European Commission
Directorate general for Energy and Transport

MEMO

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# Towards an efficient internal energy market

## Conclusions of the 2005 Report on the functioning of the electricity and gas markets

Europe is currently seeking to re-launch its economic growth and competitiveness in the context of the renewed Lisbon strategy. A reliable electricity and gas service at acceptable prices is a key driver of economic performance, especially in an environment where global energy prices are increasing. It is now one year since the new Directives for electricity and gas should have been implemented, extending competition in this sector of the economy, ultimately leading to full market opening in 2007.

The monitoring efforts of the Commission, undertaken in the context of the 2005 progress report, show that market opening has largely been a success to date. For example, electricity prices are lower in real terms than in 1997 despite recent price increases for oil, gas and coal. However, much more needs to be done by Member States to ensure that consumers receive the full benefits flowing from market opening.

**The main cause of this picture is first and foremost the failure of Member States to implement the second electricity Directives in time and with sufficient determination**. A large number of Member States were as much as a year late in implementing the Directives; others still have not done so. Furthermore, only few Member States have complemented the minimum principles of the directive by additional measures, aimed at making the market work in practice given the specific national circumstances.

Therefore, the ball is now in the hands of Member States. Member States need to quickly and fully implement the Directives, pursuing not only the letter of the Directives, but also their spirit. The European Commission will continue to put pressure on Member States to implement measures that are key to achieving a higher level of growth and competitiveness in Europe. If this does not happen stronger action will be needed.

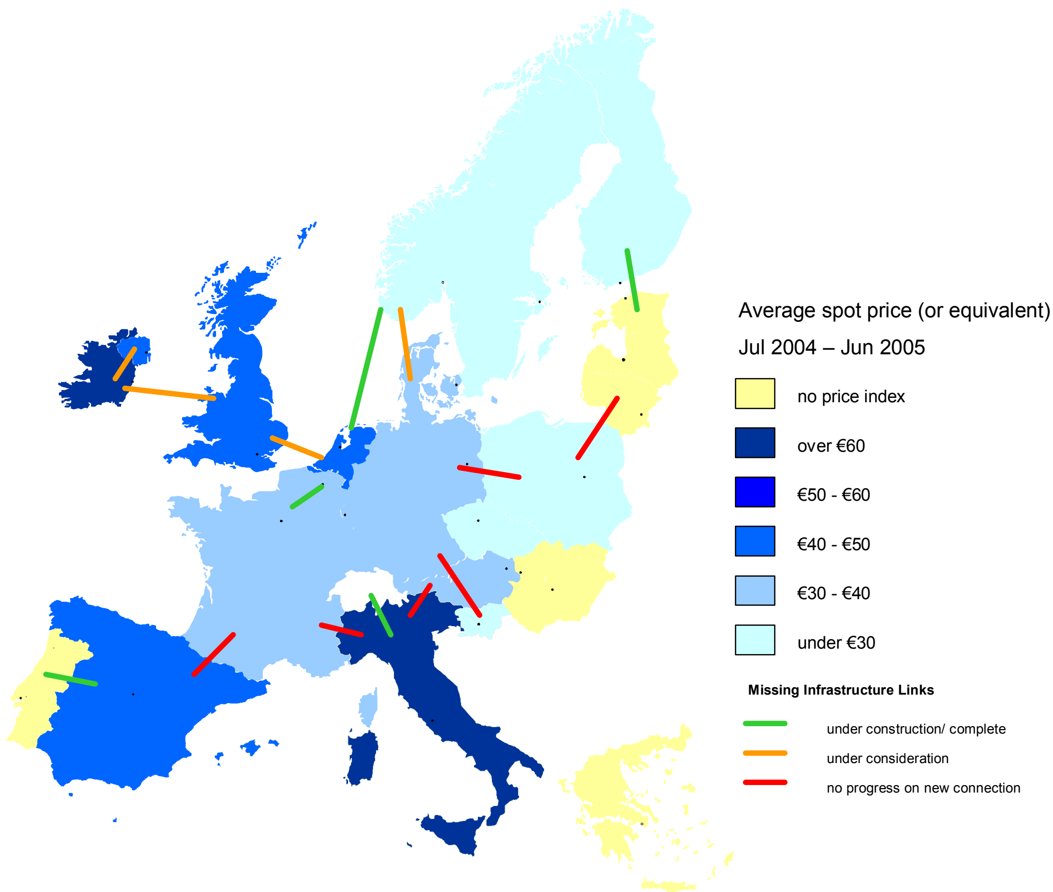
# Market integration still insufficient

**At present all EU electricity and gas markets, except in the Nordic countries, remain national in economic scope.** In other words, for almost all countries, imports of electricity and gas are not yet sufficiently developed to provide customers with a real alternative from the nationally established suppliers.

Two key indicators lead to this conclusion:
- significant price differences within in the internal market
- low level of cross-border trade in electricity and gas.

The lack of market integration is largely due to the fact that the interconnection capacity made available to the market between many Member States is still insufficient to allow genuine integration of national markets and competitive pressure from imports. Congestion occurs frequently at many borders within the EU. It must be recalled that back in 2002 the European Council in Barcelona adopted the objective that all Member States must have interconnection capacity equivalent to at least 10% of their national consumption, an objective which has not yet been achieved. The reality is that many important projects remain on-hold and that limited efforts are being made to made additional capacity available from existing infrastructure. Similarly, the European gas grid, although well developed, is not used to its full potential.

The graph below illustrates the correlation between missing electricity links and price differences on the internal market.



## Concentration and consolidation characterise industry structure

In the absence of well developed cross-border competition, the structure of national markets requires special attention. The starting point for market opening in many Member States was a monopolistic market structure with only one or a few big companies. The introduction of competition at EU level should put an end to this situation by exposing companies to EU-wide competition. This has not yet been achieved.

With only a few exceptions, the largest three national companies have a very large share of the market (over 75%) for both electricity and gas. Furthermore, the largest companies at European level increasingly have subsidiaries in all Member States and there is growing consolidation at European level. This points to the need for real competition at European level.

Given the high degree of concentration of the industry in almost all Member States there is a real risk that EU citizens will not be able in practice to effectively us their right to choose a supplier in a competitive market.

The Commission is investigating, among other things, the impact of the concentration and consolidation of the industry on the level of competition in more detail as part of the ongoing sector competition inquiry into electricity and gas markets in June 2005.

## *Several Member States late to implement new directives*

**In view of the industry structure and underdeveloped cross-border competition, the failure of Member States to implement the second electricity Directives in time and with sufficient determination** is particularly damaging. A large number of Member States were as much as a year late in implementing the Directives, others still have not done so: Spain (electricity and gas), Luxembourg (Electricity and gas), Greece (electricity), Estonia (gas), Portugal (electricity), Ireland (gas) and are now before the European Court of Justice, or will be shortly.

**Furthermore, a number of Member States have taken a rather "minimalist" approach in implementing the Directives, and this approach must be re-considered if the real needs of citizens and consumers are to be met.**

**Member States need to quickly and fully implement the Directives. In doing so, they need to ensure that they pursue not only the letter of the Directives, but also their spirit**. The Directives provide a common minimum set of principles and measures applicable to all Member States.

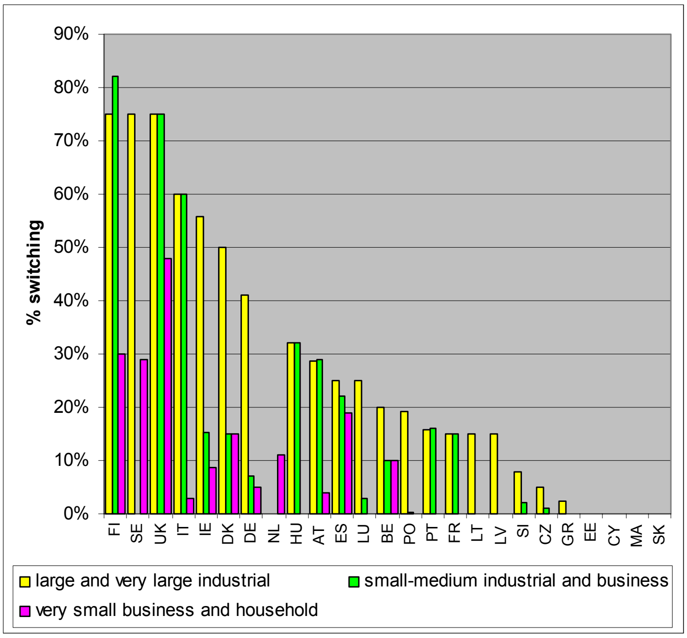
However, **additional measures may well be necessary in certain areas, to take account of the specific characteristics existing in certain countries**. Some Member States have already taken such active, additional steps: for example reinforcing the minimum unbundling measures provided in the Directives, strengthening the power and independence of Regulators, freeing up existing and building new interconnection capacity, and taking measures to promote liquidity on gas markets.

# Customer response remains underdeveloped

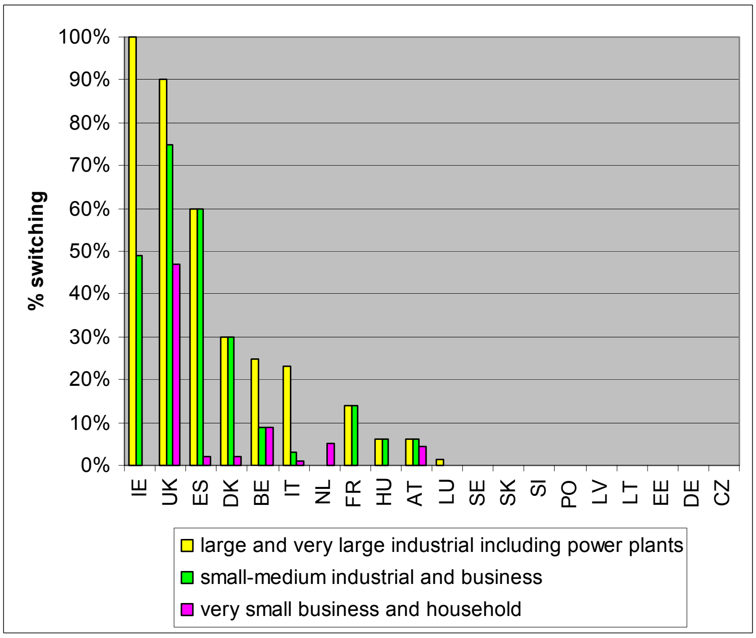
Whereas the switching rates of larger customers continue to rise, particularly for electricity small businesses and households remain reluctant or unable to exercise their right to choose. Many factors contribute to this. Often competing offers are unavailable or are too similar to constitute a genuine choice. Dominant positions and insufficient unbundling, especially at the distribution level, seem to discourage switching, and changing suppliers is often still perceived as risky both for customers and for potential new suppliers.

The graphs below demonstrate the diverging performance between Member States.

## Electricity




## Gas



# Trends & Challenges

## ○ *Price trends*

Particular attention must be paid to electricity and gas price trends on the internal energy market. Certain energy-intensive industries have recently expressed concerns about rising wholesale market prices, which have been particularly acute in some Member States. This was one of the reasons why the Commission decided, in June 2005, to launch an inquiry into the electricity and gas sector, to examine whether competition is restricted or distorted within the common market.

It should however be noted that, despite recent price increases, electricity prices have overall decreased over the last 10 years in real terms. Meanwhile, prices of other fuels such as gas and oil, which are equally important for certain industries, have increased.

## ○ *Independence of network operators*

Effective unbundling of network operation from the competitive parts of the business is essential to ensure independent network operation and non-discriminatory access to networks for all market participants. This is a key requirement of the Directive.

However these stricter unbundling rules are not yet fully effective in practice. In many instances the process of unbundling has yet to be finalised by network operators, partly as a result of the late implementation of the Directives by most Member States.

## ○ *Effective regulation by regulatory authorities*

Energy regulators – the "watchdogs" of the market - need to be given clear responsibilities in national legislation and sufficient authority, in order to allow them to fulfil their tasks. Currently the levels of powers and independence of energy regulators appear to differ between Member States.

Regulators also need to work together at EU level. To encourage this, the Commission, in December 2003, set up the European Regulators Group for Electricity and Gas (ERGEG). In addition, the European regulatory fora for electricity and gas (known as the "Florence Forum" and the "Madrid Forum"), provide a discussion platform for all interested parties. This co-operation needs to be intensified in order to deliver wider European markets for electricity and gas.

## ○ *Customer service and public service considerations*

The objective of the Electricity and Gas Directives - to maintain and improve the position of customers - is being met. Surveys of consumer opinions have concluded that the level of satisfaction with the quality of the electricity and gas services provided is generally high. Fears that the introduction of competition would lead to a decline in service standards or problems in the provisions of universal service have proved unfounded.

## Security of supply – special attention to gas

Competition is delivering new investment, both in electricity production and gas infrastructure. It is not expected that intervention will be required provided that the basic market rules are transparent and stable.

Gas has become increasingly important for electricity production. At the moment nearly all gas imports into the EU come from only three countries - Russia, Norway and Algeria. With indigenous gas reserves declining and gas consumption worldwide expected to increase significantly, the current heavy dependence on a small number of supplying countries needs to be overcome.

Given the heavy demand forecasts for gas and the resulting increased competition for gas resources worldwide, in particular on the evolving world market for LNG, the EU gas market must remain attractive. It must function properly, have a reliable and stable regulatory framework and allow gas to flow freely throughout the EU, enabling suppliers and investors to benefit from business opportunities offered by an open market.

## Security of supply – the role of nuclear power

Nuclear power accounts for more than one third of electricity production in the EU. The total amount of nuclear power generated hit a record high in 2004. It does not emit $CO_2$ and plays an important role in security of energy supply in the EU. The Commission has proposed a framework for the EU-25 on the issue of nuclear safety and management of nuclear waste. It is important that Member States adopt this framework, whether or not they intend to use nuclear energy.

***Conclusions & Outlook***

With the adoption of the second Electricity and Gas Directives, the basic framework for the development of a functioning internal market is in place. Taking into account that in many Member States the legislation transposing the directives was only recently adopted and that results from the competition sector inquiry are not yet available, the Commission does not yet at this stage draw definitive conclusions on the need for additional measures at European level. The Commission will therefore, in addition to following-up closely the formal legal compliance with the Directives, carry-out detailed country-by-country reviews of the effectiveness in practice of legislative and regulatory measures in connection with market opening, including specific additional national measures. This will lead to a further Report by the end of 2006 and, if necessary, proposals to redress any remaining requirements.

MEMO is prepared by the Strategy, Coordination, Information and Communication Unit of DG Energy and Transport. Don't hesitate to contact us for further information (tel +32 2 2968 042)
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