

CEER response to the Preliminary Report of the Gas and Electricity Sector Inquiry

20 April 2006

Executive Summary

CEER welcomes the results of the European Commission's Preliminary Report concerning the Sector Inquiry. In CEER's view the Report correctly identifies at a headline level the main barriers to the full functioning of the internal gas and electricity markets. CEER also agrees with the preliminary assessment that it may be appropriate for remedies to be taken through competition law, energy regulators, and restructuring. The full implementation by Member States of the relevant European legislation is also crucial for fully functioning markets.

In CEER's view, recent years have seen some progress to more liberalized and competitive gas and electricity markets, with some further integration of national markets. However there remain significant difficulties. Market concentration is high in both gas and electricity markets, resulting in among other things a lack of proper and liquid price discovery. Non-discriminatory access to pipes and wires, particularly across borders, hinders both trade and new market entry. A lack of market transparency compounds these problems.

CEER comments on the content of the Report as follows.

Market concentration

CEER agrees that market concentration is a major problem in EU energy markets, with many of the former incumbents remaining dominant in national or local markets. The preference expressed in the Report for structural remedies in merger cases, within the framework of existing legislation, could go some way to preventing further market concentration. CEER suggests that the following measures could help:

- Deeper and more effective unbundling of network activities.
- Facilitation of market entry
- Market integration
- Scrutiny of any market power abuses

Regarding market integration, CEER's gas and electricity Regional Initiatives should provide a further measure to ameliorate market concentration effects. The Initiatives have the central aim of promoting trade and integration between national markets into regional markets. CEER recognises that these measures cannot solve all concentration problems.

Vertical foreclosure

CEER supports the Commission's emphasis on wholesale markets. They are a key to stronger competitive developments in the gas and electricity sectors. Vertical integration between production and retail as well as between supply and network operation have been identified by the Commission as core problems in this respect.

Unbundling of network activities is a key prerequisite in this regard. Current arrangements do not deliver the necessary separation of network and competitive activities and so CEER is fully

supportive of the Commission's suggestion that further action here is needed. CEER notes in addition that vertical foreclosure may be expressed through contractual as well as ownership links, implying that it is also necessary to assess the impact of relevant contractual links. 'Legacy contracts' for gas transit and long term contracts are particularly relevant here.

Lack of market integration

Differences in price levels and changes between national markets not clearly linked to underlying demand and supply movements strongly imply that national markets are not well integrated and that trade between them is not yet fully efficient.

The Report notes that a lack of market integration stems from inefficient utilisation of existing interconnecting infrastructure, insufficient provision of new interconnecting infrastructure, and a lack of wholesale market harmonisation. The CEER agrees with this assessment, and suggests that further market integration will require a number of measures, including:

- Understanding and developing gas hub to hub trade.
- Understanding and addressing the impediments to the provision of cross border pipes and wires capacity. This might include giving incentives to TSOs to invest, and addressing the 'regulatory gap' that exists in terms of cross-border matters, as well as the problem of investment outside of the EU and the role of long term contracts.
- Facilitating TSO-to-TSO co-operation and information exchange in order to maximize commercial use of cross-border capacity.
- Pushing forward with CEER Regional Initiatives in order that particular impediments at a regional or local level can be identified and addressed.

Transparency

CEER fully agrees with the Report that lack of market transparency is a key impediment to fully functioning markets. The lack of transparency - of information needed by market participants in order for them to make efficient use of the networks - has been a concern of the regulators for several years. In addition, a proper process for TSOs to handle confidential information is also needed to prevent discrimination and to promote confidence in the market. It is essential that TSOs, and other parties, publish all information that is needed to promote efficient operation of the energy system as a whole.

CEER and ERGEG have therefore been actively promoting market transparency. Voluntary Guidelines for Good Practice for gas storage system operators included measures to increase transparency, and CEER is currently considering how these measures might be expressed more strongly. ERGEG has in addition published for public consultation Guidelines for Good Practice on Information Management and Transparency in Electricity Markets.

The ERGEG's Regional Initiatives will also address transparency issues and in particular attempt to identify and overcome local legislative and other barriers to increasing market transparency.

Price formation

CEER would agree that effective competition requires liquid wholesale markets and for prices at all levels of the value chain to be set through supply and demand processes. It is possible that vertical integration can reduce the necessary liquidity, although it should also be borne in mind that such integration can also reduce transaction costs or bring other efficiencies that in a competitive market may be passed to customers.

The setting or other control of retail prices by regulatory authorities needs, in CEER's view, to be done in a careful manner such that they complement rather than cut across the development of retail competition. Prices set below costs for example will deter new retail entry.

Issues to be addressed

CEER suggests that at a minimum the following issues require attention.

Legislation and the powers of regulators

Experience demonstrates that the development and oversight of liberalized and competitive gas and electricity markets requires independent regulatory oversight, where the regulator concerned has adequate powers to monitor and control proper market functioning. Regulators need to be independent of industry in order to be above any suspicion that they are beholden to industry which could undermine the economic effectiveness and fairness in regulating competitive markets. Regulators would also need to be independent of government in the exercise of their regulatory powers. In order to promote market integration, regulators also require competences to oversee matters relating to cross border issues, in collaboration with other relevant regulators.

The CEER therefore suggests that the Commission and Member States should look again at the powers of independent regulators, most notably in order to match the tasks assigned to them within the EU legislative framework for liberalisation.

Unbundling

Promoting competition in generation and supply require TSOs and DSOs to act, and to be perceived to act, independently of commercial interests in the market, in a strictly non-discriminatory manner. In the absence of ownership links with market participants, TSOs and DSOs have no incentive to discriminate between market participants, for example in relation to access to the networks.

The goal of legislative or regulatory arrangements on unbundling must therefore be to achieve ownership unbundling or to mimic as closely as possible its effects in terms of the impact on TSO and DSO behaviour. Without ownership unbundling, regulatory arrangements must be detailed and need to be monitored and enforced by regulators with adequate powers and resources

Transparency

Information necessary to the efficient working of gas and electricity markets needs to be made available to market participants. Much of this information is held by TSOs or could be made available to them by other market participants.

The management of information will also be a key issue. Information that is known to TSOs but which is not to be released to the market needs to be appropriately ringfenced within the network business. Conversely data that is to be released must be done so to all market parties simultaneously. Governance structures that enable market participants to propose improvements in information handling and transparency will also be helpful in this regard.

Existing legislation, particularly the gas and electricity Regulations, provide some obligations regarding transparency. However they are in CEER's view insufficiently comprehensive, and require supplementing in either a voluntary or mandatory form.

Regional Initiatives

ERGEG during Spring 2006 has launched gas and electricity Regional Initiatives. The objective of each Regional Initiative is to establish functioning and effective regional markets as a step towards a competitive single European market. The Regional Initiatives are intended therefore to identify barriers to further progress towards competitive markets, and develop options for overcoming these barriers. They will bring together all of the relevant parties — regulators, market participants, consumers, Member States, the European Commission, and other stakeholders — and will identify which parties are best placed to act in each case.

Thus the Regional Initiatives should deliver practical improvements to European gas and electricity markets, addressing in a concrete manner many of the impediments to market integration identified in the Report and elsewhere.

1. Introduction

CEER¹ believes that the European Commission's gas and electricity sector inquiries are a vital contribution to the process of liberalising Europe's energy markets and promoting effective competition, to the benefit of consumers of gas and electricity across Europe. The preliminary report identifies the major problems currently standing in the way of further liberalisation or preventing effective competition. CEER supports and shares the analysis through which these problems have been identified.

Having successfully identified these problems, it is essential that a comprehensive set of remedies be implemented, covering competition law action, regulatory action, and legislative change if needed. The sector inquiries must therefore move on to implement solutions in the field of competition law, as well as identifying other remedies (regulation and legislation).

Action is also required by energy regulators and by legislators (both at European and at national level) - especially, but not only - because of the failure by some Member States to implement existing European legislation effectively. Full implementation and effective enforcement of existing legislation in all Member States is a prerequisite for achieving a single European Market. Voluntary action (e.g., exchange of best practice, codes of conduct, non-binding guidelines) is to be welcomed, but monitoring by the Commission and by regulators shows that significant problems remain to be overcome in European gas and electricity markets.

The complementarity of these three approaches (competition law action, regulation, and legislation) can be seen from the extent to which DG Competition's sector inquiries, DG Transport and Energy's benchmarking report, and CEER's *Roadmap* papers reach common conclusions. These three components — competition law remedies, action by energy regulators, and legislation — can help achieve successful liberalisation of and effective competition in European gas and electricity markets. A combination of *ex ante* regulation/legislation, and *ex post* enforcement of competition law is needed, and CEER urges the Commission to recognise this and to ensure that the conclusions of the inquiry are used both to identify competition law cases and in their consideration of any proposals for new legislation.

This paper discusses the issues identified in the Preliminary Report and suggests how some of the problems currently facing European gas and electricity markets could be solved, with a focus on the practical steps that the European energy regulators are taking to address these issues. The paper concludes with a more detailed discussion of the four most important areas in which regulators believe action is needed: legislation and the powers of regulators, unbundling, transparency, and regional initiatives. The regulators' regional initiatives will further develop the evidence from which to identify priorities for action.

CEER strongly supports DG Competition's determination that the European Commission, regulators, and Member States should act to overcome the outstanding problems in the EU's gas and electricity markets.

¹ CEER is the regulators' group which prepares material for ERGEG and facilitates informal co-ordination and co-operation between national regulators. ERGEG is the body through which regulators prepare formal advice for the European Commission.

1.1. The state of EU electricity and gas markets

Regulators are wholly committed to the vision of a competitive, liberalised and well-functioning EU energy market, established for the benefit of all energy consumers. The work programmes adopted by CEER and ERGEG, and the ERGEG gas and electricity road maps, and the regulators' recently-launched Regional Initiatives embody that commitment. Our assessment of today's situation in electricity and gas is positive but we identify major steps still needed even for the interim stage of compatible regional energy markets. Application of competition law at national, regional and EU level must be consistent in order to ensure a level-playing field for all market agents. The DG Competition sector inquiries are therefore fundamentally important, as is full implementation by Member States of the relevant European legislation.

In electricity there has been considerable progress in some regions. In many, wholesale trade is showing some signs of greater liquidity, but there are widely different wholesale prices between some regions that probably indicate structural problems either in transmission or in generation. Wholesale electricity markets, like gas, are still highly concentrated and will require the closest monitoring of potential market abuse as regional markets develop. Although there has been some integration of wholesale markets, with increased cross-border trade, very few new generation projects have been commissioned by independent, non incumbent generators. The high share of long-term reserved interconnection capacity (often over 50% of capacity) for cross boarder trade can entail significant problems in driving towards a more integrated EU electricity market, due to their potential to contribute to increased market power in some areas.

For gas, the development of markets is at a much earlier stage than electricity in the vast majority of Member States, with incumbents dominant at both wholesale and retail levels. There are some potentially positive market developments, notably the increased availability of LNG, which should bring greater diversity of supplies. However, concentration is even higher than in electricity, and this, in the absence of hub-based trading, indicates the lack of competition across Europe, mainly because wholesale gas is not available to new entrants. This lack of hub based trading is a significant obstacle to the development of the market. The DG Competition sector inquiries are thus crucially important. Availability of transport capacities remains a key requirement for the development of a competitive internal market in natural gas: effective gas-to-gas competition on wholesale markets is hindered where competitors and new market entrants are denied appropriate third party access (TPA) on a non-discriminatory basis. Retail competition is likewise hindered if TPA is refused or transport capacities are not made available to a sufficient extent. The current lack of efficient and non-discriminatory access to gas transport infrastructure should be tackled by capacity release and the introduction of effective use it or lose it provisions. In case existing congestion management mechanisms do not efficiently manage capacity constraints and ensure that all reasonable demands for capacity can be met, the congestion should be relieved by the TSO investing. Abuse of exemption provisions in the 2003 Directive for new investments (e.g. LNG terminals or interconnectors) must be avoided to allow new entrants to be active in the market. Non discriminatory access to storage is also crucial. ERGEG's voluntary guidelines are a step forward, and will be of real practical importance provided they ensure that improvements are delivered.

2. Addressing the issues raised in DG Competition's preliminary report

To deliver competitive markets, it is essential that competition authorities and national regulators apply their powers in complementary ways, recognising the complementary nature of the competition law framework and the framework of the liberalising legislation in the energy sector (which share the same goal of transferring the benefits of effective competition to end consumers). National regulators fully recognise this, and the need to work together with competition authorities, and are therefore strongly supportive of the work of DG Competition in conducting the sector inquiries. Regulators urge DG Competition to consider the full range of remedies available, and look to see vigorous application of competition law to any infringements detected during the sector inquiries. The Commission should also recognise the need for both *ex ante* regulatory/legislative action and *ex post* enforcement of competition law, and should therefore use the results of the sector inquiry not only in pursuing competition law cases but also in considering proposals for new legislation. Regulators will play their part in driving forward the regulatory agenda, with the aim of contributing to the achievement of a competitive European market for gas and electricity.

We recognise the five problems — market concentration; vertical foreclosure; lack of market integration; lack of transparency; and the price formation mechanism — highlighted in the preliminary report; we strongly encourage DG Competition to pursue the full range of remedies available; and we are already working—notably through the regional initiatives—to address some of the problems DG Competition highlights. In the following sub-sections CEER's suggestions on both *ex ante* and *ex post* remedies are briefly described, with the emphasis on short- and medium-term actions that CEER will take. In addition, some ideas are also mentioned which have not yet been adopted by CEER but which might, subject to the necessary analysis and discussion, be undertaken by CEER in the longer term.

2.1. Market concentration

Market concentration is a major problem in EU energy markets, with many of the former incumbents remaining dominant in their local markets. Most wholesale electricity markets for example remain national in scope with high levels of concentration in generation, which gives scope for exercising market power. Even if market power is not used, high market concentration will reduce confidence in the proper functioning of the market and therefore forms a barrier for new entrants. Furthermore, reduced competition does not give incentives for market actors to improve their efficiency which also incurs social costs.

The preference expressed in the preliminary report for structural remedies in merger cases, within the framework of existing legislation, could go some way to preventing further market concentration. In addition, the following measures may help:

- Deeper and more effective unbundling
- Facilitation of market entry
- Market integration
- Scrutiny of any market power abuses

Mergers and concentration

Electricity generation and gas markets are characterized by relatively high entry barriers. As a result, entry in such markets is mostly from market players already operational in other geographic markets, notably incumbents in other countries, and so such entry tends not to impact significantly market concentration levels.

The CEER therefore suggests that merger control policy is strictly applied at both national and EU level to efficiently tackle the problem of concentration. Special attention needs to be paid to the definition of relevant product and geographic market. For example, while wholesale trade may be a single relevant product market, a thorough analysis of concentration and abusive market behaviour requires a detailed analysis at the segment level (e.g. spot and forward markets). In particular, it is necessary to recall that merger and acquisition activity that occurs at a national level can have EU level effects on competition. Even though the economies of scale and scope arising from consolidation may be evident the lack of workable competition may result in that the benefits are not accrued to the customers. Consequently, common tools to evaluate market concentration in national, regional and European-wide energy market should be developed as the traditional tools might not necessarily be applicable to markets characterized by technical conditions.

Furthermore, since the market structure of the national gas and electricity markets at the time of market opening has been strongly concentrated, a very vigilant and mostly negative approach towards mergers and acquisitions should be applied. This is also important for cross-border acquisitions and electricity-gas cases, because potential competitors in electricity markets could be gas companies. The ongoing wave of consolidations that has been seen since the launch of the first Gas and Electricity Market Directives and which seem set to continue is a real threat to the goal of achieving a well-functioning, integrated electricity market. Against this background, the remedies available to competition authorities should be used to address the negative effects of increased concentration in case of a merger or an acquisition. The remedies to be used include for instance measures regarding divestiture of generation assets.

Additional legislative measures could also be considered to prevent further market concentration: even where there is sufficient physical transportation capacity and equal treatment of all market participants, gas may be unavailable for contractual reasons, thereby preventing liquid trading from developing. In order to promote liquid trading, unused volumes under take-or-pay import contracts could be released onto hubs under existing and new contracts; importers could be required to offer a proportion of volumes under new import contracts to the market via hubs; alternatively a market share cap could be considered in analogy to the telecoms sector. Trading on and between hubs could be made obligatory.

Unbundling

Deeper and more effective unbundling (discussed in detail below) would encourage new entry.

Market entry

To lower the threshold of new market entry and to level the playing field, asymmetric regulation for dominant companies could be envisaged. For example in the electricity sector, that could relate to access to interconnectors where the rival companies could be favoured, import contracts to get competing supply to the market, encouragement in the building of new power stations by new entrants, notably by a careful treatment of their connection to the grid (but no capacity payments or markets, for instance), and eventual market share caps to mitigate the concentration in generation in some areas. One instrument that has been used is the so called VPPs where the buyer of the VPP gets the right to draw electricity from a plant that it does not own. It can be seen as a second best alternative to physical divestiture, as it enables buyers to ensure an access to electricity but does not enable to sell in order to control their sourcing price, which they could achieve if they owned generation assets.²

Market integration

One way to reduce market concentration is to enlarge the geographical market. In a very concentrated market structure integration with the neighbouring markets is a key to alleviate the problem, but further measures will be necessary and must be investigated. Regarding electricity the major areas to work on include increasing interconnection through advocating new interconnection infrastructure and ensuring the maximum interconnection capacity to be available to the market participants. The latter issue relates to congestion management mechanisms and tackling of existing – partly non-market based – long-term cross-border contracts to minimise undue foreclosure of interconnection capacity from other market actors. Regarding gas, better hub-to-hub trading and access to cross-border gas pipe capacity would help here.

The gas and electricity Regional Initiatives introduced by ERGEG in spring 2006 aim at developing and integrating regional gas and electricity markets respectively, which are a middle step between national markets and EU-wide integrated markets. Regarding electricity, during spring and summer 2006, a second round of regional mini-fora will address a group of common and region-specific issues to firmly promote regional market integration. Regulators expect the regional initiatives to make a major contribution to reducing market concentration in the medium term, and hence to improving the effectiveness of competition. Over time, therefore, regulators expect the currently fragmented local markets to coalesce, promoting effective competition even where the absolute size of energy companies is large.

² See “Lessons from liberalised electricity markets”, International Energy Agency (2005), p. 64-65.

Scrutiny of any market power abuses

To address eventual abusive behaviour of incumbent generators and wholesale suppliers is a challenging area of antitrust. We encourage the intensified efforts of both DG COMP and national competition authorities to investigate alleged abuses and to develop tools to identify and demonstrate them. For this purpose it would be beneficial to increase and deepen co-operation between competition and regulatory authorities as together they could develop their competencies to develop regular and wider market surveillance mechanisms and to treat anticompetitive problems. CEER and its members offer their competencies and resources and would be happy to elaborate this co-operation in more detail.

In specific cases and in specific geographic markets, remedies following an infringement of competition law could involve market share caps (e.g., the recent prohibition of certain long-term contracts by the German competition authority), gas release programmes, and VPP auctions.

2.2. Vertical foreclosure

The CEER support the Commission's emphasis on wholesale markets. They are a key to stronger competitive developments in the sector in total. Vertical integration between production and retail as well as between supply and network operation have been identified by the Commission as core problems in this respect.

Regulators fully recognise the importance of unbundling provisions that result in TSOs which act independently of commercial interests of all companies using their networks. Current arrangements do not deliver this essential outcome, and regulators are therefore fully supportive of DG Competition's suggestion that further action on unbundling of TSOs is needed. Effective unbundling is discussed in more detail below. Where TSOs in one Member State have ownership links with supply businesses in a neighbouring Member State, relevant unbundling rules need to be enforced across national borders. Regulators also note that in some circumstances it is necessary to assess the impact of contracts, which can have similar effects (on incentives and the development of competition) as ownership links between companies.

Gas

Entrants may find it difficult to get access to networks, particularly where incumbents have grandfathered access rights. Optimal allocation of financially firm rights would promote entry and facilitate effective competition. Regulators could review compliance with and effectiveness of the Gas Regulation as regards congestion management and capacity allocation, and could develop more detailed guidance on UIOLI, especially on 'transit' pipes. If necessary, proposals for improving the guidelines under the Gas Regulation could also be brought forward. In relation to gas storage, ERGEG will produce a second report monitoring compliance with the voluntary guidelines for storage operators introduced in 2005. Following this report, ERGEG will bring forward new proposals if necessary.

In addition to investigating the compatibility with competition law of so-called 'legacy contracts', e.g. for gas transit, it is also important that the impact on these contracts of the current legislative package and the new Gas Regulation is properly and fully understood. Regulators agree with DG Competition that the 'grandfathered' access rights under contracts signed before the second gas Directive and the Gas Regulation came into force are, in many cases, preventing the development of effective competition. Removal or renegotiation of these contracts, where they are preventing the development of effective competition, should therefore be a priority for regulators, competition authorities, and legislators (where there are gaps in the regulatory framework). Removal or renegotiation should be achieved by a combination of competition law action (where the contracts are not compatible with competition law) and regulatory or legislative action (where they are compatible with competition law). In tackling legacy contracts, in addition to removing barriers to effective competition, it is essential that the principle of regulatory certainty is also respected, because continued regulatory certainty is necessary for continued investment in a sector which has high sunk costs. Regulatory or legislative action should not strand investment which was made under a legitimate expectation that the regulatory and legislative framework would remain unchanged. The judgment of the Court of Justice in case C03–17 is relevant here.

Contracts involving companies with significant market power for long durations may foreclose the market to new entrants. In respect of downstream markets, customers can be effectively exclusively tied to one source, effectively removing them from the market. For upstream markets, new entrants may be unable to obtain wholesale gas and hence cannot enter the market. Such contracts could infringe article 81 of the EC competition law, and various competition law remedies would be available (either to the Commission or to national competition authorities). Furthermore, guidelines could be used to clarify the responsibilities of LT capacity holders (under competition law) – i.e., guidance on what kind of behaviour is / is not compatible with the law. TSOs with dominant supply businesses could be attacked for exclusionary behaviour where there is contractual congestion or other behaviour that discriminates against entrants.

Electricity

Vertical integration

Vertical foreclosure as regards generation and retail supply can take the form of vertical integration or long-term contracts. The lack of well-functioning balancing markets is prone to give incentives to integrate vertically by improving the short-term hedging risk. CEER agrees that liquidity of markets must be improved in order to reduce the problem of volatility of prices and the consequent lack of trust by market participants in the functioning of the market.

However the objective of ensuring liquidity does not imply having mandatory pools. It can be achieved under any wholesale market organisation provided that generators sell a sufficient large share of their production on the market, unlike what is currently observed in most countries because of vertical integration and insufficient attractiveness of organised markets. Moreover, to ensure confidence in the functioning of the market, a trusted and reliable price is needed. Unlike PX's prices, OTC prices lack these characteristics. Therefore sufficiently liquid organised markets are a key to achieving this goal. The attractiveness of organised markets raises the issues of their design and of their regulation especially as far as their transaction costs are concerned.

The data collected and analyzed by the Commission do give a sense of the difficulty of the problem. The data clarify that the development among Member States differs significantly. This implies that some countries have developed more competitively than others. This can be due to structural measures in the direction of vertical integration as shown by several examples in the Preliminary Report but also due to late implementation of the Electricity Market Directive and differences in market design. Consequently, conclusions must be drawn considering also the possible effects of cross-border trade, differences in national market designs, market rules and regulatory gaps.

Long term cross-border contracts and their foreclosing effect on competitors are a major concern for regulators and national competition authorities. The ruling of the European Court of Justice of last summer (C-17/03) had a major effect in this respect as a number of national regulators issued decisions requiring TSOs not to grant priority rights for long term contracts on cross-border auctions any more. For certain borders this releases a significant part of the available capacity and consequently increases cross-border trade and competition. This will also have a positive effect on the liquidity of regional markets.

Unbundling

CEER sees that the present Electricity Market Directive provides a reasonable basis for the regulation of network access rules and pricing. However, it must be ensured that the national implementation of the Directive is sufficient in this respect and equips the regulatory authority with the necessary powers to regulate and supervise network access. It has to be noted that this is not sufficiently achieved for cross-border issues yet.

The legal and management unbundling requirements of distribution system operators as defined by the Electricity Market Directive are mandatory for large distribution system operators only. However, in some Member States the legal unbundling requirement has been extended to all distribution network operators or to smaller ones than required by the Directive.

CEER regards the neutrality of network operators as one of the key issues for the well-functioning wholesale and retail electricity markets. In case the experience shows that the present rules on unbundling and neutrality of network operation are not sufficient, CEER envisages further measures to address the problem. These could include ownership unbundling of the transmission system operators and an extended legal unbundling of distribution network operators. Additionally, relying on the principle of subsidiarity, sufficient rules and regulatory powers have to be enacted to guarantee neutrality of network operators.

2.3. Lack of market integration

The current lack of market integration is a key concern of the regulators, because it confers market power on incumbents within limited national markets. It is evidenced by price differentials and price changes over time which cannot easily be understood in terms of changes to underlying supply and demand. A single market requires removal of barriers that hinder cross-border trade. Effective TPA to European networks therefore clearly calls for an obligation on TSOs to co-operate with each other. Monitoring of market participants' behaviour, however, indicates significant differences between individual systems.

Furthermore, interconnectors are a key for market integration and that further transmission investments (both international and national) are needed to increase the level of available capacity offered to the market. The framework for investment in grid improvements such as interconnectors and interconnection related lines is indeed a key issue. This includes issues such as incentives on TSOs to invest, the lack of a full regulatory regime applying to cross-border investment and capacity provision, and the planning regime for new infrastructure.

The Report leads to the preliminary conclusion that the lack of market integration mainly results from insufficient interconnecting infrastructure, an inefficient utilisation of existing infrastructure and a lack of harmonization. CEER broadly shares this conclusion and comments on each of these points more in depth.

In both gas and electricity, ERGEG has launched a 'roadmap' approach, under which regulators see the creation of 'regional markets' as a practical stepping stone on the road towards an effectively-functioning single European market. The Regional Initiatives that have been launched by regulators will be an important contribution to further market integration, but will require full participation by and support from industry and other stakeholders, including, as appropriate, the Commission, Member States, and competition authorities. The Regional Initiatives are described in detail below.

In gas markets, regulators' priority is to understand how gas hubs develop, and to identify the barriers currently preventing further development of hubs in most of Europe. In this way, options for overcoming these barriers can be developed. In principle, action may be required by regulators, industry, or Member States — in addition to any competition law actions resulting from the sector inquiries.

In addition to the Regional Initiatives, regulators are also developing common principles in a number of areas, where different approaches taken in different markets could result in barriers to cross-border trade. For example, understanding how to treat gas of different quality specifications so that treatment costs can be efficiently recovered without hindering cross border trade will be a major piece of work for 2006. CEER will carefully evaluate the costs and benefits of any changes it might propose as a result of this work.

Where there are cross-border capacity constraints, it would be desirable to give incentives to TSOs to maximise the usage of existing capacity, and to invest in additional capacity to respond to market demands. Such incentive schemes would be subject to the implementation of effective unbundling rules.

The lack of a full regulatory regime across borders – a ‘regulatory gap’ – is likely to hinder cross-border trade and hence further market integration. Further market integration will require strengthening of the integrated European gas and electricity grids, including investment in cross-border capacity. However, strengthening the grids may not be possible while regulatory gaps remain. Understanding in more detail the practical implications of such gaps is part of the work of the Regional Initiatives. However, regulators do believe that the current legislative framework is insufficient, e.g. in order to give the necessary regulatory oversight of cross-border investment, certainty and stability for investors, and non-discriminatory third-party access for users. For example, in order to improve the trade of electricity between Finland and Norway, transmission investment needs to take place in Sweden. The questions arise of who pays and who benefits, and which regulators or authorities oversee or approve this. In some cases, regulators do not have the competencies for oversight of investment plans. Similar issues have arisen in respect of the Nabucco pipeline.

The issue of investments outside the EU is also related to the lack of a full regulatory regime across borders. Nabucco is an example of an investment backed by long-term contracts where the imposed conditions imposed by regulators did not occur within a widely understood – and cross border - regulatory framework aimed at encouraging investment whilst allowing downstream competition.

Bridging regulatory gaps will require new legislation at Member State level, in order to give national regulators sufficient powers to allow them to co-operate fully and effectively at European level (as well as, in many cases, sufficient powers to operate effectively within national markets).

Moreover, it must be taken into consideration that in most of the Member States, building a new transmission or gas pipe line currently requires a difficult and lengthy procedure. In many cases increasing the level of cross-border capacity requires next to the interconnector investment also substantial internal grid reinforcements behind or after the link. Interconnectors alone are not sufficient. Internal grids can also be mostly influential. Then a more global approach is necessary. In a synchronous meshed grid, nothing technically distinguishes a cross-border link from a geographically internal link included. Then more coordinated procedures between TSOs and competent national authorities must be enforced as required by the Directive 2005/89/EC. They should include shared load flow computations that may assess the usefulness of any additional link crossing borders or being purely internal.

Gas

In addition, there are further policies which might have beneficial impacts on the market in the longer term, but where CEER has not yet analysed the trade-off between costs and benefits and the likely effectiveness of the policies. Depending on various circumstances these policies might be instrumental in improving the situation. In the long term, pancaking of network access tariffs for gas flows crossing one or more national borders could be avoided by a Europe-wide entry–exit system. This would require a corresponding system of inter-TSO payments in order to allow national TSOs to recover the costs of their networks. Such a system would have costs as well as benefits (not least because of the complexity involved), which have not yet been considered by CEER. For the purpose of capacity planning and security of supply, TSOs could be required to co-operate in long-term planning on a European level to determine necessary investments in infrastructure. Also in the long term, a related development could be the promotion of a single European TSO (which could be a single *operator*, separate from existing system *owners*), or an interface so that network users would have a single contract with the network operator rather than multiple contracts, with each national TSO. This has, however, also not yet been considered by CEER.

Electricity

Assessing market integration and congestion

Bearing in mind the significance of market integration and the need to assess the extent to which markets might be said to be integrated, CEER suggests that the ratio between demand for interconnecting capacity and available offered capacity may not be the best tool to measure congestion. Indeed, regulators observe that even in the situations where the prospects of congestion between two interconnected countries are low (i.e. the forward price differential between two countries is near zero), demand for interconnecting capacity always exceeds offer, that is market actors always value the offered capacity at a positive price, which is called the “option value”. The existence of an option value for the offered capacity, even when the prospects of congestion are low, results from the design of current allocation mechanisms (i.e. the fact that capacity and energy markets are traded separately and the fact that allocated capacity rights only represent an option (not an obligation) to nominate, later, the corresponding energy). It can be observed that the longer the period during which the option could be exercised (annually for example), the higher it will be valued during the auction. Therefore, it turns out that the ratio between actual nominated commercial flows and available offered capacity would constitute a better criterion to assess actual congestion.

Utilisation of existing interconnecting infrastructure

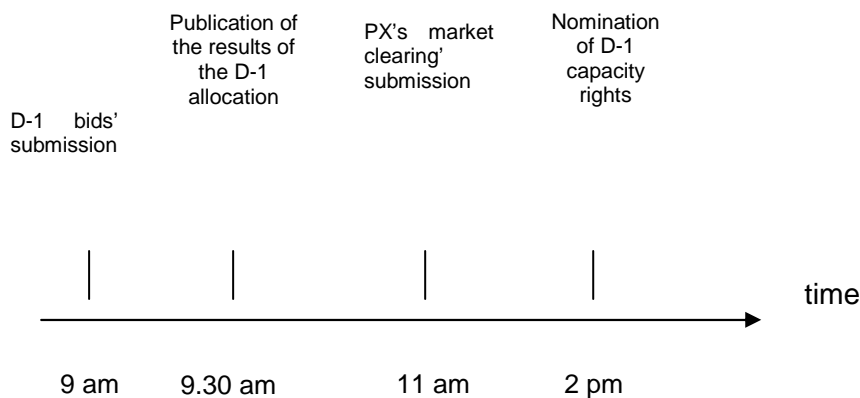
Optimal use of existing interconnecting infrastructure results from both calculation of capacities that can be offered to market players in a secured manner and allocation of these capacities.

CEER considers that further improvements in the coordination and exchange of information between TSOs should be more strongly encouraged in order to increase the existing or future level of capacity offered to market players. In this respect, the actions, which should be quickly implemented by TSOs, are mainly to exchange a common set of information/forecasts regarding in particular the best estimation of detailed generation and demand pattern, network topology and relevant operation features, making use of winter and summer NTC-values, and already committed transactions. Furthermore, a definition of a common calculation method (network model) based on this common set of information/forecast should be optimally updated. This is foreseen in the Congestion Management guidelines and calculation methodologies have to be approved by regulators according to the Regulation 1228/2003 (Article 5.2).

CEER considers the implementation of such actions very important to better assess the level of available capacities and to evolve towards a flow-based congestion management method near the real-time.

The practical implementation of such actions raises the issue of how to encourage TSOs to better coordinate their contributions. Notwithstanding the requirements of articles 9 and 10 of Electricity Directive, it must be investigated whether the lack of harmonization in the statute of each national TSO (unbundling, consistency of duties, etc.) could constitute one of the main obstacles to such coordination. The NordREG³ has recently reviewed the core duties of transmission system operators of the Nordic TSOs. The report concluded that the core activities are quite similar but the organization of them under legislative framework and how they are conducted is differently managed. The NordREG recommended further analysis evaluating whether a more harmonized Nordic regulatory set-up would contribute to an enhanced development of the Nordic electricity market.

Concerning capacity allocation method, the statement that “explicit auctions do not lead to an optimal use of scarce interconnector capacity” must be discussed more in depth. It is clear that the price signal given by a bid for transmission capacity is in principle influenced by the time lag between capacity allocation and the fixing of wholesale market price, for example on the power exchange. However, it is often the case that the deadline for nominating day-ahead auction products generally occurs after the wholesale price is fixed on the Power Exchange, as illustrated in the diagram below. Nevertheless, harmonization of PX’s clearing times will improve efficiency of explicit auctions.



Therefore, potential inefficiencies observed on some interconnectors should be more carefully examined in order to assess whether they come directly or indirectly from the design of the explicit auction rules and/or abuses of market power.

³ The NordREG is the co-operation organisation of Nordic regulators comprising the Danish, Finnish, Icelandic, Norwegian and Swedish energy regulators. See the NordREG report 4/2006, “A common definition of the system operators’ core activities”.

The situation where import and export capacity is auctioned separately (and consequently that no netting is realized on such border) is not just linked to the principle of explicit auction allocation mechanism but only results from an insufficient coordination between the involved TSOs. Consequently, the statement that implicit auctioning « *may increase the available capacity significantly* » may require deeper investigation.

Moreover, while recognizing that explicit auction mechanisms could involve some structural inefficiencies, it is worth noting that implicit auctioning also raises a lot of fundamental issues that should be addressed in depth, particularly in the context of a highly meshed network. The different statutes and roles of PXs from one Member State to another also constitute an important drawback for the implementation of implicit auctioning.

More likely the Regulation (EC) No 1228/2003⁴ has been implemented too recently to allow a sound conclusion in favour of any particular market-based allocation mechanism and that longer experience with a full in-depth analysis is needed before drawing such conclusion.

Due to the specific functioning of electricity markets and the current state of the industrial organization of the sector, different and complementary allocation methods are likely to improve completeness and efficiency of cross-border markets. Explicit auctioning mechanisms look unavoidable for longer term timeframes and are usually asked for by market participants that consider them as suitable to secure trading positions. But, in addition, the development of intra-day and balancing cross-border trade could significantly improve the efficiency of the use of existing interconnecting capacities. Moreover, mentioning the importance of intraday and balancing cross-border trade would be the occasion to assess in depth the issue of implicit auctioning and the potential role of Power Exchanges since this kind of allocation mechanism is particularly recommended for these shorter term timeframes.

Summarizing, some potential remedies are:

- Create clear incentives to build the necessary infrastructure (internal and cross-border)
- Speed up permission and licensing processes for new infrastructure
- Increased co-ordination and co-operation for calculating cross-border capacities

The need for deeper harmonization

There are clear indications that incompatible market designs (e.g. differences between balancing regimes, nomination procedures, differences in opening hours of power exchanges) between TSOs and/or spot market operators constitute a serious obstacle to market integration and to the development of significant new entries in cross-border trade.

It must be concluded that existing approaches to allocate capacities are not sufficiently coordinated and that some improvements are necessary. In this respect, harmonization or at least greater compatibility of auction rules all over Europe could be an important step for the near future.

⁴ Regulation (EC) No 1228/2003 of the European Parliament and of the Council of 26 June 2003 on conditions for access to the network for cross-border exchanges of electricity (OJ 2003 L 176/1).

To continue the work already done through the first round of mini-fora and Guidelines on Congestion Management, the CEER will be glad to provide its technical competencies to further analysis of improved and more harmonized solutions to increase the availability of cross-border interconnection capacities and to give incentives to market participants to better use them.

2.4. Transparency

The lack of transparency—of information needed by market participants in order for them to make efficient use of the networks—has been a concern of the regulators for several years. In addition, a proper process for TSOs to handle confidential information is also needed to prevent discrimination and to promote confidence in the market. It is essential that TSOs, and other parties, publish all information that is needed to promote efficient operation of the energy system as a whole (for example, information on future capacity availability as well as historic physical flows, gas demand, storage capacity/stocks, injections, and balancing actions taken by TSOs). Currently it is sometimes impossible for market participants, regulators and customers to understand the factors that influence changes in price.

Information is needed in order for market participants to make the right investment and operational decisions, and in order for the market to work effectively. Publication of this information needs to be strictly non-discriminatory, in the sense that all market participants must have equal access to the information at the same time. In addition, all information held by TSOs that is not published must be kept strictly confidential and ring-fenced from any market-participant with affiliation to the TSO.

Transparency and non-discriminatory access to information is vital for encouraging and attracting new entrants, promoting liquidity, and building customers' trust in emerging markets – by allowing all of these groups to understand what determines prices on the wholesale markets each day and, if necessary, to bring to regulators' attention concerns when prices do not appear to reflect supply and demand. Transparency on secondary markets for capacity is also crucial if such markets are to be effective mechanisms for ensuring efficient use of capacity.

If, from a theoretical point of view, in some situations, access to certain kind of information in a non-aggregated format might introduce a danger of collusive behaviour or market distortion, the current low level of transparency in a large number of Member States gives room for significant improvement of the transparency level. In any case, the provision of greater market transparency to both market participants and regulators will, all other things being equal, tend to increase the likelihood of the discovery of any market abuses and so provide an incentive not to engage in any such abuses.

In addition to low level of transparency in many regions, the Preliminary Report shows strong discrepancies in the degree of transparency between Member States. CEER believes that a common, coordinated approach of relieving information national differences through disclosing necessary data on all components of the gas and electricity value chain in a consistent and compatible manner would significantly contribute to the better efficiency of cross-border flows and, amongst other things, to an improvement of the operational security of the European electric power systems.

Transparency and information handling will therefore be a key theme in the Regional Initiatives.

Gas

Storage Guidelines

Transparency is therefore an important part of the guidelines that ERGEG implemented during 2005 for good practice on the part of storage system operators — this is an example of where, in the absence of sufficient detail in the legislative framework on access to and operation of gas storage capacity, ERGEG developed voluntary guidelines for the industry. Our initial monitoring report published at the end of 2005 showed disappointing results, so we are now undertaking further monitoring work and will be considering what further steps may be required (possibly a strengthening of the transparency requirements in the Gas Regulation).

Gas Regulation

The new Gas Regulation is to be welcomed as a first step, and in the second half of 2006 regulators will start work to assess its effectiveness. This will include examining whether the Regulation itself goes far enough, as well as how it is being implemented and enforced. Regulators have an important role, under the Gas Regulation, in determining whether issues of commercial confidentiality should outweigh the need for transparency in order to promote competitive gas markets. The approach that might be taken to this trade-off is discussed in the transparency section below; Regulators note that, under the Gas Regulation, the question of commercial confidentiality can only arise where one or two network users are involved (and Regulators expect to count both primary and secondary capacity holders). It is important that all the information needed by the market is made available, and the method of publication (i.e., how soon after real time, how often, at what level of aggregation) is also crucial. CEER believes that there is a strong public interest in promoting competition through increasing transparency.

Electricity

The results of the Preliminary Report clearly show the wide dissatisfaction of market participants with the current level of transparency almost everywhere. The Report also shows a likely correlation between the liquidity and apparent efficiency of wholesale markets and the transparency requirements that are enforced. The outcome of the Report is that the issues on which information is considered to be most important by market participants are (in decreasing order):

1. Technical availability of interconnectors
2. Technical availability of TSO network
3. Generation (capacity)
4. Balancing and reserve power
5. Load
6. Generation (production)

This listed information shows that electricity markets require specific information (e.g. balancing). Therefore EC financial services rules, in particular the Market Abuse Directive (MAD) and its implementing rules might provide a general framework for some aspects but look unlikely to contribute efficiently to the enforcement of efficient transparency obligations on electricity markets. In the countries where transparency requirements are already enforced these requirements take into account the specificities of the electricity trade and are contained in specific regulation, either the national law or self-imposed transparency requirements in individual markets that can make a condition of trading on a market to subscribe to certain transparency rules. Grid Codes and Market Rules or Guidelines are examples of such specific and precise documents than are appropriate for such use.

CEER considers such specific rules necessary to obtain major improvements regarding the publication of information considered as important by market participants. ERGEG has recently launched a public consultation on the Guidelines for Good Practice (GGP) on Information Management and Transparency in Electricity Markets, a document prepared by the CEER. It intends to establish a consistent approach to the provision of market related information to wholesale market participants across Member States. Since voluntary approaches have not achieved sufficient progress in the last years, transparency could be enforced at the European level by European rules and become part of relevant national rules concerning wholesale markets and conditions for proper grid use.

Furthermore, ERGEG has been preparing Guidelines on Good Practice for Electricity Balancing Markets Integration and a public consultation on the document is scheduled to take place in summer 2006.

2.5. Price formation

If competition is to be effective it is necessary that there should be liquid wholesale markets where prices are set through the interplay between sources of supply and demand. Vertical integration between upstream and downstream gas suppliers, and between electricity generation and supply, reduces liquidity on wholesale markets. However, vertical integration may also reduce transaction costs or bring other efficiencies that could, in a competitive market, be passed on to consumers.

Promoting liquidity requires increased confidence in the wholesale market, and therefore relates to the control of market power where it exists. Competition law guidelines on the special responsibilities of dominant firms not to abuse their position of dominance could therefore be helpful in encouraging liquidity.

At the retail level, in markets where final price controls are still in place, we agree that price controls, existing alongside market prices, have to be set very carefully in order that consumers are fully protected from the market power of incumbents before competition is fully developed, but without stifling the process of developing competition.

It is clear that end-user price regulatory regimes affect the market in a negative manner as they decrease the size of the competitive market thus reducing the traded volumes and liquidity. Such regimes should therefore be abolished. However, the protection of vulnerable customers should be carefully taken care of. To address the problem of too high or uncompetitive prices other measures than price regulation should be applied

During times of volatile wholesale prices, it is even more difficult to ensure that final price controls are set at the right level, particularly for example not below cost. Although this may be technically difficult, there is no objection in principle to final price controls set by independent regulators. However, where tariffs are set by Governments (as in several Member States), the political pressures on prices may introduce significant distortions. The goal should be to have such a market design and a competitive platform that such end-user energy price regulatory regimes can be dropped and a well-functioning end-user market evolves that will produce a competitive outcome like any other commodity market.

The ERGEG's Customer Focus Group is with the financial assistance from the Commission reviewing the end-user price regulation regimes and their effects during this year. The task is included in the ERGEG Work Programme for the year 2006.

Gas

Hubs

Regulators' regional initiatives (see below) will support the development of liquid wholesale markets based around gas hubs. Regulators will also be taking steps to ensure that gas quality does not present a barrier to efficient cross-border trade.

In addition to promoting hubs through the regional initiatives, other measures described above could increase liquidity on wholesale markets, and hence improve the effectiveness of the price formation mechanism.

Oil-gas price link

Many gas supply contracts are priced by reference to the price of oil, and thus do not reflect the fundamentals of supply and demand for gas. In the view of regulators this is best viewed as a symptom of the lack of effective competition in European gas markets, rather than as a problem to be addressed in isolation. With effective gas-on-gas competition on liquid wholesale markets (based on hubs), oil indexation would disappear as gas price indices became available.

Electricity

CEER agrees with the DG COMP that the effect of external factors in the formation of the wholesale electricity price needs further investigation. This relates to the prices of fuels and particularly to CO₂ emission rights. Their correlation with electricity prices can give clear indication to the extent of competition in the relevant markets.

3. Other issues to be addressed

3.1. Legislation and the powers of regulators

The existing package of legislation has not yet been fully implemented. The Commission is right to emphasise the high price paid for many Member States' poor record in transposing and implementing legislative measures to which they are politically and legally committed. The Commission should be fearless in stressing such failure, not least given the commitment of Heads of Government to deliver a genuine internal energy market.

Welcome progress has been seen both from the legislation itself and the guidelines developed by regulators within this framework which have delivered in a practical way a competitive, liberalised energy market. ERGEG is established and has already delivered proposals and advice to the Commission (for example on gas storage, on electricity congestion management and network tariff harmonization) and they have been well-received by stakeholders. The Comitology process is being applied for the first time (to the electricity Congestion Management Guidelines). In addition to preparing ERGEG advice and proposals, CEER itself has undertaken extensive analysis and monitoring activities. It is working hard to bring greater coherence in the way regulation is produced and applied at national level and to develop voluntary guidelines - which can avoid lengthily negotiated and inflexible legislation - in an effective way. The Madrid and Florence fora are also evolving into sound consultation mechanisms that, along with the CEER/ERGEG processes of consultation, allow all stakeholders to comment constructively on the proposals under consideration. The commitment to Better Regulation is strongly and demonstrably supported in the initiatives undertaken by national regulators in CEER and ERGEG.

Regulators need adequate powers within national and regional markets, and they need to be independent to be above any suspicion that they are beholden either to industry (which is illegal) or to government which could undermine the economic effectiveness and fairness in regulating competitive markets. To be fully effective in helping to deliver the vision of a liberalised, competitive energy market, national regulators must be able to:

- a. exercise appropriate regulatory oversight (and control, where appropriate) over the detail of key technical and legal rules which may influence the operation of the (national and, where appropriate, regional) market;
- b. monitor activity within the retail and wholesale markets (including having information-gathering powers and ability to investigate price formation mechanisms), notably in order to detect non-compliance with regulatory rules, and to assess the success of liberalising measures;
- c. be empowered to impose sufficient sanctions to deter and penalise non-compliance and have sufficient resources (staff and budgetary support) to carry out their responsibilities efficiently and effectively;
- d. within their regulatory competences, be sufficiently independent to drive forward the liberalisation agenda agreed by national Governments (and to advise on related issues, such as the design and operation of environmental policy instruments);
- e. be independent of Governments in exercising their regulatory powers, especially where the State controls parts of the industry. In some Member States key regulatory decisions are shared with or taken (or subject to overrule) by Governments. Such Government control risks

undermining economic principles and bringing regulatory uncertainty to the market, inhibiting investment and market confidence.;

- f. incentivise TSOs to invest in cross border infrastructure and to maximise capacity availability;
- g. oversee cross-border network access and trading arrangements, including hub-to-hub trading.

The Commission and Member States should look again at the powers of independent regulators, most notably in order to match the tasks assigned to them within the EU legislative framework for liberalisation. We must avoid a situation in which national legislation transposing the directives goes in too much detail into the definition of tariff methodology, or regulators' powers are limited by inflexible tools (such as rigid licensing conditions). This can lead to problems or risks may arise as it is difficult or impossible: (i) to adapt the terms and conditions to every category of investments or of system users, in order to guarantee that they are fair in each case and (ii) to converge at European level, in order to harmonise whenever appropriate.

In the absence of ownership unbundling, the effectiveness of functional and management unbundling of TSOs, as well as the control of market sensitive data, is crucial if there is to be effective competition in European energy markets (see below). In turn, the effectiveness of unbundling provisions depends on regulators having appropriate powers to set detailed rules to implement effective unbundling, as well as the powers to monitor and enforce compliance with the rules. At present it seems that few regulators have these powers.

3.2. Unbundling

Regulators identify insufficient unbundling as a major impediment to the development of competitive markets.

DSOs have an important role in the customer switching process. It is therefore essential for effective competition that DSOs do not discriminate between different suppliers, and therefore must be effectively unbundled (at least in organisational and management terms) from affiliated supply businesses.

TSOs have a central role in a competitive wholesale market because both operational and investment decisions by TSOs have a significant commercial impact on market participants (the TSOs' customers). Promoting competition in generation and supply therefore requires a TSO which acts, and is perceived to act, independently of commercial interests in the market, in a strictly non-discriminatory manner. Affiliations between the TSO and participants in the market (i.e., generators, gas producers, gas shippers, gas and electricity suppliers) is likely to raise concerns that the TSO will be biased in favour of its own affiliated gas supply/shipping/import/production and electricity generation and supply interests.

In the absence of ownership links with market participants, DSOs/TSOs have no incentive to discriminate between market participants, for example in relation to access to the networks. Market participants can be confident that confidential information will be handled properly by the TSOs. TSOs can also be directly incentivised to maximise the availability of and investment in network capacity because there is no risk of perverse incentives due to affiliates holding long-term access rights.

The goal of legislative or regulatory arrangements on unbundling must therefore be to achieve ownership unbundling or to mimic as closely as possible its effects in terms of the impact on DSO/TSO behaviour. Without ownership unbundling, regulatory arrangements must be detailed and need to be monitored and enforced by regulators with adequate powers and resources.

In the absence of ownership separation, appropriate national legislation and detailed regulatory rules are needed to ensure that TSOs behave independently. Compliance must be effectively monitored and fully enforced. There should be strict arrangements for the management of information held by TSOs to ensure that it is put into the public domain where possible or strictly ring fenced where publication is not possible or is only possible with some delay. Compliance needs to be closely monitored and enforced by regulators with adequate resources and powers.

The goal of unbundling arrangements is to ensure, so far as is possible, that the TSO behaves independently of any commercial interests among the users of the networks, such that it acts to promote competition on the wholesale market. A TSO which is effectively unbundled will, for example, actively pursue the transparency and information handling goals touched on above, since it thereby generates confidence among its customers. Equally, an effectively unbundled TSO can be incentivised to maximise the availability of network capacity, including through new investment where there is a market need.

In the absence of effective unbundling of the TSOs, it is hardly surprising that the European transmission networks are currently incomplete – in the sense that there is significant congestion (whether contractual or physical). In electricity it seems clear that there are large congestion rents that are not resulting in investment in new capacity. In gas the situation is so un-transparent that it is difficult to say whether congestion is contractual or physical. As identified in the Hampton Court summit and recognised in the Commission's Green Paper, a fully effective European transmission network is a prerequisite for proper functioning of the internal market. There must be effective mechanisms in place for facilitating investment in the network, where this is justified by a market need. Equally there must be effective mechanisms in place to ensure that neither energy consumers – nor tax payers – pay for investments that are unused.

3.3. Transparency

Information necessary to the efficient working of gas and electricity markets should be made available to market participants. Much of this information is held by TSOs or could be made available to them by other market participants. The information required includes both information about national and cross-border networks, such as historic flows and capacity reservations, available capacity, and operational information that would influence prices, such as generator maintenance schedules or hydro power availability.

The need for transparency and proper handling of information

Gas and electricity TSOs (as well as storage operators, and to a lesser extent DSOs) possess a large amount of information about the operational performance of the network, as well as information from individual users of the network that is used over operational and longer timescales. This information includes data about constraints, outages, connection timetables and other information which is market sensitive, in addition to longer-term information such as system upgrades and supply–demand balance forecasts which is relevant to market participants' investment plans.

Much of this information, in aggregate form, needs to be published (because without it network users cannot decide how to make efficient use of the network), whereas confidential disaggregated information provided to the TSO by individual users needs to be kept confidential. Aggregate information is important because it helps market participants take informed and efficient decisions, and thus contributes to the overall efficiency of the industry as a whole (and therefore benefits consumers). For example, information about patterns of interruption in the past will allow network users to form a more accurate view of the likely future value of non-firm network capacity. Information on historic flow patterns helps new entrants determine where there may be scope for additional trading activity (e.g., cross-border imports). Information on planned generator outages helps ensure that market participants are aware of when capacity may be in short supply, and can thus schedule their own outages more effectively. Information on future supply–demand balance forecasts helps market participants assess the value of possible investments in new generation or gas storage capacity. The independence of TSOs needs to be demonstrated by the transparency of information released to all market players. TSOs should make available to the market all information in their possession that does not relate to the commercially confidential aspects of an individual third-party account.

Real-time (for electricity) or close to real-time information (for gas) about the system as a whole (i.e., the transmission network and the overall supply–demand balance) must be available to network users if they are to contribute fully to overall efficiency of the industry. Any information which would be relevant to market participants' decision-making should be made available (for example, network maintenance schedules; planned production and import flows; storage stocks; aggregate demand forecasts). In many cases the TSO will be best placed to make this information available (because it will have the information anyway for system operation purposes). Information from other industry participants (e.g. storage operators and generators) is also important.⁵

Furthermore, publication of these kinds of information allows market participants and regulators to monitor more effectively the behaviour of TSOs (and incumbents), and thereby to check compliance with market rules (and competition law). It also allows market participants to observe the effect of events on market prices and to use that information to predict the likely price effect of future events. This helps market participants to make efficient decisions and encourages competition.

⁵ Guidelines for good TPA practice for gas storage system operators (GGPSSO), ERGEG 2005.

Confidentiality

The role of the TSO in handling confidential information (i.e. whether, when, and how it is published, and how commercially-sensitive information is to be kept confidential), and publishing aggregate data in a non-discriminatory fashion is very important for overall market efficiency and for building confidence in the market on the part of competing network users and customers.

Where information held by TSOs is not published (i.e. made available to all market participants at the same time and in the same way), it is essential that the information is kept strictly confidential even if the information is held by the TSO for a relatively short period of time before publication. In particular, if the TSO has commercial affiliations with one or more market participants, the information held by the TSO must be strictly ring-fenced from its affiliates. Information (for example on outages) often has value to those market participants that possess it and can be used to the advantage of some participants over others even over quite short timescales. Arrangements for monitoring and enforcing such ring-fencing provisions must be robust if effective competition is to develop, and they are an important component of effective unbundling provisions (discussed above).

If information management arrangements are sufficiently robust then the effect should be that companies behave as if they were separate entities. In Great Britain, British Gas voluntarily ownership unbundled into a network company (Transco) and a shipper and supply company (Centrica) because the information management arrangements were sufficiently strict that the company found no synergies in remaining a single entity.

Balancing confidentiality and transparency

TSOs and market participants (incumbents) often argue that greater transparency is not possible because of commercial confidentiality. Whilst it is important that commercial confidentiality is respected, it is also important that markets are transparent (without facilitating collusion). A balance therefore needs to be struck.

The new Electricity and Gas Regulations should enable important improvements to be made to the availability of information from TSOs. Improvements in transparency and information handling by TSOs (and hub operators) would bring benefits in terms of market efficiency, liquidity, reduced barriers to entry, and general confidence in the market. It would also assist regulators and competition authorities to monitor compliance with market rules and competition law. In order to make such improvements, lessons need to be learned from the approach taken in national gas markets (and other markets, including electricity) where effective arrangements are in place.

Some items of information may be of benefit to market participants in general, yet may also be commercially confidential or commercially sensitive. In such cases, TSOs (and supervising regulators) need to balance these competing interests. On the one hand, publication of a certain piece of information could promote the interests of consumers. On the other hand, publication of any matter which relates to the affairs of a particular company or group of companies might seriously and prejudicially affect their interests, either because the information is commercially sensitive and/or the information is confidential. In such a case, TSOs (and supervising regulators) should consult the relevant company or companies. The subsequent decision on whether to publish should depend on, in particular, the representations provided. The onus should be on that party to make such representations as it is best placed to understand and substantiate any potential prejudice.

All such decisions involving the balance between transparency and confidentiality should be made on a case-by-case basis, a number of criteria may be relevant to the decision: period of aggregation; scope of aggregation; and age of the data. Thus, real time data is more likely to be commercially sensitive than the same data expressed as an annual average; data relating to a specific company is more likely to be commercially sensitive than the same data aggregated for all shippers using a particular entry point (as discussed above, for the purposes of the Gas Regulation, regulators expect aggregation of data in respect of three network users (primary and secondary) to remove confidentiality concerns; and data published at the day ahead stage is more likely to be commercially sensitive than the same data published a month later. However, these are just general criteria which cannot be applied in a blanket fashion.

Governance

The way in which TSOs publish information and keep confidential information that is not published has a direct impact on market participants – the customers of the TSO – and general confidence in the market. For this reason, it is important that market participants are able to propose improvements to the TSOs' transparency and information handling policies. It is also important that national regulators are empowered to monitor and enforce the application of these policies (as well as compliance with relevant legal rules), and to decide on the merits of improvements proposed by network customers. If an appropriate governance system is in place, network users will be able to propose changes that will require TSOs to publish more information.

This can be achieved if the transparency and information handling policies are given effect to through provisions in the network code governing the commercial relationship between TSOs and network users. Changes to the network code must be overseen by the independent regulator.

The gas and electricity Regulations

Existing legislation covers some aspects of transparency and information handling. For example, the Gas Regulation (Article 6) requires TSOs to publish technical information necessary for network users to gain effective network access. For example, information on technical, contracted, and available capacities must be published. The regulation defines the points on the transmission system for which information must be published. Guidelines under the regulation give further detail, including specifying that annual average flows must be published.

However, the Gas Regulation does not specifically place a duty on TSOs to facilitate effective competition or effective use of its network (though perhaps this is arguably close to the wording ('effective network access') of Article 6. It does not give regulators (or anyone else) the power to monitor and enforce the regulation. The guidelines under the regulation arguably specify some but not all of the detailed information that should be published (for example, only annual average historic flows are required). Finally, the regulation does not specify an appropriate governance arrangement for the detailed transparency policy of TSOs. The regulation does not address information handling, nor does it specifically require TSOs to publish information in a non-discriminatory fashion.

The electricity Regulation does not currently address transparency except in respect of cross-border transfer capacities, but it is anticipated that a new set of binding Guidelines under the Regulation, to be determined by the Commission, will contain requirements regarding market transparency (particularly in respect of cross-border transfer capacities).

3.4. Regional Initiatives and the roadmap approach

The further development of regional markets, together with further liberalisation within national markets, is an important and practical step towards the eventual goal of a competitive single electricity market. ERGEG therefore in February 2006 launched an Electricity Regional Initiative (ERI) intended to move towards this goal. A similar Gas Regional Initiative (GRI) followed in April 2006. These Regional Initiatives are the outcome of ERGEG's 2005 consultation papers and 2006 conclusions papers which together set out a 'Roadmap' for the development of the single market through regional initiatives⁶. They are also part of the regulators' response to the problems highlighted in the European Commission's 2005 Benchmarking report, and the interim findings of DG Competition's energy sector inquiries.

What the Regional Initiatives will achieve

The objective of the Regional Initiatives is to establish functioning and effective regional markets as a step towards a competitive single European market. The Regional Initiatives will identify barriers to further progress towards competitive electricity markets, and develop options for overcoming these barriers. They will bring together all of the relevant parties — regulators, market participants, consumers, Member States, the European Commission, and other stakeholders — and will identify which parties are best placed to act in each case. Thus the Regional Initiatives will deliver practical improvements to European electricity markets, of real benefit to consumers. The focus will be on the practical issues that are most important to the further development of effective competition within each region.

⁶ For electricity, see ERGEG's "The Creation of Regional Electricity Markets" Consultation Paper (June 2005) and Conclusions Paper (February 2006). For gas, see ERGEG's "Road Map for a Single Competitive Gas Market in Europe" Consultation Paper (November 2005) and Conclusions Paper (March 2006). Fact Sheets and further information on the Electricity Regional Initiative (ERI) and Gas Regional Initiative (GRI) are on the ERGEG website www.ergeg.org.

For example, key issues in electricity wholesale markets are the management of congestion at borders, and associated measures to maximise the availability of cross-border capacity. In gas, the Regional Initiatives will include looking at ways of improving the way in which gas is currently traded (at and between gas hubs) and other factors – such as transparency and information provision and access to networks. Progress under the Regional Initiatives must — and will — recognise the over-riding principle that regional markets must be compatible with the eventual goal of a single European market.

The Regional Initiatives build on existing work, including the ‘minifora’ and ongoing local initiatives to bring together national markets. Progress made in each Regional Energy Market (REM) project will be reported by ERGEG to the ongoing programme of consultation meetings between regulators, Member States, industry, and the European Commission (the ‘Florence and Madrid’ fora).

Organisation of the Regional Initiatives

The national regulator at the centre of each REM will chair a regional co-ordination committee of regulators from the Member States involved. The committee will co-ordinate the work and direct working groups made up of regulators, transmission system operators and, where appropriate, other stakeholders such as market operators. Network users and other stakeholders will be invited to be closely involved in the process in an appropriate manner, including for example consultation and involvement through the continuation of the mini fora. It will be the task of the committee to establish the groups, define ways of working, and define a detailed timetable. The committee will also consider how to involve Member State Governments and the European Commission.

Individual national regulators may lack specific powers necessary for implementing conclusions of the Roadmap papers and so the involvement of Member States and the European Commission will be particularly important where overcoming barriers to progress identified through the regional initiatives.

Each committee will prepare regular progress reports to ERGEG, and ERGEG will provide updates to the European Commission and progress reports at meetings of the Florence and Madrid fora.

4. Conclusions

CEER is fully supportive of the analysis in Preliminary Report. We recognise as serious challenges the problems identified in the Preliminary Report, and we encourage DG Competition to turn now to identifying remedies. These remarks indicate where the work of the energy regulators may help to address some of the problems that have been identified. Nevertheless, it is clear that full resolution of all of these problems – which is essential – is a very significant task. Existing possible remedies might not be sufficient to solve all the problems. We will continue to support the inquiries, and we await with interest the conclusions that are expected to emerge over the coming year.