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COMMUNICATION FROM THE COMMISSION

Inquiry pursuant to Article 17 of Regulation (EC) No 1/2003 into the European gas and electricity sectors (Final Report)

{SEC(2006) 1724}

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1. INTRODUCTION

1. Well functioning energy markets that ensure secure energy supplies at competitive prices are key for achieving growth and consumer welfare in the European Union. To achieve this objective the EU decided to open up Europe's gas and electricity markets to competition and to create a single European energy market. The process of market opening has significantly changed the functioning of the markets, provided new market opportunities, led to the introduction of new products and services. Competition initially lowered energy prices in Europe in line with market fundamentals.
2. However, while progress has been made, the objectives of market opening have not yet been achieved. Despite the liberalisation of the internal energy market, barriers to free competition remain. Significant rises in gas and electricity wholesale prices that cannot be fully explained by higher primary fuel costs and environmental obligations, persistent complaints about entry barriers and limited possibilities to exercise customer choice led the Commission to open an inquiry into the functioning of the European gas and electricity markets in June 2005. This inquiry, based on Article 17 of Regulation (EC) No 1/2003¹ on the implementation of the Treaty rules on competition, aimed at assessing the prevailing competitive conditions and establishing the causes of the perceived market malfunctioning. The Final Report (Commission Communication) summarises the results of the inquiry, which are presented in more detail in the Technical Annex² to the Final Report.
3. While the Sector Inquiry was launched amidst perception that consumers were not reaping the full benefits of liberalisation, it should be underlined from the outset that it was not the object of the inquiry to describe the progress made in the liberalisation process and the advantages resulting from it. There are many such achievements and customers in markets where liberalisation has been successfully introduced are still among those benefiting from the widest choice of suppliers and services. They also pay – compared to customers in other Member States – more cost-reflective prices on average. The Commission remains thus convinced that there is no alternative to the liberalisation process. It is, therefore, essential to ensure that existing liberalisation

¹ Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (OJ L 1 of 4.1.2003, p. 1), as amended by Council Regulation (EC) No 411/2004 (OJ L 68 of 6.3.2004, p. 1).

² Commission staff working paper SEC(2006) 1724.

Directives are fully and effectively transposed³. However, more needs to be done before consumers can reap the full benefit.

4. The Energy Sector Inquiry has focused on identifying areas where competition is not yet functioning well and those areas which need to be addressed the most rapidly in order for liberalisation to bear fruit. For the purpose of the inquiry the key areas were grouped under the following headings: (1) market concentration/market power, (2) vertical foreclosure (most prominently inadequate unbundling of network and supply), (3) lack of market integration (including lack of regulatory oversight for cross border issues), (4) lack of transparency, (5) price formation, (6) downstream markets, (7) balancing markets, and (8) liquefied natural gas (LNG).
5. The shortcomings identified in these key areas call for urgent action and priority should be given to four areas: (1) achieving effective unbundling of network and supply activities, (2) removing the regulatory gaps (in particular for cross border issues), (3) addressing market concentration and barriers to entry, and (4) increasing transparency in market operations. The Commission's intentions concerning regulatory proposals to be made in this regard are set out in its Communication on "Prospects for the internal gas and electricity market"⁴ which is presented in parallel to the Final Report.

1.1. The wider context

6. The introduction of competition in Europe's gas and electricity markets is an integral part of European energy policy which is directed at achieving the three closely related objectives of: a competitive and efficient energy sector, security of supply and sustainability. All European consumers, i.e. households, commercial users and industrial users, heavily depend on the secure and reliable provision of energy at competitive prices. Also, the achievement of the Union's goal of adequate protection of the environment is of fundamental importance as can be demonstrated by the commitment to reduce the emission of greenhouse gases in implementation of the Kyoto Protocol. The Sector Inquiry therefore has to be seen against this wider policy context.
7. European energy policy was set out in the Commission's Communication to the 2006 Spring European Council⁵ concerning the renewed Growth and Jobs strategy. That Communication puts the creation of an efficient and integrated energy policy at the heart of the Commission's priorities. This goal was further underlined in the Commission's Green Paper "A European Strategy for Sustainable, Competitive and Secure Energy"⁶ which was adopted by the Commission in March 2006.

³ The Commission is conducting infringement procedures against a number of Member States in this respect – see further in the Commission's Communication on the Prospects for the internal gas and electricity market, referred to below.

⁴ Communication from the Commission: Prospects for the internal gas and electricity market - COM(2006) 841.

⁵ Time to move up a gear - Annual Progress Report on Growth and Jobs, 25 January 2006.

⁶ COM(2006) 105, 8.3.2006, SEC(2006) 317.

8. The Final Report of the Sector Inquiry is presented in parallel to the Commission's Strategic EU Energy Review⁷ and the Energy Package that includes the "Communication on Prospects for the internal gas and electricity market" referred to above and the follow-up to the Green Paper. Account is also taken of the work undertaken within the High Level Group on Competitiveness, Energy and the Environment, which underlined the need for better functioning electricity and gas markets in its first report adopted in June 2006.
9. It transpires from all these documents that the three policy objectives "competitiveness, security of supply and sustainability" are closely interlinked and complementary. Competitive markets provide the necessary signals for investment, which leads to supply security in the most cost efficient manner. Similarly, the creation of a competitive internal market will allow the Union's energy companies to operate in a market of a larger dimension, which will improve their ability to contribute to security of supply. At the same time, market forces oblige European operators to use the most cost effective methods of production, which in the appropriate regulatory environment can benefit sustainability. Consumers will be able to choose between different providers and contract schemes, and could thus reduce their electricity costs and adapt their consumption to market developments. Competitive, cost reflective prices will help encourage energy efficiency, which can reduce the dependence on external suppliers and which supports the Union's objective for sustainability and security of supply.
10. The Final Report concentrates on the competition aspects of Europe's energy policy and the remaining obstacles to creating a single European energy market. Quite apart from the fact that this aspect merits a thorough analysis in its own right, the focus is also dictated by the procedural framework (Regulation (EC) No 1/2003), in which the inquiry was carried out. This does not mean that e.g. security of supply goals are not taken into account when assessing likely pro- and anti-competitive effects in the context of applying the Community competition rules in individual cases. Indeed a competitive internal market is a key instrument in delivering this objective. However in the context of the Sector Inquiry the main focus has been on competition.

1.2. The procedure leading to the adoption of the report

11. The Sector Inquiry into the European energy markets was launched on 17 June 2005. Initial results were presented in the form of an Issues Paper published on 15 November 2005. Following publication of the Preliminary Report on 16 February 2006 the Commission launched a public consultation. In their submissions stakeholders welcomed the report, generally praising its objectivity as well as the wealth of information. Contributions came from companies operating in the sector, both from incumbents and new entrants, from national regulators, competition authorities, consultancies, law firms, energy traders, grid operators, customers, industry associations and national government agencies.
12. The majority of the stakeholders support the findings, although there were variations in the assessment of the gravity of the situation and whether the situation is improving or not. As regards the possible ways forward there was both support and

⁷ Communication from the Commission "An Energy Policy for Europe" - COM(2007) 1.

opposition to the ideas put forward in the Preliminary Report such as structural unbundling, while some called for even more radical remedies. Generally speaking the vertically integrated incumbent companies were not in favour of further measures, whilst consumers, traders/new entrants and authorities supported the call for legislative initiatives.

2. THE FINDINGS

13. The main findings of the Sector Inquiry can be grouped – as indicated above – under eight headings. Whilst there are some obvious differences between the gas and electricity sectors, the many similarities and inter-relationships between the sectors plead for a common presentation.

2.1. Market concentration

14. At the wholesale level, gas and electricity markets remain national in scope, and generally maintain the high level of concentration of the pre-liberalisation period. This gives scope for exercising market power.
15. Wholesale gas trade has been slow to develop, and the incumbents remain dominant on their traditional markets, by largely controlling up-stream gas imports and/or domestic gas production. Incumbents trade only a small proportion of their gas on gas exchanges (“hubs”). With little new entry in retail markets, customer choice is limited and competitive pressure constrained. The overall picture for potential new entrants is one of dependency on vertically integrated incumbents for services throughout the supply chain.
16. Although electricity trading is more developed, sales on wholesale electricity markets generally reflect the significant level of concentration in generation. Analysis of trading on power exchanges shows that, in a number of them, generators have scope to exercise market power by raising prices, a concern also expressed by many customers. Analysis of trading positions on forward markets, which overall shows less concentration, demonstrates that the electricity markets depend on few suppliers with long positions (i.e. generate more than they resell). Analysis of generation portfolios also shows that the main generators have the ability to withdraw capacity to raise prices.
17. In the context of the inquiry, a study has been conducted on concentration levels in the electricity sector⁸. An analysis of concentration on an hourly basis shows that even during off-peak hours markets remain highly concentrated and that concentration levels, even in the less concentrated markets, reach significant levels at peak hours. The analysis based on measurements of the structure of the market in every hour also reveals that, in certain markets, long-term contracts and, to a lesser extent, the reserve requirements can reinforce concentration levels. Further, the analysis shows that the existing level of interconnection capacity is not sufficient to significantly reduce concentration.

⁸ This issue is presented as a separate chapter in the Technical Annex to the Final Report.

2.2. Vertical foreclosure

18. The current level of unbundling of network and supply interests has negative repercussions on market functioning and on incentives to invest in networks. This constitutes a major obstacle to new entry and also threatens security of supply.
19. New entrants often lack effective access to networks (in gas, also to storage and to liquefied natural gas terminals) despite the existing unbundling provisions. The operators of the network/infrastructure are suspected of favouring their own affiliates (discrimination). Vertical integration also leads to a situation where operational and investment decisions are not taken in the interest of network/infrastructure operations, but on the basis of the supply interests of the integrated company (including grid connection for competing power plants). This is highly damaging to security of supply.
20. Another form of vertical foreclosure was found to exist by way of the integration of generation/imports and supply interests within the same group. This form of vertical integration reduces the incentives for incumbents to trade on wholesale markets and leads to sub-optimal levels of liquidity in these markets. In particular, the prevalence of long-term supply contracts between gas producers and incumbent importers makes it very difficult for new entrants to access gas on the upstream markets. Similarly, electricity generation assets are in the hand of a few incumbent suppliers or are indirectly controlled by them on the basis of long-term power purchase agreements (PPAs) giving the incumbents control over the essential inputs into the wholesale markets. Low levels of liquidity are an entry barrier to both gas and electricity markets.

2.3. Market integration

21. Cross-border sales do not currently impose any significant competitive constraint. Incumbents rarely enter other national markets as competitors. Insufficient or unavailable cross-border capacity and different market designs hamper market integration.
22. For gas, available capacity on cross-border import pipelines is limited. New entrants are unable to secure transit capacity on key routes and entry capacity into new markets. Very often, the primary capacity on transit pipelines is controlled by incumbents based on pre-liberalisation legacy contracts which are not subjected to normal third party access rules. Incumbents have little incentive to expand capacity to serve the needs of new entrants. This is reinforced by ineffective congestion management mechanisms, which make it difficult to secure even small volumes of short-term, interruptible capacity on the secondary market. In many cases, new entrants have not even been able to obtain a sufficient amount of capacity when there have been expansions of transit pipeline capacity. Expansions have generally been tailored to the needs of the incumbents' own supply businesses.
23. In electricity, integration is hampered by insufficient interconnector capacity and a lack of adequate incentives to invest in additional capacity to eliminate long-established bottlenecks. In addition, on certain borders, long-term pre-liberalisation capacity reservations still exist despite the ruling of the European Court of Justice that such reservations are not compatible with EC law, unless they were notified

under Directive 96/92/EC. Improving access to existing interconnectors requires better methods of congestion management. However, better use of capacity is often not in the interest of vertically integrated network operators.

2.4. Transparency

- 24. There is a lack of reliable and timely information on the markets.
- 25. Network users require more transparency going beyond the current minimum requirements set by EU legislation. Of particular importance is data relating to network availability, especially for electricity interconnections and gas transit pipelines. Data on the operation of generation capacity and gas storage also needs to be more widely available. For electricity, in particular, it was noted that rules on proper market conduct and supervision differ significantly between Member States, as there is little harmonisation at EU level of the transparency requirements.
- 26. To ensure a level playing field, all market participants require information to be made available on an equal footing and in a timely manner. At present there is an information asymmetry between the vertically integrated incumbents and their competitors. Improved transparency would minimise risks for new market players and so reduce entry barriers and improve trust in the wholesale markets and confidence in price signals. Obviously it needs to be ensured that no collusion takes place on the basis of the published information and, although commercial confidentiality is important, this should not be allowed to undermine effective transparency by being given too wide an interpretation.

2.5. Price formation

- 27. More effective and transparent price formation is needed in order to deliver the full advantages of market opening to consumers. Many users have limited trust in the price formation mechanisms, while regulated supply tariffs below market prices discourage new entry.
- 28. Gas import contracts use price indices that are linked to oil derivatives (e.g. light fuel or heavy fuel) and prices have, therefore, closely followed developments in oil markets. This linkage results in wholesale prices that fail to react to changes in the supply and demand for gas, which is damaging to security of supply. No clear trend towards more market based pricing mechanisms can be observed in long-term import contracts. Ensuring liquidity is crucial to improving confidence in price formation on gas hubs, which will allow for a relaxation of the linkage to oil.
- 29. Electricity price formation is complex. Increases in the price of primary fuels have certainly played a role in recent electricity price developments, especially in marginal plants. However this does not appear to fully explain the recent price rises. Similarly, the effect of the EU CO₂ emissions trading scheme on electricity prices is not yet entirely clear.
- 30. In several Member States, regulated tariffs have generated adverse effects for the development of competitive markets, since they have been set at very low levels compared to market prices and cover a large part of the market, thereby effectively leading to re-regulation. Similarly, in several Member States, special measures to

reduce electricity bills for energy intensive industries have been considered. Such schemes must be compatible with antitrust and State aid rules.

2.6. Downstream markets

31. Competition at the retail level is often limited. The duration of retail contracts for industrial customers and local distribution companies can have a substantial impact on the opportunities for alternative suppliers to successfully enter the market.
32. The cumulative effect of long contract durations, contracts with indefinite duration, contracts with tacit renewal clauses and long termination periods can be substantial. The analysis shows that the degree to which the industrial customers are tied to incumbent suppliers on a long-term basis differs significantly between Member States.
33. Customers demand more competitive offers from non-incumbent suppliers and regret the absence of pan-European supply offers. The number of competitive offers that customers receive is particularly unsatisfactory in some Member States characterised by a high level of concentration.
34. For gas, restrictions on how customers can dispose of their gas, in combination with restrictive practices by suppliers regarding delivery points, limit competition and prevent the achievement of efficiencies by these customers. In electricity, certain standard contracts contain restrictions, which may also raise competition concerns.

2.7. Balancing markets

35. Currently, balancing markets often favour incumbents and create obstacles for newcomers. The size of the current balancing zones is too small, which leads to increased costs and protects the market power of incumbents.
36. For gas, the small size of current balancing zones increases the complexity and costs of shipping gas within Europe. Costs are increased by highly complex and divergent rules in each zone, and by the obligation to reserve capacity at each border point. These problems are exacerbated by the time dimension: the shorter the balancing period, the higher the risk of imbalance for the supplier. All these aspects create major obstacles for new suppliers to enter the market, which the vertically integrated incumbents have little incentive to remove. Furthermore, balancing charges, clearing costs and penalty charges are not transparent and often contain unjustified penalty charges, favouring incumbents. Effective unbundling is necessary to create a level playing field in the balancing markets and to reduce barriers to entry.
37. In electricity, the markets on which transmission system operators have to acquire balancing and reserve energy are highly concentrated, which gives generators scope for exercising market power. This can result in entry barriers for new suppliers facing a high risk of high imbalance prices and/or high network charges (to the extent that balancing costs are included in the costs of the network). Concentration in balancing markets could be reduced if the geographical size of control areas was enlarged. Harmonization of balancing market regimes would be an important step to increase the size of control areas, improve market integration and simplify trade. In some Member States the structural relation between TSOs and their affiliated

generation provides an incentive for the TSO to buy excessive reserve capacity and/or to pay high prices, thereby favouring their affiliated generation arm. Results indicate that the amount of capacity reserves bought differs substantially between TSOs.

2.8. LNG markets

38. LNG supplies widen Europe's upstream supplier base and are therefore important for both security of supply and competition between upstream suppliers. The potential for LNG supplies to favour less concentrated downstream markets still needs to be realised.
39. Traditionally LNG has been imported by national incumbents who also own LNG terminals, and this situation has prevented LNG imports from increasing downstream competition. Recent trends, however, point to more capacity going to new entrants and to producers themselves. This is likely to have a positive impact on fostering downstream competition unless such effects are frustrated by anticompetitive rules or behaviour. Strong investment in LNG terminals has taken place and is scheduled to take place in the coming years. Investments in some LNG terminals have benefited from exemptions from third party access obligations under a test applied by national regulators with Commission supervision. This test seeks to achieve a balance between *ex ante* incentives to invest and competition once the investment has been made. While experience is largely positive, improvements are possible.

3. REMEDIES

40. In order to address the malfunctioning of the market identified in the Sector Inquiry and to significantly improve the scope of competition, it is essential to apply both competition and regulatory-based remedies. Competition law enforcement can make a significant contribution, but cannot by itself open markets and resolve all the shortcomings identified by the Sector Inquiry: a number of regulatory measures are, therefore, also needed.

3.1. Competition law enforcement

41. Full and combined use of the Commission's powers under antitrust rules (Articles 81, 82 and 86 EC), merger (Regulation (EC) No 139/2004)⁹ and State aid control (Articles 87 and 88 EC) is needed to maximise the impact of the Commission's enforcement action. The Commission is forcefully pursuing infringements of Community competition law (antitrust) in the sector wherever the Community interest so requires, in close cooperation with National Competition Authorities.

3.1.1. Market Concentration

42. **Market concentration has been identified as a major concern for the success of the liberalisation process.** The market power of pre-liberalisation monopolies has not yet been eroded. This makes the Community's action under the merger regulation essential so as to ensure that the competitive structure in relevant markets (which

⁹ Council Regulation (EC) No 139/2004 of 20 January 2005.

currently are at most national in scope) does not further deteriorate. In recent merger cases remedies such as divestitures, contract and/or gas release have been applied. In addition, the impact of long-term upstream contracts on downstream concentration has emerged as a major theme.

43. Energy release programmes (i.e. electricity Virtual Power Plant auctions and gas release programmes) are a means to develop market liquidity and increase entry opportunities. They constitute suitable remedies to competition concerns not only in the merger area but also under antitrust rules. In order to be fully effective they must be well-designed and large scale. Substantial experience has been gathered with such programmes by competition and regulatory authorities at national level (e.g. in Spain, France, Austria, Germany) and by the European Commission (in merger cases) allowing the authorities to avoid pitfalls and ensure their effectiveness. For gas, such release programmes have the additional advantage that they are likely to increase hub liquidity which supports the introduction of price signals not biased by the gas-oil-price link.
44. In certain circumstances applicable antitrust law also permits the application of farther reaching structural measures as a remedy to infringements of competition rules. This is the case where behavioural remedies would be less effective to bring the infringement to an end, where there is a substantial risk of a lasting or repeated infringement that derives from the very structure of the undertaking, or where behavioural remedies would be more burdensome¹⁰.

3.1.2. *Vertical foreclosure*

45. Wherever competition infringements are facilitated by vertical integration between supply and generation and infrastructure businesses and insufficient unbundling, the full force of the Commission's powers to prevent future abuse needs to be applied.
46. The Sector Inquiry has also confirmed the vertical tying of markets by long-term downstream contracts as a priority for review of case situations under competition law and for providing guidance where required. When such contracts, concluded by dominant firms, foreclose the market, Article 81 or 82 EC may be infringed unless there are countervailing efficiencies benefiting consumers¹¹. Similarly, power purchase agreements in the electricity sector can have foreclosure effects.
47. Furthermore, the concentration of gas import contracts in the hand of a few incumbents is one of the main reasons why competition at the subsequent level of trade does not take off. Whilst this does not as such put into question existing and future upstream contracts, it requires attention with respect to their effects for the downstream markets.

¹⁰ See Article 7(1) and recital 12 of Regulation (EC) No 1/2003.

¹¹ In the analysis of long-term contracts, sunk investments, if any have been made by the parties, are taken into account - see Commission Guidelines on the application of Article 81(3) of the Treaty (OJ C 101, 27.4.2004, p. 97, paragraph 44).

3.1.3. *Market integration*

48. Foreclosure can also arise at other levels of the value chain, most prominently as regards access to infrastructure (transmission and distribution networks and/or storage facilities), particularly in cases where cross-border access is concerned, thereby preventing market integration. Such access can be blocked through long-term transmission contracts and through the associated risk of capacity hoarding. Action in this field should include an analysis of the competition effects of pre-liberalisation long-term contracts and the compatibility of such contracts with competition rules.
49. Additionally, lack of investment and delayed investments by transmission companies with vertically integrated supply companies are other serious sources of concern. It is recalled that one National Competition Authority has found that a vertically integrated network operator deliberately stopped an investment project in order to benefit its supply branch by depriving competitors of access to more capacity¹².
50. **Market partitioning remains one of the most serious obstacles** to market integration. The fight against collusion between incumbents remains a priority of antitrust enforcement action, reflecting the overall priority of the Commission to fight attempts by undertakings to coordinate rather than to compete.

3.2. **Structural issues and pro-competitive regulatory environment**

51. The findings of the Sector Inquiry will enable the Commission to focus its enforcement action on the most serious concerns identified in the report. They also make it easier for the Commission to identify efficient remedies that can effectively resolve the competition problems identified in individual cases.
52. However, **key issues relating to market structure and the regulatory environment will have to be addressed in parallel**, in order to remedy the malfunctioning of the markets that has been demonstrated by the inquiry.

The Sector Inquiry has identified the following main fundamental deficiencies in the competitive structure of current electricity and gas markets:

- **Structural conflicts of interest: a systemic conflict of interest caused by insufficient unbundling** of networks from the competitive parts of the sector;
- **Gaps in the regulatory environment: a persistent regulatory gap** particularly for cross border issues. The regulatory systems in place have loose ends, which do not meet;
- **A chronic lack of liquidity**, both in electricity and gas wholesale markets: the lifeblood for our markets is lacking and the market power of pre-liberalisation monopolies persists;
- **A general lack of transparency** in market operations in the sector.

¹² The Italian Competition Authority has recently taken action against the delaying tactics of an incumbent operator to expand an important import pipeline.

Options for regulatory action at EC level are discussed by the Commission in its Communication on “Prospects for the internal gas and electricity market”. The findings of the Sector Inquiry and the resulting deficiencies identified below support and confirm the analysis brought forward by the Commission in that Communication.

3.2.1. *Unbundling*

53. The Sector Inquiry confirms the finding that it is essential to resolve the systemic conflict of interest inherent in the vertical integration of supply and network activities, which has resulted in a lack of investment in infrastructure and in discrimination. It is crucial to ensure that network owners and/or operators do not have incentives that are distorted by supply interests of affiliates. This is particularly important at a time when Europe needs very large investments to ensure security of supply and to create integrated and competitive markets.
54. To achieve this, it will be necessary to decisively reinforce the current inadequate level of unbundling. This would, in turn, also facilitate cooperation among network operators.
55. Economic evidence shows that full ownership unbundling is the most effective means to ensure choice for energy users and encourage investment. This is because separate network companies are not influenced by overlapping supply/generation interests as regards investment decisions. It also avoids overly detailed and complex regulation and disproportionate administrative burdens. The independent system operator approach would improve the status quo but would require more detailed, prescriptive and costly regulation and would be less effective in addressing the disincentives to invest in networks.
56. Furthermore, the public consultation has not revealed any significant synergy effects linked to vertical integration. Indeed, where ownership unbundling has been implemented, experience shows that both the network business and the (production and) supply business continue to thrive after separation.

3.2.2. *The regulatory environment*

57. Whilst ownership unbundling would substantially contribute to reducing problems of market power and lack of liquidity, it is clear that also other measures will be needed. As the Sector Inquiry confirms, **Europe needs a substantial strengthening of the powers of regulators and enhanced European coordination**. This goes in hand with the findings presented by the Commission in its Communication on “Prospects for the internal gas and electricity market”. Only a strengthened regulatory framework can provide the transparent, stable and non-discriminatory framework that the sector needs for competition to develop and for future investments to be made.
58. The main ingredients of such a strengthened framework should be:
 - enhanced powers for independent national energy regulators,
 - reinforced coordination between national energy regulators,

- reinforced cooperation between Transmission System Operators (TSO), and
- substantially enhanced consistency of regulation in cross-border issues.

59. Reinforced coordination between national energy regulators, with a stronger role for Community oversight to ensure the Internal Market interests, particularly as regards cross-border issues and areas most critical for market entry, will be necessary to overcome the current regulatory cross-border gap which cannot be remedied by application of competition rules alone. Options for regulatory measures are discussed in the Communication on “Prospects for the internal gas and electricity market”.

3.2.3. *Chronic lack of liquidity*

60. Reinforced unbundling rules and an improved regulatory environment for cross border issues in particular should, in the medium term, substantially reduce the problems of market power and lack of liquidity in a sustained manner, by bringing additional supplies to concentrated national markets. However, there **remain serious concerns in the short term, as regards the lack of sufficient liquidity** and sustained market power in wholesale markets, which is leading to higher prices in retail markets just as full liberalisation is to be implemented on 1 July 2007.

61. As already indicated, competition law enforcement will be an important tool to address any anti-competitive conduct concerning this issue. However, more may be needed. As the levels of concentration in gas and electricity markets have remained high, often reflecting pre-liberalisation monopolies, national energy regulators should analyse conditions in their respective markets in co-operation with competition authorities and make appropriate proposals. Measures taken in the past by a number of Member States include release programmes (i.e. electricity Virtual Power Plant auctions and gas release programmes).

62. It is also recalled that certain Member States have introduced under national law ceilings on ownership of electricity generation and control over long-term upstream gas contracts (imports and national production), as an effective measure to rapidly reduce market power. For electricity, such measures could imply either divestiture or asset swaps of power plants on a European scale. For gas, it could mean contract release, contract swaps and/or divestiture of domestic production, as have been applied in recent merger cases. Widening of small TSO areas and introducing more open and flexible tendering procedures for balancing energy could reduce the current high levels of concentration in balancing markets and remove obstacles to entry, with a positive knock-on effect in wholesale markets.

63. Furthermore, the Sector Inquiry has highlighted the importance of enhancing the scope for entry through investment in new generation and gas import infrastructure as well as strict application of use-it-or-lose-it provisions for infrastructure and suitable generation sites.

3.2.4. *Lack of transparency in market operations*

64. There is general recognition that **access to market information** should be further enhanced. All relevant market information should be published on a rolling basis in a timely manner. Any exceptions should be very strictly limited to what is required to

reduce the risk of collusion. Guidelines as well as monitoring and eventually adaptation of existing regulation should serve to further enhance transparency in the gas and electricity sector. Intended proposals are outlined in the Communication on “Prospects for the internal gas and electricity market”.

3.2.5. Other important issues

65. In addition to these four fundamental areas, other issues of pro-competitive market environment need consideration. On these issues, specific suggestions for regulatory action at EC level are made by the Commission in its Communication on “Prospects for the internal gas and electricity market”.
66. **Regulated retail tariffs can have highly distortive effects** and in certain cases pre-empt the creation of liberalised markets. It is of crucial importance to assess the impact of remaining regulated supply tariffs on the development of competition, and remove distortions¹³.
67. In order to achieve that access to new infrastructure is not unduly restricted, the Commission should continue to ensure that **exemptions from access provisions are not detrimental to the development of competition**. It is important that projects continue to be scrutinized on a case by case basis with strict application of competition principles striking a proper balance between incentives for *ex ante* investment and *ex post* competition, and that the exemption procedures are streamlined.
68. In order to achieve a single European network from the perspective of the network user, there is a need for appropriate harmonisation of **market design, especially regarding methods having an effect on cross border trade**. Action is needed, wherever current capacity is insufficient, to develop interconnector capacity as a necessary condition for the development of competition and the integration of markets. These aims can only be achieved through increased cooperation between national regulators inducing increased cooperation among TSOs across national borders within a well-defined procedural framework.
69. In order to put **more gas transmission capacity on the market**, it will be important to clarify the legal position of *pre-liberalisation* long-term gas transmission contracts under the Second Gas Directive¹⁴, which are already now subject to strict use-it-or-lose-it rules and to the rules of competition law.
70. Further changes are needed regarding the method for **allocating limited interconnector capacity**. For electricity, implicit day-ahead auctions or equivalent measures should be promoted as much as possible to ensure that interconnectors are

¹³ For the household market segment, there is a need to strike the right balance between competition and universal public service obligations.

¹⁴ Directive 2003/55/EC of 26 June 2003 concerning common rules for the internal market in natural gas (OJ L 176, 15.7.2003, p. 57). Replaces the First Gas Directive.

used to their maximum extent. TSOs should also have incentives to maximise the amount of cross border capacity made available to the market¹⁵.

71. In order to provide sufficient guarantees for effective access, third party access for gas storage should be reviewed so as to strike the right balance between the need for effective access and maintaining incentives for new storage developments.
72. **A monitoring system for trading on wholesale markets (e.g. power exchanges)** would increase market participants' confidence in the market and limit the risk of market manipulation. Regulators should be empowered to collect and exchange relevant information in this respect. They should have the power to make recommendations for enforcement action or have the power to carry out such enforcement action themselves.

4. CONCLUSION

73. The Sector Inquiry has identified a number of serious shortcomings which prevent European energy users and consumers from reaping the full benefit of the liberalisation process. The findings support the conclusions of the Communication on "Prospects for the internal gas and electricity market", which has been carried out by the Commission in the follow up to the Green Paper and in the course of the preparation of the Strategic EU Energy Review. These initiatives bring forward the Commission's intentions as to proposals for regulatory reform, aiming at an Internal Market for energy that contributes to sustainability, competitiveness and security of supply. In addition, and in parallel, the Final Report also draws conclusions with regard to enforcement action under EC competition law. Both these documents aim at identifying and remedying obstacles to creating a single European energy market, in which consumers fully benefit from the opening of markets to competition.

¹⁵ E.g. Scarce capacity that is kept in reserves by some TSOs for emergency situations may be offered to the market as interruptible capacity, and can be bought back when required, using for instance cross border congestion rents.