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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 15.4.2008
COM(2008) 192 final

**REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN
PARLIAMENT**

Progress in creating the internal gas and electricity market

[SEC(2008) 460]

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Progress in creating the internal gas and electricity market

A. CONTEXT

The relevance of energy to Europe's growth and competitiveness is steadily increasing. Reliable energy services at acceptable prices for both industrial and household users continue to be a key factor in social and economic development. A well-functioning internal energy market is essential if all three of Europe's energy challenges of competitiveness, sustainability and security of supply are to be met.

The last step on the road to competitive energy markets was achieved on 1 July 2007 with the full opening of national retail markets. From a legal perspective, all European consumers are now able to choose their supplier and benefit from competition.

However, this report shows that, in practice, market integration is still far from a success. With very few exceptions, electricity and gas markets in the EU remain national in economic scope with limited competition.

This report highlights that the problems identified in the Commission's 2006/07 Progress Report and Sectoral Inquiry Report on the European electricity and gas markets to a large extent still remain. Not all the shortcomings can be solved within existing legislation: improved legislative measures are needed.

B. DEVELOPMENTS IN KEY AREAS, REMAINING DEFICIENCIES

1. Implementation of legislation

All Member States¹ have met the deadline of 1 July 2007 for full opening of their gas and electricity markets.² Restrictions to free and fair competition have, however, developed through the coexistence of open market segments and end-user supply price regulation.

More than three years after the deadline of July 2004 for implementation, some Member States have still not properly implemented the legal requirements of the Electricity and Gas Directives.³ This concerns in particular core areas of market liberalisation, such as regulatory oversight, unbundling and regulated supply tariffs as well as the communication of Public Service Obligations.

Regulators have a key statutory role in monitoring compliance of network operators. ERGEG⁴ plays an important role in coordinating national monitoring and thus harmonising compliance

¹ Insofar as not benefiting from derogation.

² Technical Annex (TA), section 1.

³ TA, section 1.

⁴ European Regulators Group for Electricity and Gas set up by Commission Decision 2003/796/EC of 11 November 2003.

review. ERGEG's monitoring⁵ in 2007 of implementation of the Electricity⁶ and Gas⁷ Regulation shows inadequate compliance in areas of core relevance for the development of liquid markets such as transparency and primary capacity allocation. Some 15% of European gas TSOs do not comply with the gas transparency requirements. Historical flows, utilisation rates and the legally required forecast of available capacities are not published by about a third of TSOs. At the same time, a third of TSOs making use of the “3 minus shipper rule”⁸ do not publish the aggregated data required and nearly 85% of TSOs apply the exemption rule without the requisite regulatory approval.

Reporting on market indicators — a Member State responsibility — is generally insufficient. For example, only 30% of national regulators can indicate the switching rates for the groups of industry, small and medium businesses and households.

2. Market integration

Market integration has still not developed to a sufficient extent. This is demonstrated by price differences, regional monopolies and persistent cross-border congestion between Member States, for example.

In a well-integrated market, competition will keep prices similar among adjacent Member States or regions. Energy prices for industrial electricity customers in the EU are starting to converge in the Central and North Western EU areas but still differ by almost 100% in some cases.⁹ More efficient use of infrastructure has led to some improvement in electricity price correlation, particularly between the region of the Netherlands/Belgium/Austria/France/Germany and the Nordic market.

Cross-border trade is a key source of competitive pressure on prices. Sufficient network capacities being a prerequisite for such trade, the persistent bottlenecks in gas and electricity infrastructure need to be removed. In five Member States, the electricity interconnection capacity in relation to installed capacity is below 10%. In a further ten Member States, it is between 10 and 30%. Coordinated planning of investment and testing of market demand are fundamental to capacity provision from a European perspective. Voluntary steps taken within the Regional Initiative promoted by the Commission with the operational support of ERGEG¹⁰ (e.g. coordinated demand surveys for gas flows on the Iberian Peninsula, regional transport and storage investment analysis in the South East Gas Region) are certainly positive. But voluntary arrangements cannot sufficiently guarantee the necessary level of security to cover market demand.

Lack of independence of network operators continues to be a barrier to adequate investment. Experience shows that in cases where national incumbents are shareholders in transport networks on their markets, their interest in limiting competition in their national market is often a barrier to sufficient capacity expansion upstream. The correlation between proper unbundling and investment is demonstrated by analyses. The share of congestion revenue

⁵ Available at www.ergreg.org.

⁶ Regulation (EC) No 1228/2003.

⁷ Regulation (EC) No 1775/2005.

⁸ Rule allowing TSOs a restricted level of publication where fewer than 3 shippers are active at the relevant network point; see Article 6(3) Regulation (EC) No 1775/2005.

⁹ TA, section 5.

¹⁰ www.ergreg.org.

reinvested in interconnection capacity has been about twice as high for ownership unbundled TSOs as for vertically integrated TSOs and investment levels in the three to four years since ownership unbundling have at least doubled.

It has to be recognised, however, that other factors influence investment levels, particularly tariff regulation. Regulators should provide an investment friendly framework, involving a stable regulatory system and fair incentives for investment and an integrated market, including, but not only, aiming for tariff reduction. Incentive regulation has not yet developed sufficiently.

Legal differences between Member States remain a barrier to market integration. For example, a coordinated gas capacity auction pilot scheme in the North West Gas Region¹¹ was blocked by differences in national legislation. More support from Member States is needed to overcome these obstacles.

The full benefits of sufficient infrastructure will not be felt unless the capacity is made available to market participants on a non-discriminatory basis that favours trading. Differentiated treatment of cross-border services and domestic transmission has to be seen as critical to non-discrimination among users and compatibility with existing (and proposed) legislation. At the same time, capacity systems need to move towards the utmost possible flexibility, which is best offered in a decoupled entry-exit system.

Regional developments

Bilateral and multilateral projects for improving cross-border integration have been set up, such as the Regional Initiatives driven by ERGEG, government cooperation within the Pentalateral Forums in North West Europe and MIBEL/MIGAS for the Iberian countries. Unlike other initiatives, the Energy Community boosts regional cooperation on a legally binding basis.

These projects play a useful role in the development of best practice solutions. For example, the Regional Initiatives driven by ERGEG have worked on coordinated capacity allocation across borders in North West European gas markets, coordinated demand analysis and investment planning in the Iberian and South East European¹² gas markets, regulatory coordination towards harmonised regulatory decision-making across borders and improved transparency. In 2006, the trilateral electricity market coupling project — a capacity allocation mechanism which guarantees energy flows in the right direction in relation to spot prices — became operational between France, Belgium and the Netherlands and dramatically increased the efficiency of dispatch of power production in the region. The Pentalateral Forum for electricity succeeded in agreeing on a common flow-based cross-border capacity allocation mechanism for the whole region. Work on gas started recently and is expected to focus on legal bottlenecks and security of supply. In November 2007, the Republic of Ireland and Northern Ireland started creating a common wholesale electricity market. Progress is planned on a gas market.

The regional approach allows different levels of market development to be taken into account, with the common goal of realising the single market.

¹¹ UK, NL, B, F, IRL, DE, DK, SW, N-IRL, Norway (observer).

¹² AT, CZ, GR, H, IT, PL, SK, SI.

3. Concentration and consolidation

Market structures on a national scale are still very concentrated. In addition, incumbents control essential infrastructure facilities, further increasing their market power.

Between 2005 and mid-2007, the number of independent suppliers on the electricity market increased in 40% of the Member States where data was available. In gas, the number increased only in a quarter of the Member States. However, in France, Italy, Poland and the Netherlands, the increase was 50% or more (10 to 15 suppliers in France; 0 to 75 in Poland; 8 to 20 in the Netherlands; 123 to 182 (2006) in Italy). In 7 out of 21 Member States, no independent supplier is active on the national gas market. In electricity this is reported only for Cyprus, but relevant data for electricity is not available for 15 Member States.

Retail markets are not yet well developed, mainly because of limited access to gas supplies for new entrants. Even in the most developed market — the UK — competitive forces are dominated by gas producers. Entry of new producers to the supply portfolio remains crucial for both competition and security of supply. LNG plays an important role.

Alongside highly concentrated national markets, the tendency towards consolidation and concentration continues. As long as the players emerging from mergers and acquisitions act on a real competitive basis, this does not necessarily have negative effects on competition. Governments, national regulators and competition authorities should actively create a framework that forces competitive behaviour where it is not expected to develop from market structures, e.g. via capacity release, gas release programmes and strict transparency requirements.

4. Price trends

Customers in the EU-15 Member States benefited from cumulative price savings from electricity liberalisation of the order of €60 billion in the period 1998 to 2004. These savings were partly countered by price increases in later periods. EU-27 gas prices have risen along with oil price developments. Prices rose for industrial users by an average of 35% between 2005 and 2006 and a further 12% in 2007. The total increase from 2005 to 2007 was comparable for household customers, although major price increases came into effect mainly in 2007.¹³

There are several reasons for these developments. As competition is still limited, competitive pressures on prices are correspondingly weak. Moreover, prices mirror general trends, notably in oil prices, which increased by more than 50% between 2005 and 2007. Given the linkage of gas prices to oil prices and the increasing significance of gas in power production, oil price developments affect the prices of both gas and electricity.

At the same time, there are indications that the independence of network operators is having a favourable influence on prices, through its promotion of network efficiency, facilitation of network access for third parties and contribution to market confidence. Since market opening in 1998, Member States with ownership unbundled TSOs have experienced more positive price developments than Member States where the TSOs were and are still related to supply companies.

¹³ Eurostat, data as of 1 January each year.

5. Independence of network operators

Functional unbundling is still not effectively implemented in all Member States.¹⁴ This applies both to electricity and gas and to transmission and distribution system operators. Some Member States have gone beyond present unbundling requirements. In electricity, about half of the Member States have ownership unbundled network operators; in gas, seven Member States do.¹⁵

At distribution level, Member States are making extensive use of derogations: half of the Member States allow DSOs with less than 100 000 customers to be exempted from legal unbundling requirements, both for electricity and for gas.¹⁶

Insufficient independence of network operators is reflected in underinvestment in network capacities and in particular in inadequate cross-border capacities. Legal unbundling has not been sufficient to cope with this effect.

6. Effective regulation by regulators

Despite the Electricity and Gas Directives requiring regulators to hold a minimum set of powers, the unequal levels of regulatory powers across borders have not improved. In some Member States, powers are split between several regulators at national and regional levels, including the competition authority and/or ministry. This is all likely to add to incoherence. Regulatory oversight of wholesale and retail markets hardly exists in any Member State.

Non-compliance with European legislation is often met by insufficient or ineffective penalties in national legislation. At the same time, ERGEG monitoring reports on the implementation of existing legislation make it clear that regulators are not sufficiently committed to making use of existing powers to actively encourage implementation of legal requirements. An ERGEG report to the 14th Madrid Forum, for example, demonstrated only one case of a regulatory authority making use of its power to impose sanctions on a TSO not complying with legal requirements.

The scope of market integration requires harmonisation of regulatory decisions across borders. ERGEG and the European Regulatory Forums for electricity and gas (“Florence Forum”/“Madrid Forum”) certainly contribute to this process by providing discussion platforms to tackle problems on a practical level and developing commonly agreed best practice solutions. However, the “regulatory gap” remains a barrier to coordinated decision making across borders, which cannot be solved by the existing model of voluntary cooperation by ERGEG.

¹⁴ Within ERGEG public consultation on functional unbundling guidelines, TSOs, for example, raised the need for network managers to be involved in the management of integrated companies, and even for those managers to be given incentives linked to the success of the integrated company as a whole. See comments published at www.ergreg.org – Public Consultations – Energy – GGP Functional Unbundling.

¹⁵ TA, section 7.

¹⁶ TA, section 7.

7. Customer dimension

Consumer response — switching

Electricity switching is at a high level in Iberian countries, the Czech Republic and Nordic countries and above average for especially large industrial customers in Germany, Austria and Luxembourg. In most other countries, the annual switching rate for households is about 1% or below. The picture is similar for gas, except that Italy is one of the +1% performers. While the rates of switching for larger customers continue to rise, most small business customers and households still have limited scope to exercise their right to choose.

Switching rates are not the only indicator of functioning competition in retail markets. Often competing offers are unavailable or are too similar to amount to a real choice. Member States and national regulators must ensure that transparent and simple switching procedures exist, to give customers the confidence they need. Moreover, retail competition is distorted by regulated supply tariffs.

Service quality

Market liberalisation typically aims to improve the position of consumers. The possibility of supplier choice and consequent competitive pressure results in a better match of service supply and user demand. The Gas and Electricity Directives put clear emphasis on consumer rights. Market surveys have concluded that the level of satisfaction with the quality of electricity and gas services provided is generally good.¹⁷ Concerns that the introduction of competition would lead to a decline in service standards or problems in the provision of universal service have proved unfounded.

Benefiting from liberalisation requires access to energy supply. Analyses¹⁸ show that a very large majority of European end-users have easy access to electricity and gas — the EU-27 average rising to 93% for the non-substitutable electricity sector and 72% for gas, where substitutes are often available. On average, two thirds (66%) of EU citizens deem the cost of electricity services to be affordable; for gas the figure is similar. Neither sector has shown significant variations by socio-demographic category or between results for EU-15 and EU-27.¹⁹

Regulated prices

Coexistence of open energy markets and regulated energy prices is quite common among EU Member States: it exists in one third of the gas markets for at least one market segment and more than half of the electricity markets. For most Members States with price regulation, regulation is not limited to small customers — all customer segments can be supplied at regulated prices.²⁰

The negative effects of regulated energy prices remain a major concern. They lead immediately to a distortion of competition and reduce liquidity in wholesale markets. In the

¹⁷ EUROBAROMETER, Prices and quality of services of general interest, September 2005; and 2007 Consumer Satisfaction Survey:

http://ec.europa.eu/consumers/cons_int/serv_gen/cons_satisf/consumer_service_finrep_en.pdf.

¹⁸ EUROBAROMETER, Services of General Interest – chapter 1.4-1.5, July 2007.

¹⁹ EUROBAROMETER, Services of General Interest – chapter 3.1, July 2007.

²⁰ ERGEG, Status review on end-user price regulation, 14.6.2007 (Ref: E07-CPR-08-04), www.ergreg.org.

long run, regulated prices give wrong price signals to investors and thus have a negative impact on the development of new infrastructure. By setting a price level that does not allow new entrants to supply at cost-covering prices, price regulation creates a market entry barrier for alternative suppliers and thus directly threatens security of supply. For the French market, for example, the power exchange has indicated its inability to set a market reference price given regulated energy prices. Measures for consumer protection should not be mixed with competitive instruments, they should be addressed by separate means.

C. SECURITY OF SUPPLY

European summer and winter electricity outlook reports drawn up in 2007 by the Group of European Electricity Transmission System Operators (ETSO) and European Gas Transmission System Operators (Gas Infrastructure Europe, GIE) suggest that no particular risk of power shortage is expected in the medium term. These reports summarise national and regional power balance forecasts, balancing generation and peak demand. The reports assess the global adequacy of interconnected systems. However, under severe conditions such as low or very high temperatures or gas-supply crises, the power systems become more stressed, especially if that same period is also critical for neighbouring countries.

Provision of sufficient transport capacities continues to be a pivotal point not only for the development of competition but also for security of supply. In terms of gas supply in particular, the European Union relies increasingly on imports.²¹ With indigenous gas reserves declining and gas consumption worldwide expected to increase significantly, diversification of routes or sources plays a key role in reducing dependence on today's three major pipeline sources, Russia, Norway and Algeria. With growing gas prices, the role of LNG in diversification is steadily increasing.

Electricity and gas networks are at the heart of a well-functioning European market. Obstacles still remain to the completion of the priority projects that have already been identified. Coordinators have been designated for the projects declared to be of European interest and encountering delays or implementation difficulties. These projects are: (1) Power link between Germany, Poland and Lithuania; (2) Connections to offshore wind power in Northern Europe; (3) Interconnection between France and Spain; and (4) Nabucco gas pipeline.

For electricity, dependence on imports is lower. Generation can be based on indigenous sources, including renewables, and on fuels for which a diversified world market exists (e.g. coal). However, the dependence of power generation on gas, much of which is imported, is increasing. Alongside this, investors in infrastructure are facing new challenges. The electricity system is becoming reliant on gas infrastructure. Investment in renewable electricity production (such as wind) requires high capacity transport infrastructure to adapt the system to unbalanced capacity use.

After the cold winter of 2005/2006, some countries undertook to build up gas storage and to maximise the use of import capacity. Italy, for instance, introduced ship or pay contracts under which shippers could opt out of transportation capacities in order to increase physical use of capacities. At the end of 2006 through to 2007, a small gas surplus emerged which allowed an increase in gas trade, bringing some liquidity to hubs. It remains to be seen whether this will become the basis for a positive and dynamic future market developments.

²¹ TA, section 8.

The EU will not only need to continue to focus on the strategic dimension of its energy relations with third countries, particularly suppliers, it will also have to keep in mind the importance of providing a market structure that enables suppliers and investors to benefit from an open market and a barrier-free flow of energy. This calls for action by the Commission, governments and regulators as much as by network operators. A critical factor is delays in authorisation procedures for investments. These now constitute a major risk to security of supply and the development of the internal market.

D. CONCLUSIONS

Despite some encouraging improvements, notably on cross-border coordination at regional level, the overall analysis of progress on the internal market in electricity and natural gas shows that major barriers to the efficient functioning of the market still exist.

Insufficient implementation of European legislation remains a crucial factor. Improvement has to be driven by the Commission, Member States, regulators and industry together:

- In parallel, national regulators must be empowered with a view to ensuring proper implementation of legislation by stakeholders.
- Regulators themselves have to act on their own responsibility to encourage implementation of legal requirements. Harmonisation of regulatory best practice models across borders is certainly needed if practical barriers to cross-border trade are to be reduced. The Regional Initiatives driven by ERGEG and other similar projects at government level are positive contributions to this process.
- The industry must observe the legal requirements without compromise. Implementation of European legislation does not allow for negotiations.
- Regulated energy prices remain a major concern.

The major concerns in the various areas all share two characteristics: significant impact hampering the development of a well-functioning internal market in electricity and gas, which cannot be solved within the existing legal framework. The Commission has therefore addressed these shortcomings in a legislative package, which it presented on 19 September 2007.