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Annual Report on the Implementation of the Gas and Electricity Internal Market

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1. BACKGROUND TO THIS COMMUNICATION

The new electricity and gas Directives¹ were due to be transposed by Member States by July 2004 and the Regulation on cross border electricity exchanges² also came into effect. The new rules are aimed at achieving to a competitive electricity and gas sector across the whole European Union as envisaged by the Lisbon Council objectives³.

The Directives require the Commission to issue regular reports on the functioning of the market on an annual basis and therefore this report has been prepared in consultation with the European Regulators Group for Electricity and Gas (EREG) using both their data and published information from a number of sources.⁴ More detailed information is contained in a supporting document which will be released at the same time as this Communication.

2. OVERALL SUMMARY

A recent report compiled for DG Enterprise on European productivity growth⁵ demonstrated the excellent performance of the utility sector as summarised in Table 1 below. This serves to underline the contribution of market opening to driving efficiency improvements in these sectors and the potential contribution from the energy sector towards the Lisbon objectives.

Table 1 Labour Productivity Growth: Gas, Electricity and Water

% per annum.	1979-1990	1990-95	1995-2001
EU-15	2.7	3.6	5.7
USA	1.1	1.8	0.1

However, many aspects of implementation remain disappointing. In October 2004, eighteen Member States had to be sent a letter warning that they had still not fully notified to the Commission the legal measures taken to transpose the latest Directives.

This delay is unsatisfactory since it is now clear that the provisions of the previous Directives⁶ have not been adequate to achieve the objective of competition, even for larger users. Such customers would normally be expected to negotiate with suppliers on a regular basis. However after five years of competition for electricity and over three years for gas, fewer than 50% have switched supplier in most Member States. In addition, many are unsatisfied with the range of services being offered.

¹ Directives 2003/54 and 2003/55

² Regulation 1228/2003

³ European Council Conclusions 24/3/2000 (English) Nr: 100/1/00 23-24 March 2000

⁴ For example: "Qualitative study - European consumers and services of general interest in the EU 25 (December 2003), DG Health and Consumer Affairs"

⁵ EU productivity and competitiveness: An industry perspective: Mary O'Mahony and Bart van Ark (ed.) for DG Enterprise, European Commission 2003

⁶ Directives 96/92, 98/30

It is not enough just to consider the number of customers changing supplier, but also the nationality of new suppliers. In many cases, customers have only been able to change to another domestic supplier with the result that penetration of national markets by foreign companies is also disappointing in many cases, reflecting a lack of integration of markets and missing infrastructure links. In most cases, foreign suppliers represent less than 20% of market share. The only exceptions are those markets reasonably well integrated with neighbouring Member States or those where the main suppliers have, in fact, been privatised and purchased by foreign companies.

Although electricity prices are lower than 1995 in real terms, they have increased in the last 18 months, partly due to increased prices for primary energy sources. At the same time, gas prices are higher than in 1995 due to the ongoing linkage with oil. Although such price fluctuations are normal, increases are unpalatable to customers where the prospects for changing supplier appear to be limited by regulatory barriers and where the negotiating power of customers is weak due to an unfavourable market structure. Particular concerns exist among the largest users that suppliers are failing to offer an adequate range of contract structures, especially longer term arrangements.

A key issue relates to the failure to fully **integrate national energy supply** into a wider European market. In this context it is vital for rules on cross border electricity exchanges to continue to be improved to ensure that existing infrastructure is utilised to its maximum possible extent. Likewise for gas, the adoption and implementation of the proposed Regulation⁷ is similarly important. New investment in infrastructure is also needed and progress in this regard remains slow, as was also noted in the Commission Communication on Energy Infrastructure and Security of Supply⁸.

Secondly, Member States are still failing to deal with the issue of **market structure**. As has been highlighted in previous reports, the gas and electricity markets in too many Member States are dominated by one or two companies, and there is often inadequate capacity for cross border competition. It is imperative that solutions are found to such problems.

Thirdly, although much process has already been made in terms of **unbundling of network operators and the introduction of regulated third party access**, there are still certain aspects which remain unsatisfactory. A fully independent transmission system operator is crucial for a well functioning market. Likewise distribution system operators need to be adequately separated from supply companies to ensure cost reflective tariffs and the removal of any cross subsidies. The independence of regulators is crucial in this respect in order to ensure fair network access in terms of tariff levels and structure. In this respect the gas sector is measurably behind that for electricity.

A final group of issues which may tend to be an obstacle to the internal market is the continued existence of a **regulated end user prices for electricity and gas** alongside the competitive market and associated long term power purchase arrangements (PPAs). Although such controls are a valuable transitional measure during the initial phase of market opening, there are risks that such an approach will stifle competition, constrain investment and confuse and contradict unbundling measures.

⁷ COM (2003) 741

⁸ COM (2003) 743

3. EVALUATION OF PROGRESS IN THE ELECTRICITY SECTOR

3.1 Summary

Although many of the necessary measures to implement competition have been taken, or are in process, the obstacles referred to in Section 2 above appear in many of the electricity markets of Europe as summarised in the table below.

Table 2 Summary of main obstacles to competition⁹

		Customer switching: Large Users
a. No major issues	SE, FI, DK, NO, UK,	>50%
b. Unbundling \ Regulation	LU, AT, DE	range 10% (LU) -35% (DE)
c. Market Structure or Lack of Integration	FR, BE, GR, IE, ES, NL, LT, IT, SI, CZ, SK, LV	range 0%(GR) - 35%(NL)
d. Long term PPAs\ Regulated end-user prices	PT, EE, PL, HU,	range 0% (EE) - 25% (HU)

In addition to this, the island states of Malta and Cyprus have limited scope for the development of competition for electricity.

3.2 Effective Regulation and Unbundling

New suppliers will only be able to enter the market if they have fair access to transmission and distribution networks. An independent transmission system operator is a vital ingredient of a functioning electricity market. Cross subsidies must be removed and access based on published regulated prices which are reflective of the costs of the network business in question. Network tariffs are now broadly comparable in the majority of Member States and it is expected that those which deviate from the normal range will be closely scrutinised by regulators.

3.3 Market Structure and Integration

Market structure is a severe problem in many parts of the EU electricity market and it appears evident that only those regions with an adequate number of players, i.e. the UK and Nordic market, have been able to deliver a really competitive market across the board. Furthermore, many of the electricity generation markets in new Member States are characterised by the continuation of long term power purchase agreements. This means that there may be much less scope for competition than indicated by market share analysis.

Ultimately a key objective is for a liquid wholesale market to be developed. This will allow market participants, including potential new entrants, to buy and sell electricity freely to reconcile their generation and supply portfolios. However, power exchanges in most Member

⁹ In this table the most important obstacle for each Member State is identified. However this does not mean that other obstacles do not exist.

States are still insufficiently liquid in this respect. There is also an insufficient degree of transparency concerning the formation of prices in many wholesale markets.

Interconnection between Member States, of course, provides significant potential for increasing the level of competition. However developments in this respect have been mixed. Some groups of Member States, such as the Nordic countries, those on the Iberian peninsula and on the island of Ireland, have shown that it is not impossible to realise projects if there is sufficient political commitment. More general improvements should also result from the implementation of Regulation 1228/03 relating to cross border electricity transmission. The co-ordination of cross border capacity allocation through, for example, the ideas of “market coupling” put forward by the participants of the Florence Forum will increase liquidity and facilitate new entrants in national markets.

3.4 Price developments

With the exception of Italy, 2004 saw a convergence of wholesale prices at around the level of €30/MWh in both bilateral markets and standardised power exchanges. However, forward markets show that price increases are likely with prices for base-load¹⁰ for 2005 significantly exceeding €30/MWh. In some respects, this represents a response to increased prices for primary energy sources on world markets.

Prices for end users, which also include network costs and a retail supply margin, have not converged. A wide range of price levels prevails in different Member States for final customers. Electricity prices for large users range from under €40/MWh in Latvia to nearly €80/MWh in Italy. Likewise prices for small customers and households range from under €60/MWh to over €120/MWh.

3.5 Conclusions

Much has been achieved since the introduction of competition including the establishment of the principles of regulated third party access, the separation of networks and a degree of integration of national markets into larger groupings. However, as has been identified in many previous reports of the Commission, the issue of concentration is now the most important obstacle to the development of more vigorous competition. While this persists, consumers may lose confidence in the market and call for tighter regulation. In this respect, the Commission’s recent prohibition decision on the acquisition of GDP by EDP and ENI¹¹ reflects an important precedent on how the Commission intends to deal with possible restructuring of the industry.

Independence of transmission system operators and an increase in the level of available interconnection is vital for the further development of electricity markets. Without such investments the contestability of the market will remain constrained and incumbent companies will retain a large part of their existing advantages.

Increased use of competition policy at national level, with greater transparency of the behaviour of participants in wholesale markets may also bring results and co-operation between national regulators, competition authorities and the European Commission also has the potential to deliver significant improvements.

¹⁰ Baseload implies delivery of a constant amount throughout 24 hours

¹¹ Press release IP/04/1455, 9 December 2004

4 EVALUATION OF PROGRESS IN THE GAS SECTOR

4.1 *Summary*

The creation of the internal gas market requires more integration and for the efforts to diversify supply to be further intensified. It is clear that those Member States which are poorly integrated with their neighbours and have limited availability of external sources have had more difficulty in developing competition.

By contrast, those which have a number of different sources available and which have also implemented capacity release seem to perform significantly better. As well as the UK, which has a mature competitive structure; and in Ireland where large users have had freedom of choice for many years, the best performance appears to be in markets close to a diverse range of resources such as Belgium, Denmark and the Netherlands. Italy and Spain have also made significant progress in the last year. In all the above mentioned Member States, it is estimated that at least 30% of large users have changed supplier. Of the remainder, only France is approaching such a degree of development, particularly in its northern regions. Progress in Germany and Austria is still very disappointing while the new Member States have a number of outstanding issues which are likely to hinder the functioning of competition.

4.2 *Effective Regulation and Unbundling*

For gas, fair network access requires not only cost-reflective access charges, but also flexible conditions relating to the nomination of flows supportive of new entrants. In general, an entry-exit system for both tariffs and booking of capacity on the transmission network is more conducive to developing a competitive market and most Member States are moving in this direction. However, in some cases, inflexible procedures without adequate use it or lose it mechanisms still represent a barrier to new participants in the market. High tariffs, particularly for the use of low pressure distribution networks, also continue to cause problems.

Balancing and storage regimes are also sensitive issues when it comes to effective market opening. Many regimes remain rather uncertain, particularly in new Member States. The failure, to date, to agree minimum standard procedures for access to storage at the recent Madrid Forum is therefore highly regrettable.

4.3 *Market Structure and Integration*

A key problem at national level is that there is often only a single company bringing almost all the gas to the market. This has an important impact on the potential for competition at supply level. Even if there are several suppliers, competition between them may be rather ineffectual if they are all purchasing from the same wholesaler.

Of course, to the extent that a wider European natural gas market can be created, this concern will be alleviated. Further development of the internal market has, however, been constrained by the continued existence of long term reservations of transmission capacity. The lack of coherence between the charging structures of individual transmission system operators has also prevented competition in some areas. To transport gas from Zeebrugge to, for example, Budapest would require the use of at least five different networks and the complexity of calculating the charge would be a significant disincentive to any network user.

4.4 *Prices*

Gas prices remain under the strong influence of international oil prices, often built into contracts between importers of gas and producing countries. The increase in oil prices during 2004 has therefore fed through to the gas market and wholesale natural gas has increased from around €10/MWh to some €12/MWh by late 2004.

Although wholesale gas prices are similar in most Member States, the latest information at retail level, published by Eurostat, still shows considerable divergence ranging from €10/MWh to €25/MWh for large users and from €15/MWh to €40/MWh for households.

4.5 *Conclusion*

Gas markets remain subject to significant rigidities in many cases, usually as a result of the continuing lack of integration between national markets. Without cross-border competition, the existing incumbents can easily protect their position. Furthermore, inappropriate balancing and storage regimes and high distribution tariffs also make it difficult to change supplier in several countries.

5 SECURITY OF SUPPLY

Electricity

Overall, the situation regarding electricity generation adequacy in the Member States of the European Union is satisfactory. Although 2003 experienced some difficulties, the position in Italy and Spain has now improved considerably as new capacity has been brought on line. However the Nordic countries still have a relatively tight situation¹².

Special measures exist in a number of cases to encourage investment in generation capacity. Many Member States have some form of explicit capacity payments while Norway and Sweden also have a form of capacity option scheme. Others have some form of capacity support in the configuration of balancing markets or in the procurement of reserve capacity by the TSO. Finally, some Member States have used the possibility of a tender process.

Development of interconnection is also required in a number of cases to ensure effective use of available generation capacity and to reduce the strain on the system caused by congestion at certain key bottlenecks. The European Union is still some way from the objective fixed by the European Council at Barcelona that cross border interconnections should represent at least 10% of production capacity in each Member State by 2005. It is for this reason that the Commission has proposed in the draft Directive on Electricity Security of Supply and Infrastructure, that the degree of co-ordination should be increased and the role of national regulators be enhanced in relation to the question of interconnections.

Gas

For the time being, import capacity into the European Union would appear to be more than adequate to serve demand. As long as capacity is available there are already strong incentives

¹² Based on data released by transmission system operators. For example System Adequacy Forecast 2004 – 2010, UCTE, December, 2003; UCTE System Adequacy Retrospect 2003, UCTE June 2004.

for producing countries and EU suppliers to conclude contracts to serve increasing gas demand. At present, therefore, there are few very specific measures currently being implemented in this area at a general level. In the medium term, a number of projects, particularly for LNG terminals are either in progress or being considered. It is expected that such investments will be forthcoming without specific support measures.

6 PUBLIC SERVICE AND USER/CONSUMER PROTECTION

By July 2007 all customers will become eligible customers having the possibility to choose the most attractive electricity and gas suppliers. In this context it is important that the opening of the market provides customers with the same degree of reliability regarding the provision of electricity and gas and at least the same degree of transparency and comprehensibility relating to the way they are charged for this service, whether they chose to change their supplier or not. Similarly with regard to the provisions of the Directives on labelling of energy sources, Member States will need to ensure the smooth implementation of this requirement so that customers are able to make an informed choice.

Some households and small business have expressed the perception that informed customer choice is often not possible as price comparisons are either not available or difficult to understand. Improvements on this issue are required and industry and regulators need to ensure that meaningful information on prices and services is available in an objective and transparent manner.

As well as ensuring the fulfilment of the above conditions of the Directives, the Commission's other main concern is that public service obligations should not distort the market and should allow equal access to customers for suppliers. In this regard, the possible distortive effect of regulated end-user prices has already been noted.

7 ENVIRONMENTAL ASPECTS

The internal energy market will need to develop in a manner consistent with the Community's sustainability objectives. This means that the necessary incentives to support the penetration of renewables, the reduction of emissions and demand management need to be maintained. Liberalisation also offers the opportunity for new innovative players to enter the market and enable market differentiation strategies, for instance on the basis of environmental characteristics.

Information provided by the authorities in Member States show that such policies are continuing to have an effect. In excess of 7000MW additional renewables and efficient CHP generation capacity was added to companies' portfolios during 2003, the majority of which was in Germany and Spain. This represented well over 50% of new generation capacity added in 2003. The prospect of further development is significant with new technologies such as micro-cogeneration beginning to appear on the market. Many Member States also continue to follow an active approach to demand management through fiscal incentives.

8 CONCLUSIONS

Europe is in the process of creating a wide energy community, going well beyond the borders of the Union based on common rules and practices. Member States need to maintain their commitment to this objective in the decisions they make regarding the implementation of the

Directives and restructuring of the industry. It is only by doing this that the objective of a competitive and secure market will be achieved.

With this in mind, the issue of investment in infrastructure and the sound operation of networks, in support of the competitive market, remains a critical issue. Although some of these issues have been addressed the concerns which were expressed in previous Communications and the proposed Directive on Infrastructure and Security of Supply remain pertinent and progress, in some form or another, is required on this issue.

The role of independent regulators remains a crucial component of the introduction of competition and their decisions relating to network tariffs and other important market rules will continue to shape the development of the market. In this context it remains important to ensure that authorities have sufficient resources and competences.

Whether the improvements made under the Directives are adequate to achieve the objectives of the internal market remains to be seen, especially if Member States take a minimalist approach to the transposition of the current legislation. One thing that is certain is that in the new global environment of higher primary energy prices it is more important than ever for the Community to live up to its commitment to a competitive market.