CAN GOVERNMENTS AND REGULATORS HELP CREATE COMPETITIVE MARKETS?

Lars Kjølbye, Head of Energy Unit, DG Comp – European Commission[1]

Setting the scene

In June 2005 the European Commission's Directorate-General for Competition launched a large-scale inquiry into gas and electricity markets. The main purpose was to analyse the functioning of these markets and to identify possible infringements of the Community competition rules. In a Preliminary Report issued on 16 February 2006, DG Competition presented its preliminary findings, identifying various areas where action might be required to improve the functioning of the markets. It is envisaged to issue the final report on the inquiry by the end of the year.

The sector inquiry and any enforcement actions that it may trigger under the Community competition rules must be seen in a wider context. Enforcement in individual cases can make an important contribution to creating open and competitive markets. However, as has been made clear by Commissioner Kroes on several occasions, an appropriate regulatory framework must also be in place and applied in an effective and consistent manner. Close coordination and cooperation between DG Competition, DG Transport and Energy and national competition authorities and regulators is therefore required. Indeed, much needs to be done if we are to achieve the goal of open, integrated and competitive energy markets in Europe.

The sector inquiry

The sector inquiry has focussed on five broad areas, namely market concentration, vertical foreclosure, market integration, transparency and price formation. Collectively, these areas cover all market aspects that feed into traditional competition law analysis and are fully in line with the objectives of sector inquiries; namely to identify competition problems in the markets concerned.

Gas and electricity markets are different in a number of ways. For one, the European Union is becoming increasingly import-dependent for its gas requirements, whereas that is not the case for electricity. In spite of such differences the core findings for gas and electricity markets are broadly similar. Numerous barriers to new entry and expansion exist. Indeed, problems exist at all levels of the supply chain, which explain why new competition has been slow to develop in many markets.

[1] The views expressed in this paper are those of the author and may not reflect those of the European Commission.

Market concentration

Markets at wholesale level generally maintain the high levels of concentration of the pre-liberalisation period. Effective new entry requires that entrants have access to gas and electricity, to transmission and distribution networks and to customers. Such access is rendered difficult by the fact that incumbents remain in control of key inputs. Incumbents control generation assets, domestic gas production (where it exists) and, through long-term contracts, also imports. They own or have privileged access to essential cross-border infrastructure. In some cases incumbents have also concluded long-term contracts with customers thereby making it more difficult for competitors to build a sustainable customer base.

Vertical foreclosure

Additional barriers to entry follow from the fact that in many Member States transmission network operators are vertically integrated with supply entities. When the same economic unit has supply interests and controls an essential infrastructure to which third parties must have access to compete on the supply market, the owner has the means and the incentive to favour its own supply business. This may take the form of discrimination of third parties or delayed investment in new capacity. A recent intervention by the Italian competition authority illustrates the latter point. The network company of a vertically integrated incumbent had launched a tendering procedure to expand the capacity of a pipeline but abandoned the project when it was realised that it would have an adverse effect on the supply business. From the point of view of the incumbent, this is rational behaviour. An integrated firm will only make an investment if it is profitable for the firm as a whole. From a social welfare perspective, however, this is not desirable. Investments that are profitable from a network business point of view should be made.

Market integration

The sector inquiry and recent merger decisions confirm that markets remain national in scope. The on-going liberalisation efforts have not succeeded in creating a fully integrated market. Incumbents rarely enter other national markets and available capacity on cross-border import pipelines and interconnectors is limited. New entrants are unable to secure capacity on key routes and overall capacity is insufficient to effectively constrain incumbents in their national markets. Even if, in the field of electricity, Member States would reach the target interconnector capacity of 10% of the market, this is likely insufficient in itself to widen the geographic scope of markets. A recent case brought by the Danish competition authority suggests that even relatively high levels of interconnector capacity are insufficient to effectively constrain incumbents. The Nordic region is the most interconnected area in the Community. Yet the incumbent in Western Denmark was able to charge what was considered excessive prices during a significant number of hours. The explanation is simple. The incumbent knows the maximum degree of import competition, which is fixed by the capacity of the interconnectors, and is a residual monopolist for the remaining part of demand.

Market transparency

There appears to be widespread consensus that there is a lack of reliable and timely information available to market participants. Network users request more transparency on *inter alia* use of interconnectors, TSO networks, generation capacity, balancing and storage. The publication of more detailed information would allow all players to take more informed action on the markets, which minimises their commercial risks and reduces entry barriers. It also helps to create a level playing field by avoiding that certain players have access to certain data while others do not. In concentrated oligopolistic markets a high degree of transparency may facilitate collusion and therefore cause competition concerns. However, it is considered that in the context of energy markets the benefits of increased transparency outweigh the costs. This is particularly so when due to vertical integration, incumbents have an informational advantage. Such asymmetries create additional barriers to entry and can be compared to a situation where two cars race on the highway but only one is able to turn its lights on. The disadvantaged driver needs very superior skill to stay on the road.

Price formation

The sector inquiry also looks into pricing issues in gas and electricity markets. As regards gas the main focus is on the current link between gas and oil prices. In most import contracts price indices are linked to oil products. The result is that wholesale markets fail to react to changes in the supply and demand for gas. For electricity it is being analysed what the scope is for incumbents to exercise market power on power exchanges - for instance by withdrawing capacity. DG Competition has contracted with consultants to analyse the large amount of data collected during the inquiry.

During the final phase of the inquiry DG Competition will revisit the current draft in light of third party comments obtained during the consultation procedure, which ended on 30 April. Moreover, further work will be carried out in a limited number of additional areas, such as pricing on electricity markets, balancing, LNG and downstream contracts, i.e. supply contracts between wholesalers and final customers such as industrial users. The final report will feed into the Commission's broader review of its policies in the energy field, which was launched by the Green Paper. Towards the end of the year the Commission will consider whether to propose new regulatory measures to complete the creation of an internal energy market with effective competition and security of supply. In the view of DG Competition there is no conflict between effective competition and security of supply. Open and competitive markets create the right incentives to invest and explore new sources of supply.

The way forward

The remedies that may be devised to address the various problems identified in the context of the sector inquiry fall into two categories: case investigations and general measures of a regulatory nature. DG Competition has the power to launch investigations in individual cases, whereas the power to propose new Community measures of a general nature rests with DG Transport and Energy. However, DG Competition intends to play an active part as a competition advocate with regard to any such proposals.

Case investigations

Sector inquiries form part of the powers of investigation attributed to the Commission under Regulation 1/2003. It is thus entirely natural that an inquiry serves as a basis for launching investigations in individual cases. DG Competition has the task of monitoring markets and launch case investigations when there are indications that competition is being unduly restricted. The main emphasis will be on cases that can make a significant contribution to remedying the problems identified during the course of the sector inquiry.

DG Competition is already actively investigating a case involving long-term contracts between a supplier and industrial users and the German competition authority recently intervened to prohibit long-term contracts between incumbent gas suppliers and Stadtwerke. When such contracts cover a good part of the market it is likely that third party competitors are being foreclosed. New competition can only emerge if competitors have regular opportunities to compete for customers. A further example of possible case investigations is capacity hoarding on essential infrastructure, i.e. reservation of capacity, which is subsequently not used. In that case third parties are denied access to capacity that they could have used to serve the market.

Case investigations address the competition problem identified in the case at hand and may have more general precedence value. Once a certain practice has been prohibited it is a strong signal to other market participants that they risk prohibition and fines if they engage in similar practices. However, case investigations are fact intensive and take time to complete. Moreover, intervention presupposes that the identified competition problem is caused by a restrictive agreement between undertakings or constitutes an abuse of a dominant position. Problems that flow directly from the structure of the market cannot be addressed. For instance, dominance as such does not constitute a violation of Article 82 of the Treaty; only abuse of dominance does. Similarly, merger control allows the Commission to prevent mergers that significantly impede competition that would likely have occurred absent the merger, but it does not allow the Commission to address pre-existing market power. These various constraints imply that competition law enforcement cannot address all the problems that have been identified. An effective regulatory framework must be in place for effective competition to develop and for markets to become integrated.

More effective regulation

The Preliminary Report identifies a number of areas where DG Competition would see scope for improvement. One such area is transparency. In order to increase trust in the market and reduce risks for new entrants it is important that all players have access to key data such as available capacity on networks. Article 82 may apply in cases where a dominant network operator discriminates in favour of its own supply business by limiting information flows to third party competitors. However, the application of Article 81 and 82 in individual cases is unlikely to provide an effective basis for imposing transparency obligations of a general nature. The recent work of ERGEG, Eurelectric, ETSO and the Madrid Forum to develop voluntary best practice guidelines is welcome. Such work throws valuable light on the type of information that should be made available in order to improve the functioning of markets and helps create a level playing field. It is also encouraging that players like RWE Power, EON Energie, ENBW and Vattenfall Europe have announced that they will publish daily aggregated plant capacity data. However, it needs to be considered whether voluntary mechanisms will suffice. In order to create transparency and a level playing field across the European Union it will likely be necessary to resort to binding measures.

Third-party access

Market integration requires that existing cross-border infrastructure is used efficiently and that real third party access is achieved. Investment in new capacity must also be encouraged. If gas and electricity cannot be moved around inside the EU current market structures will remain. At present this is not the case. For instance, one of the reasons why this winter the IUK interconnector was not fully used in spite of high prices on the UK gas market was that bottlenecks existed on certain border points.

In the electricity field an important step was taken when in 2005 the Court of Justice decided that privileged access to interconnector capacity granted prior to liberalisation is contrary to the electricity directives unless a special exemption procedure had been applied. This is a very important judgment that – once implemented at Member State level – will improve the situation for third parties. In the gas field the directives recognise greater scope for grandfathering, i.e. maintaining capacity rights that were obtained pre-liberalisation. In the view of DG Competition there is good reason to have a fresh look at the directives and clean out remaining pre-liberalisation rights.

Insufficient unbundling

The conflicts of interest created by insufficient unbundling of network and supply interests may also have to be addressed by new regulatory measures. While there are several instances of Member States still having to fully implement the unbundling obligations of the current directives, the question remains whether legal unbundling can be fully effective in terms of creating a level playing field and integrated and competitive markets. General antitrust experience would suggest a negative reply to this question. It is inherently difficult to devise, monitor and enforce behavioural remedies. The main problem is that behavioural remedies do not change the incentives of the addressee and that the authority monitoring compliance is at an inherent informational disadvantage. This means that it can often only hope to address more blatant violations of the remedy. For instance, it would seem very difficult to ensure that the vertically integrated firm does not take supply interests into account when making investment decisions unless one would resort to very heavy-handed regulation such as imposing obligations to invest. Effective behavioural remedies – to the extent that they can be devised – often come at a high cost to addressees and authorities alike. Structural solutions avoid these costs by changing the incentives of the firm. Once a business has been structurally unbundled, the incentives change and decisions will be taken without regard to the interests of the previous owner.

Greater cooperation

The creation of an integrated market in an environment where each national network is an essential facility presupposes close cooperation between all relevant players including national regulators. There is already a significant degree of cooperation in the context of CEER and ERGEG. The recent regional initiatives are a good example of this. These initiatives constitute a significant step towards the ultimate goal of creating a single European market. Current cooperation mechanisms are voluntary in nature and experience in the competition field suggests that there are substantial benefits from creating a more formalised cooperation based on a binding legal framework.

On 1 May 2004 Regulation 1/2003 created an entirely new framework for cooperation between the Commission and Member State competition authorities. While this framework is particular to the anti-trust field, some of the key features may serve as a source of inspiration for other areas. This framework is based on the application of a common set of rules – Articles 81 and 82 – to all cases where there is a cross-border impact. This has several advantages. First, it creates predictability. All market operators know that they are subject to the same set of rules. Secondly, it creates a basis for close cooperation between the authorities. In the case of Regulation 1/2003 such cooperation has two main objectives: effective enforcement and consistent application of the rules.

The Regulation has led to the creation of a European Competition Network within which all enforcers are obliged to inform each other of new cases under investigation. This allows all members to know what is going on and for cases to be reallocated to another authority when it is better placed to deal with them. All authorities can exchange confidential information and subsequently use it in evidence. They can also conduct investigations on behalf of each other.

With a view to ensuring consistent application of the common rules the national competition authorities are obliged to inform the Commission before they adopt negative decisions and the Commission has 30 days to make comments. If there is serious disagreement the Commission may withdraw the case from the national competition authority in question and deal with the case itself. As a last resort, conflicts are thus solved by the adoption of a decision at the centre. The Commission's decision can be appealed to the Court of Justice, which has the final say on the matter.

The experience since 1 May 2004 has been very positive. Having a common set of rules and a binding framework has greatly enhanced cooperation between authorities and increased predictability for market players compared to the pre-existing situation where national competition authorities applied their own rules and where cooperation was based on informal contacts.

Conclusions

The sector inquiry carried out by DG Competition has confirmed that a number of problems persist in creating a competitive internal energy market. There is considered to be a compelling case for new action to address the various problems identified. Assuming the presence of political will there is much to be done in terms of improving the regulatory framework. New measures are required to create a real level playing field and an effective framework for cooperation between regulators. In parallel, the competition rules should be enforced in a rigorous manner to ensure that competition is not distorted in favour of pre-liberalisation incumbents. Open and competitive markets go hand-in-hand with security of supply. Recent market developments should therefore not be allowed to blur the picture and distort the fact that competitive market structures are superior to monopoly in terms of bringing benefits to consumers.