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by Jonathan Green

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Europe's energy markets

Opening up competition still has some way to go

by **Jonathan Green***

Soaring spot market prices for gas and electricity in the UK have, once again, focused attention on energy markets and the operation of competition. Unexplained price differences between the UK and continental Europe have highlighted concerns about the extent of competition in the EU market.

There has been a fivefold rise in the spot market price of gas in the UK over a few weeks, well above the levels in the rest of Europe. With around a third of electricity generation coming from gas-fired power stations, this has had a knock-on effect to electricity prices. Yet there has been very little market response from continental gas suppliers. The UK-Belgium gas interconnector has been operating at less than full capacity despite the profitable trading opportunities offered by the high prices in the UK. Ofgem, the UK regulator, has called on the Commission to investigate.

These concerns are not new and the Commission is already well advanced with its own inquiry. Initial findings have been published and these will be the subject of public consultation early in 2006. The challenge then will be to move from analysis to action that can remedy the defects identified by the Commission.

Sector review

The new procedures for implementing the provisions of articles 81 and 82 agreed at the end of 2002 contained provision for the Commission to carry out its own inquiries into particular economic sectors where it appeared that competition within the common market was restricted or distorted (see Council Regulation (EC) No 1/2003, article 17). The energy sector was identified as an early candidate for such a review. This followed critical comments from market participants and from the Commission itself in its 2004 report on market liberalisation. An investigation was formally launched in June 2005.

The investigation is being carried out by the Competition Directorate General in collaboration with DG Transport and Energy. It is centred on the operation of the European gas and electricity markets, with the objective of establishing whether current indications of market malfunctioning result from breaches of competition law. There will be four main phases of work: (1) identification of issues – November 2005; (2) consultation on preliminary findings – February / March 2006; (3) proposed remedies – summer 2006; and (4) final report – end 2006.

The first issues paper was published on 15 November 2005 and identified significant impediments to competition in both the gas and electricity markets. These were discussed by ministers at the Energy Council in early December and will go out to public consultation in 2006. At this stage, the Commission has not given any indications of possible remedies to improve the competitive position.

Initial findings

The first phase of work has grouped restrictions on competition into five broad categories: market concentration; vertical foreclosure; lack of market integration; lack of transparency; and the price formation mechanism. Problems are identified in both the gas and electricity markets but the issues appear to be more significant and, potentially, harder to address in the gas market.

Gas market issues

Most EU national gas markets are highly concentrated. In addition, the incumbents often control indigenous gas production and hold long-term contracts for imported gas, the bulk of which comes from Russia and Norway. As a result, the scope for new players to enter the market is very limited. Vertical integration and long term off-take contracts lead to low liquidity in the wholesale markets, which is a further inhibition on new entry. Preferential treatment of pre-liberalisation contracts restricts access to cross-border pipelines and contributes to continued market segmentation. This is made worse by lack of information about pipeline availability.

A particular feature of the gas market is the extent to which the pricing of gas in long-term contracts is linked to oil prices. As a result, all gas contract prices tend to move in a similar way in line with oil prices and do not react directly to changes in the balance of supply and demand for gas.

The structure and functioning of the gas market has significant implications for the electricity sector where gas-fired generation is increasingly responsible for setting wholesale electricity prices. Lack of competition in gas will reflect through into the price of electricity.

Electricity market issues

The level of concentration in electricity generation varies from state to state but is high in many cases, creating potential market power. There is also a high degree of vertical integration between generation and retail supply and this contributes to illiquid wholesale markets and represents an obstacle for new entrants. Long-term power contracts between independent generators and incumbents add to this problem. In addition, and despite the provisions of the electricity liberalisation directive – see Directive 2003/54/EC concerning common rules for the internal market in electricity – inadequate unbundling between network activity (a regulated monopoly) and supply to final consumers (progressively open to competition) also deters new entrants.

Interconnectors between national markets are the key to further market integration. Long-term contracts and inadequate capacity allocation rules are seen as barriers to further development. As a result, it is difficult for importers of electricity to provide competition against national incumbents.

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Lack of transparency of information both about the operation of wholesale markets and interconnectors was identified by many market participants as a serious constraint and a factor which undermined confidence in the market and market prices.

A new way forward?

The liberalisation of energy markets has developed over the past decade through a directive-driven process, which has concentrated on setting market rules. While that process has taken liberalisation forward, it has been a slow march and has not addressed a number of fundamental market issues. This energy sector inquiry by the Commission provides the opportunity for a new approach to be adopted alongside the continuing implementation of the directives.

The issues paper represents a forthright start to the Commission's investigation. There are no great surprises in the list of issues identified as being of concern but the tone of the paper is strong in positioning the concerns firmly in the context of competition law. However, the big challenge now lies in developing remedies for the obstacles to development of competition. Making the transition from analysis to action will not be easy and, as yet, the Commission has given few clues as to its thinking.

The emphasis in the issues paper on the existence of dominant players, particularly in the gas market, suggests that use of article 82 powers will offer the main way forward. However that leads to further questions. If dominance is principally within national markets, will national regulators be prepared to take action? If not, will the Commission be able and willing to take action over their heads? Either way, what abuse of dominance will be targeted? There appears to be considerable choice – pricing, refusal to supply, exclusion through long-term contracts?

The story may be given an interesting additional twist when the Commission finalises its new approach to the operation of article 82. This is expected to put greater emphasis on the effects rather than the form of actions by dominant firms. That may allow the Commission to develop new and, possibly, quicker approaches to enforcement.

Even if action is successfully taken under article 82, that in itself does not ensure that competitive markets will prevail. Structural or behavioural remedies would need to be identified and there is again the potential for conflict between national and community-wide objectives.

An example of different approaches can be seen in the operation of merger control in the energy sector: In 2002, the takeover of Ruhrgas by E.ON, which fell under national jurisdiction, was approved by the German government, despite concerns about the strengthening of E.ON's market position expressed by the German federal cartel office. In 2004, the Commission blocked the takeover of Gas de Portugal by Energias de Portugal, which would have created a combined gas and electricity business similar to E.ON. In 2005, the Commission declined to intervene in the bid for Endesa by Gas Natural, which would, again, create a large gas and electricity business. The decision has been left to the Spanish competition authority. At the time of writing, the outcome of this contested bid remains in the balance.

It is difficult to see any consistent pattern leading to more competitive markets in this sequence of decisions. Can EU merger control play a positive role in maintaining and developing competition in the energy market?

In all, there are many questions still to be answered about the future development of competitive energy markets. 2006 will be a year in which the resolve of all those involved, not least the Commission, will be put to the test.

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