

## **CAN THE STRUCTURAL BARRIERS TO COMPETITIVE ELECTRICITY AND GAS MARKETS IN EUROPE BE OVERCOME?**

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### **Setting the scene**

*Europe has not yet developed fully competitive internal energy markets. Only when such markets exist will EU citizens and businesses enjoy all the benefits of security of supply and lower prices. To achieve this aim, interconnections should be developed, effective legislative and regulatory frameworks must be in place and be fully applied in practice, and Community competition rules need to be rigorously enforced. Furthermore, the consolidation of the energy sector should be market driven if Europe is to respond successfully to the many challenges it faces and to invest properly for the future. (Green Paper on a European Strategy for Sustainable, Competitive and Secure Energy, March 2006)*

A major objective of the European Union, if not **the** major objective at this moment in its history is to improve economic performance and achieve a higher level of growth and competitiveness.

One key element of the so-called "Lisbon strategy" is the secure, sustainable and competitive supply of energy to businesses and people throughout the European Union.

A reliable electricity and gas service at acceptable prices is a vital element of this.

### **Report on progress in creating the internal gas and electricity market**

A year after the second Electricity and Gas Directives should have been implemented by the Member States, the Commission compiled a report that took stock of the situation regarding the markets and identified areas requiring further improvements. This report was adopted by the Commission in November 2005.

The main conclusion of the report is that, whilst the initial opening period of energy markets has largely been a success to date, with, for example, lower electricity prices in real terms than in 1997, more needs to be done to ensure that industry and citizens receive the full benefits flowing from market opening. This assessment was shared by energy regulators and most interested parties consulted during preparation of the report.

Some of the critical findings were:

- The most important shortcoming identified was the lack of integration between national markets. Key indicators here were the absence of price convergence across the EU and the low level of cross-border trade, generally due to the existence of barriers to entry, inadequate use of existing infrastructure, and - in the case of electricity – insufficient interconnection between many Member States, leading to congestion;
- Many national markets continued to display a high degree of concentration of the industry, impeding the development of effective competition;

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<sup>1</sup> The views expressed in this paper are those of the author and may not reflect those of the European Commission

- The gas market continues to suffer from a lack of liquidity of both gas and transport capacity. An important element that needed further study was the effects of long-term gas contracts, both in terms of competition and the fact that such contracts may be necessary to underpin the financing of major new gas infrastructure;
- Another indicator of the lack of real competition is that switching by customers remains limited in most Member States and that choosing a new supplier from another Member State remains the exception; and
- In economic terms, with very few exceptions, electricity and gas markets in the EU remain national in economic scope. Sufficient cross-border competition has not yet developed to provide a fully effective constraining influence on the economic power of companies in each national market.

The report clearly identified the main immediate action necessary was the full and complete and effective implementation of the second Gas and Electricity Directives. The fact that most Member States had been late in transposing the Directives - and some not done so at all - was particularly damaging.

### **Green Paper – A European Strategy for Sustainable, Competitive and Secure Energy**

In March 2006, the Commission adopted a Green Paper on energy that identified the three main objectives of a European energy policy as sustainability, competitiveness and security of supply.

#### Energy for growth and jobs in Europe

In this paper, the completion of the internal energy market was the first of six priority areas of the European energy policy under the heading of “*Energy for growth and jobs in Europe*”. The Commission clearly believe that:

- Sustainable, competitive and secure energy will not be achieved without open and competitive energy markets, based on competition between companies looking to become European-wide competitors rather than dominant national players. Open markets, not protectionism, will strengthen Europe and allow it to tackle its problems; and
- A truly competitive single European electricity and gas market would bring down prices, improve security of supply and boost competitiveness. It would also help the environment, as companies react to competition by closing energy inefficient plant.

Unfortunately, while much has been done to create a competitive market, work is not yet complete because:

- Many markets remain largely national, and dominated by a few companies; and

- Many differences remain between Member States' approaches to market opening, preventing the development of a truly competitive European market, including:
  - the extent of powers given to independent regulators;
  - the level of independence of network operators from competitive activities;
  - grid rules;
  - balancing; and
  - gas storage regimes.

Within the next 12 months, a decision, based on a full impact assessment, will be made on any additional legislative measures needed: in particular, to ensure non-discriminatory network access, adequate available network capacity, liquidity on gas and electricity markets and effective regulation. However, it is already clear that five core areas need particular attention. These are:

(i) A European grid

Consumers need a single European grid for a real European electricity and gas market to develop. This can be done by ensuring common rules and standards on issues that affect cross-border trade. Progress is being made on these issues, but it is too slow. **Issues to be discussed further are a European grid code to encourage harmonised, or at least equivalent, grid access conditions; a European energy regulator to look at cross-border issues; and a** Such a European Centre for Energy Networks to bring the network operators together in a formal body to assist work on developing a European Grid Code.

Comment [r1]: A what?????

(ii) A priority interconnection plan

At the Barcelona European Council in 2002, the Heads of State and Government agreed to increase minimum interconnection levels between Member States to 10%. Progress has not been satisfactory. There can be no truly competitive and single European market without additional physical capacity. Similarly there is a need for new investment in infrastructure in gas markets. In many Member States, action needs to be taken to free up capacity reserved for former incumbents under long-term electricity and gas contracts.

(iii) Investment in generation capacity

To replace ageing electricity generation capacity and to meet demand, the EU will need substantial investment over the next 20 years. For timely and sustainable investments, a properly functioning market is needed, giving the necessary price signals, incentives, regulatory stability and access to finance.

(iv) A level-playing field: the importance of unbundling

Significant differences persist in the level and effectiveness of unbundling of transmission and distribution from competitive activities. This means that in practice national markets are open to differing degrees to free and fair competition. The provisions of the second electricity and gas directives on unbundling need to be fully implemented - not just in their letter but also in their spirit. If progress to a level playing field does not result, further measures at Community level should be considered.

(v) Boosting the competitiveness of European industry

One of the most important objectives of the internal energy market is to promote the competitiveness of EU industry and thus contribute to growth and jobs. Industrial competitiveness requires a well-designed, stable and predictable regulatory framework, respectful of market mechanisms. Energy policy therefore needs to favour cost-effective options and be based on a thorough economic analysis of different policy options and their impact on energy prices. Secure availability of energy at affordable prices is crucial. It is hoped that the new High-Level Group on Energy, Environment and Competitiveness will play an important role in identifying ways to promote the competitiveness of all sectors of affected industry. This requires considering, for example, what is the best way to accommodate the legitimate needs of energy intensive industry whilst, at the same time, respecting competition rules.

An internal energy market that guarantees security of supply

The Green Paper also places priority on ensuring security of supply in the internal market. Liberalised and competitive markets help security of supply by sending the right investment signals to industry participants and ensuring access to the widest range of customers for companies investing in energy markets. But for this competition to work effectively, the market needs to be transparent and predictable.

The physical security of Europe's energy infrastructure against risks from natural catastrophe and terrorist threat, as well as security against political risks (including interruption of supply), is critical to predictability. The development of smart electricity networks, demand management and distributed energy generation could all help at times of sudden shortage.

Several areas for possible future action are identified:

- The establishment of a European Energy Supply Observatory to monitor the demand and supply patterns on EU energy markets, identifying likely shortfalls in infrastructure and supply at an early stage and complementing on an EU level the work of the International Energy Agency.
- Improved network security through increased collaboration and exchange of information between transmission system operators in defining and agreeing common European security and reliability standards. A more formal grouping of transmission system operators that could develop into a European Centre for Energy Networks.
- With respect to the physical security of infrastructure, two main actions merit further consideration. Firstly, a mechanism could be developed to prepare for and ensure rapid solidarity and possible assistance to a country facing difficulties following damage to its essential infrastructure. Secondly, common standards or measures might be taken to protect infrastructure.

**The views of the European Council on the internal energy market**

On 23/24 March the European Council debated the issue of an Energy Policy for Europe (EPE) on the basis of the Commission's Green Paper.

It reached a number of conclusions on the subject, including on the internal energy markets - in particular from the viewpoint of competitiveness. It pointed out that an EPE should contribute in a balanced way to ensuring the competitiveness of European economies and the affordability of energy supply to the benefit of both businesses and consumers, in a stable regulatory framework, by:

- Working with Member States to complete the opening of the internal market for electricity and gas for all consumers by mid-2007, while accepting the special circumstances of some small and isolated Member States;
- Ensuring full, effective and transparent implementation of internal market legislation, which should also play a key role for the security of supply;
- Promoting approaches similar to that of the internal energy market to neighbouring countries and enhancing the coordination and role of energy regulators;
- Accelerating the development of regional energy cooperation within the EU, facilitating the integration of regional markets into, and further development of, the EU internal market, paying particular attention to the countries and regions largely isolated from the EU energy market;
- Fostering the rapid and coherent development of storage and infrastructure, in particular of gas and electricity interconnections with, for electricity, the target of at least 10% of Member States' installed production capacity, and, as agreed by the 2002 Barcelona European Council, financing requirements should be met mainly by the enterprises involved; and
- Reviewing existing directives and legal framework in order to speed up the administrative authorisation procedures for, and develop a regulatory environment more conducive to, investment projects.

Finally, the Council asked the Commission, given the urgency of the challenges to be faced, to start with a small number of measures including:

- Developing a priority Interconnection Plan and facilitating the realisation of priority infrastructure projects contributing to diversification of supply and integration of regional markets into the EU internal market, while noting the primary role of the enterprises involved; and
- Developing a strategy for exporting the internal energy market approach to neighbouring countries.