System Operator ("DSO") and another on the provision of electricity. Although it could be argued that by its very set-up the DSO cannot discriminate between different electricity wholesalers as only the customers themselves enter into the transportation agreement with the DSO, nevertheless in DONG's opinion this restricts competition as it precludes all electricity wholesalers from access to the distribution system networks, explicit reference is made to DONG reply to question C.32 under DK-0324-CUS.

In our experience the lack of household customers switching is inter alia likely to have been brought about by the fact that only a very small sum may be saved from switching, see also below under 2.4.

2.4 Price Formation

On the issue on price formation and regulated supply tariffs the Report on p. 180 points to some of the adverse effects of setting supply tariffs below the corresponding wholesale benchmark as this may lead to new suppliers not entering or being squeezed out of the market. The Report rightly points out that "*Parallel regimes are no threat to a liberalised supply market and its participants as long as regulated energy prices are comfortably above market price levels.*" In our experience the intense price regulation of the regulated supply tariffs allows only for small margins/marginal profits, which makes it less desirable for new suppliers to enter the market as the there is a tendency for all suppliers to converge toward the regulated supply tariff because this already is close to break-even. Consequently, the current enforcement of the legislation in place on regulated supply tariffs runs counter to the objective desired by the Commission.

3. Issues under Review, Structural

In addition to the issues already addressed above the Commission in the Report on p. 191 also suggests (under the heading "Structural") that it may be necessary to consider further unbundling measures - so-called full structural unbundling - to ensure effective competition on the European energy markets.

It was not fully clear to DONG whether the term full structural unbundling covers legal or ownership unbundling. Should it cover the latter, in DONG's opinion such ownership unbundling would be both extremely cumbersome and legally difficult as it could border on expropriation.

Effective implementation of legal unbundling is sufficient to bring about the desired pro-competitive effects if the principles of non-discrimination and objectivity are applied rigorously. Both DONG's own ownership unbundling of its storage and distribution activities and Centrica's recent acquisition of Rough Storage subject to strict non-discrimination and objectivity criteria are successful examples of such legal unbundling.

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Kind regards
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