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Competing concerns: EU energy market liberalisation

In November 2005, the European Commission published its initial issues paper as part of the ongoing energy sector inquiry. What is the purpose of this inquiry, and what are the implications of its findings for identifying where the core problem lies—in the liberalisation process itself or the behaviour of firms within the markets?

The European Commission has long been taking action to promote competition in energy markets. In 2003, it revised the requirements of the Gas and Electricity Directives, to address concerns over the slow progress of market liberalisation, including the condition that the markets for all customers should be liberalised by July 1st 2007. More recently, the Directorate-General for Competition initiated a sector inquiry into how the energy markets are currently operating, on the basis that the available evidence suggested that competition may be restricted or distorted within the Common Market.

This article considers the emerging results of the sector inquiry contained in the European Commission's issues paper,[1] and puts them in the context of the liberalisation measures already contained in the Directives. It concludes by considering whether the measures in the Directives are sufficient for competition to be introduced and established in energy markets.

Sector inquiries: towards proactive competition policy

Since modernisation of the competition rules in 2004, the Commission has been placing greater emphasis on the role of sector inquiries as an enforcement tool. In particular, it sees these inquiries as an intrinsic part of a more proactive competition policy, enabling it to identify where action under the competition rules may be required.

In these inquiries, if the European Commission identifies factors that distort or restrict competition, it can initiate specific investigations under Articles 81 or 82. Alternatively, if the issue is national or sub-national, rather than affecting cross-border trade, the Commission can refer it to a national competition authority.

A further option, which was taken in the sector inquiry into the supply of sports rights via 3G mobile phones,[2] is for the Commission to publish a policy paper setting out those forms of behaviour considered likely to generate competition concerns, and which would be targeted in future investigations. While, to date, there have been no cases launched on the back of the 3G sector inquiry, the Commission's aims in publishing such a policy paper will have been to influence behaviour of operators in the sector.

The Commission may therefore be seeking to use its statements to influence the manner in which companies operate. This scope for the sector inquiry findings to influence future behaviour may represent one of the more important motivations behind the energy sector inquiry. If, through pronouncements made by the Commission as a result of the sector inquiry, it has the

What is the aim of a sector inquiry?

Sector inquiries are an information-gathering tool, designed to enable the Commission to understand how particular markets are operating and to provide an initial filter for identifying whether there are issues of competitive concern that could warrant further examination under Articles 81 or 82 of the EC Treaty. The powers enabling the Commission to undertake such inquiries have existed since 1962, but their use was limited until relatively recently.

Recent inquiries relate to the supply of sports content via 3G mobile phones (concluded September 2005), retail banking and energy markets (both announced in June 2005).

effect of changing the way that, for example, companies contract with new entrants, then it may improve the effectiveness of the liberalisation process and hence the development of competitive market structures.

The preliminary findings illustrate that the Commission has been looking at a range of structural, informational and behavioural features of the markets, as summarised in the box below.

Market structure

Structure is an essential element of any competition assessment. High concentration does not imply that outcomes are necessarily harmful (as once believed under the structure–conduct–performance paradigm of economic thought), and it is not against the law to be dominant, but to abuse that position is. Therefore, for the sector inquiry to act as a filter, it is necessary to identify which operators might have positions of dominance.

It is notable that the Directives have not sought to decrease horizontal concentration directly, and it is outside the Commission's powers to enforce any structural separation even were it to find evidence of abuse of dominance in the context of the sector inquiry. Instead, the focus of the Directives was on vertical separation (legal and functional unbundling of transmission and distribution system operators). This emphasis on vertical structure can be seen as a necessary precondition to effectively minimise the risk that fully vertically integrated players would raise barriers to entry through discriminatory access conditions or cross-subsidisation between their wholesale/retail and network activities.

This leaves open the question of whether vertical separation alone is a sufficient, as well as a necessary, condition for effective competition in retail energy markets. The European Commission's progress report on energy market liberalisation,[3] published alongside the energy sector issues paper, highlights a high degree of horizontal concentration in both gas and electricity markets, as shown in Figure 1 below.

An implication of this position is that the development of competition and an integrated European energy market may depend on the existence of strong competition between national incumbents. Although there is no real reason why this may not emerge, the strategic interdependence of the main players' market shares may limit the incentive to compete vigorously outside the acquisitions arena, thereby slowing the emergence of a European market at the retail level.

Vertical foreclosure and other issues

Vertical foreclosure is central to the remaining conclusions raised in the preliminary findings. It is identified as a separate topic from transparency and pricing, but transparency and pricing have the potential to contribute to market foreclosure. At its simplest, to be

Preliminary findings of the sector inquiry

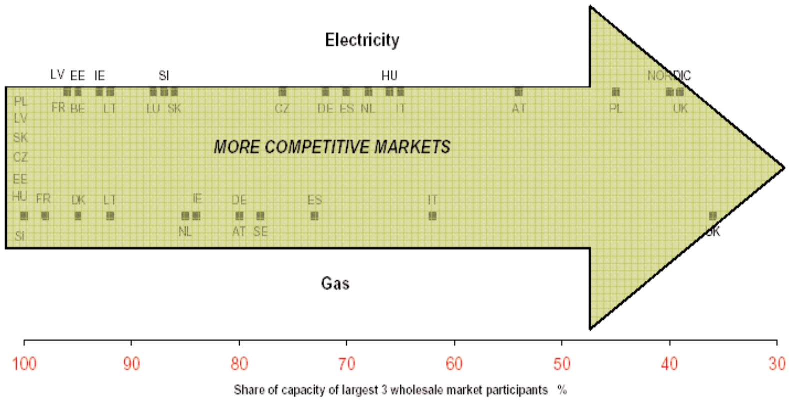
Issue	Description
Market concentration	**Gas: incumbents remain dominant in their national markets and largely control imports and/or production. Electricity: there is a high level of concentration in most Member State markets, creating scope for market power for incumbent operators.**
Vertical foreclosure	**Gas: there is limited liquidity in gas markets because of long-term vertical contracts, denying new operators the reliable short- and long-term sources of gas required to enter supply markets. Electricity: there is still significant vertical integration between generation and retail activities in many Member State electricity markets.**
Insufficient market integration	**Gas: cross-border sales are limited by incumbents' hesitance to enter other national markets, as well as by a lack of available capacity on import pipelines and crucial entry points to national gas systems. Electricity: there is inadequate interconnecting infrastructure and different market design between transmission areas.**
Transparency	**Gas: reliable information made available at the right frequency is the main deficit of gas transport access. Electricity: there is a lack of transparency in wholesale markets, undermining confidence in trading.**
Prices	**Gas: the use of oil price indices in import contracts remains a problem. Electricity: there are doubts that prices on spot and forward wholesale markets are the result of fair competition.**

Source: EC energy sector inquiry.

able to enter at the retail level, an operator needs to have access to both the energy source and the consumer.

Access to energy sources relies on the existence of well-functioning wholesale markets. In the absence of effective markets, a new entrant will find it difficult to secure the supplies needed to meet potential retail contract commitments, and will face excessive uncertainty over the cost of such purchases, thus making entry unattractive. Historical contractual arrangements, prevalent under the prior, vertically integrated, incumbent structures may exacerbate this position, as will lack of supply.

Figure 1 Energy market competition



Source: European Commission (2005), 'Report on Progress in Creating the Internal Gas and Electricity Market', November.

In electricity markets, some of these aspects can be overcome through the nature of the trading arrangements established—eg, with both sides having to participate in a mandatory gross pool arrangement. In gas, either the existence of a substantial gas bubble (such as in the UK in the mid-1990s), or the imposition of gas release programmes for incumbent operators (as have been used in, for example, Spain and Austria), may be necessary to support initial entry.

A key objective of the Commission is to encourage cross-border trade, in order to harmonise national markets to encourage development of European markets. Wholesale markets would appear to exhibit more potential for developing genuinely European characteristics. However, this would rely not only on the existence of the physical infrastructure to ensure that suppliers can respond to pricing signals in different parts of Europe, but also on an absence of distortions affecting flows of energy supplies between (national) markets, such as divergent policies on security of supply or on access arrangements for interconnectors or gas storage facilities. For example, Ofgem has identified a potential distortion in the European gas market due to the Spanish regulator establishing an imbalance charge linked to UK or US wholesale price movements.[4]

This raises the question of whether further harmonisation of market rules is necessary to ensure the effective development of competitive European energy markets. It may be argued that the most important aspect is the transparency of the regimes and the application of the same principles of operation of the market, rather than comparability in the detailed methodologies applied in each national jurisdiction. As long as the market participants are aware of the prices and how they are set, they can react appropriately. However, there are two core problems with this.

– *Identifying the appropriate level of detail at which to apply harmonisation*—the EC Directives themselves were set to define certain minimum requirements as part of the liberalisation process, but there are indications within the sector inquiry that certain aspects of, for example, information release may benefit from further mandatory requirements and consistent application.

– *Ensuring that participants are incentivised to respond to price signals*—recent discussions on UK wholesale gas prices have focused on the asymmetry in the degree of liberalisation in the market across Europe constraining the responsiveness of Continental gas suppliers/producers to price differentials in the market, thereby exacerbating the effects of high prices in the UK.[5]

There appears to be an implicit assumption within the UK that liberalisation of the European markets will alleviate a significant proportion of current problems. However, if the liberalised markets have too many nuances in their market rules, there remains a risk that the development of competition may be adversely affected, continuing to expose some countries to higher price risks as a result of the asymmetries.

Conclusion

The energy sector inquiry has a complex political context. It is a sector where the Commission has struggled to introduce liberalisation. Some countries have embraced the principles of competition and liberalisation in energy markets without the need for intervention from the Commission. Others have repeatedly refused to implement more than the bare minimum requirements set out in the energy sector

Directives to introduce measures to liberalise the energy markets.

This differential liberalisation has contributed to the emerging structure of the European energy markets, where some major incumbents have been able to obtain (through acquisition) significant presence in a number of EU countries, but without facing any significant threat in their domestic market. The consolidation, it may be argued, has perpetuated many of the problems identified in the sector inquiry issues paper. This suggests that the liberalisation process itself has not been sufficiently tightly defined to ensure the outcome it was designed to achieve without further remedial action by competition authorities.

An alternative viewpoint is that the efficiency of the market will inevitably improve as the remaining countries implement full liberalisation and the competitive pressures in newly liberalised markets become established. This implies a necessary period of inefficiency and adverse effects on some of the more mature, liberalised markets, as the transition to competition is effected. However, if this is the case, we can expect to witness significant changes in market behaviour across Europe over the next 18 to 24 months, and thus the relevance of findings in the current market may be of little long-term consequence.

The key question is whether the inquiry is really addressing concerns over the behaviour of incumbents, or concerns over the rules within which those incumbents operate. If it is the latter, remedial actions may well be the responsibility of DG TREN, rather than DG Comp. However, the answer is probably a mix of both. Nevertheless, action is still required from DG TREN and national regulators, and the sector inquiry has served to stir the action up.

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[1] European Commission (2005), 'Energy Sector Inquiry: Issues Paper', November.
[2] European Commission (2005), 'Concluding Report on the Sector Inquiry into the Provision of Sports Content over Third Generation Mobile Networks', September 21st. Oxera assisted the Commission during this inquiry; see 'Watching 3G: Sector Inquiries by the European Commission', *Agenda*, August 2005, available at www.oxera.com.
[3] European Commission (2005), 'Report on Progress in Creating the Internal Gas and Electricity Market', November.
[4] Ofgem (2005), 'European Gas Market: Letter to the Competition Directorate General', November 29th.
[5] See, for example, Ofgem (2005), op. cit.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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