

Office of Economic Competition

Promoting Competition In the Natural Gas Industry February 2000

I. Industry Overview: Regulatory Framework and Market Structure

Gas consumption of Hungary exceeded 12 billion m³ in 1998. This represents 38.6 percent of the primer supply which is the second highest proportion in Europe. In the structure of communal and households' energy consumption gas represents more than 40 percent, moreover, around 70 percent of households and institutions use this source of energy.

National Context and Key Regulation

(1.1) The objectives of the Hungarian Government are incorporated in the Governmental Decision of 2199/1999. (VII. 6.): "Basis of Hungarian energy policy, a business model for energy sector". This document has been made public in the Official Gazette of Hungary.

Major objectives relating to the gas industry are as follows:

- through the progressive establishment of competition on the market of gas industry the Hungarian energy transmission has to be placed on entrepreneurial basis,
- the Hungarian gas industry has to be made an integral part of the single European energy trade with special emphasis to provisions of EC Directive of 98/30/EC,
- further (physical) diversification of gas import has to be stimulated by economic policy incentives,
- system of a transparent supply fee-structure has to be elaborated in order to run supply and distribution,
- for non-authorized consumers service obligation will be maintained further on, in order to protect small consumers and to ensure certainty, gradual character, quality and regulated prices of supply.

The reform process going on in the gas industry is closely connected to other industries, mainly to electric industry. There is about one year time-lag between the schedules of reregulation of electric industry on the one hand and that of gas industry on the other hand. In the electric industry new regulation will enter into force in 2001. The planned date for introduction of the new regulation in the gas industry is 1 January 2002. According to information of January 2000 the government intends to

accelerate the work aiming at reregulation of gas industry, in order to promote competition to be developed in the electric industry.

There are 7 Acts, 6 Government Decrees, 1 Parliamentary Resolution, 23 Government Resolutions and 9 Ministerial Decrees containing detailed rules for gas industry.

The Acts are as follows:

- Act on Price Setting (Act No LXXXVII of 1990),
- Act on Concessions (Act No XVI of 1991),
- Act on Mining (Act No XLVIII of 1993),
- Act on Gas Supply (Act No XLI of 1994),
- Act on General Rules for Environment Protection (Act No LIII of 1995),
- Act on Prohibition of Unfair and Restrictive Market Practices (Act LVII of 1996).

Regulatory Institutions

(1.2) Institutions shaping economic policy in the field of energy sectors are as follows:

Parliament makes energy policy public through its resolutions and requires report about their fulfilment every two years.

Government, Ministry of Economic Affairs as part of the economic policy form the energy policy of the country and submit it to the Parliament for approval.

Regulatory institutions:

Ministry of Economic Affairs shapes the main directions of the regulation drawing into this work other ministries, the competition authority and undertakings as well

Hungarian Energy Office concrete regulatory authority. According to relevant directives this institution works out the detailed rules. All institutions taking part in the formulation of the directives (managed by the Ministry of Economic Affairs) are involved to this work also. The HEO issues permission which are necessary for the undertakings to operate.

The Hungarian Energy Office is the regulatory authority of the energy sector. The Office is managed by a General Director who is appointed by the Minister of Economic Affairs with the assent of the Government. The Office is dependent from the Government but it enjoys full independence from the industry. (Nevertheless, the

principles of the new regulatory system envisage the analysis, how greater independence of the regulatory authority could be created.)

Key Features of the Demand for Gas

(1.3) In Hungary the primary uses of gas are as follows:

- communal and households' consumption represents around 40-45 percent (for heating, cooking, hot water supply)
- in power generation (around 20-22 percent) and
- for other purposes: about 30-40 percent (in chemistry, construction material industry, metallurgy and agriculture).

In certain areas - mainly in power generation, in some particular industrial sectors (e.g. in construction material industry) and in communal heating gas can be substituted (e.g. by oil). Price is regulated with regard to these substitution possibilities.

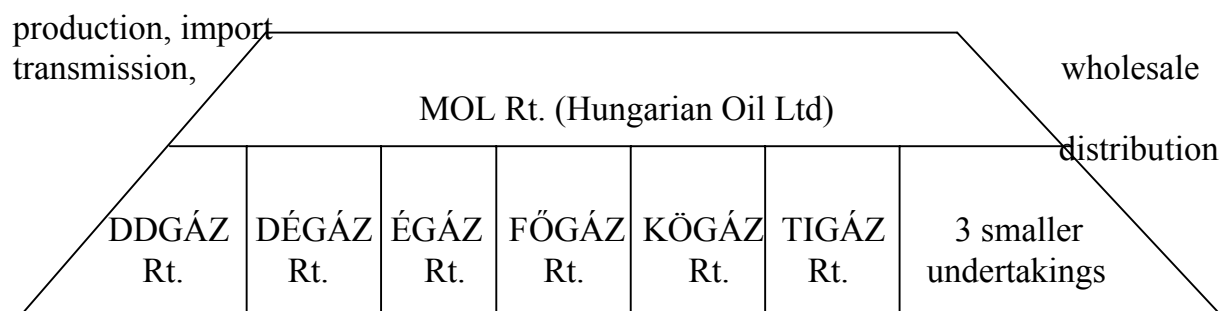
Inter-fuel competition has limited impact on final gas prices.

The power stations and also the district heating companies are ready to purchase interruptible gas supply, even completely. For the last few years this has rarely happened.

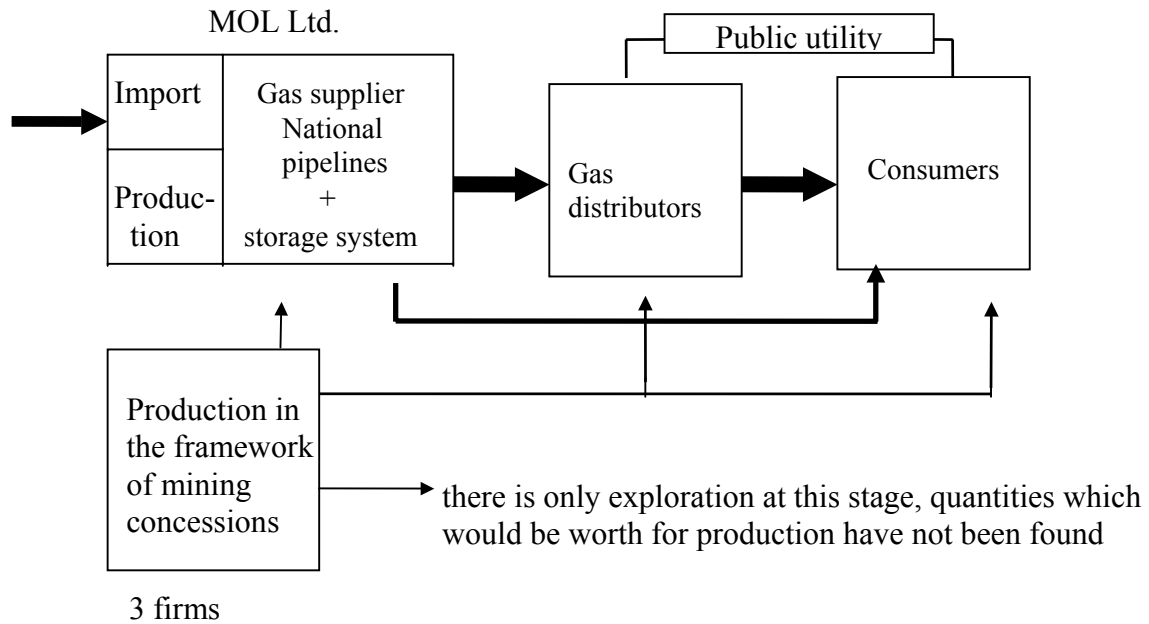
Key Features of the Supply of Gas: Market Structure

(1.4) Today in Hungary gas industry is operated in a two-stage system: the gas supplier is responsible for nation-wide gas supply, while the gas distributors are responsible for distribution of gas for consumers.

The system stands as follows:



The model of the operation of the Hungarian gas industry is as follows:



There is only one firm active on the market of gas production - MOL -, which is a vertically integrated public limited company. Beside MOL, there are 3 multinational undertakings which have acquired concessions for exploration, however these have not produced gas yet in the country. MOL is the only undertaking which imports gas to Hungary. Production covers 1/3, import covers 2/3 of the Hungarian consumption. Two pipelines are available, one of them transmits gas from East the other from Austria. Since there is only one gas producer in the country, competition does not exist in this segment of the industry.

MOL runs the gas storage as well as the high-pressure pipelines. MOL has majority ownership in some smaller distributors and minority ownership in some larger distributors.

MOL distributes about of 23 percent of the annual consumption to consumers directly.

- In Hungary competition does not exist between the two existing pipelines.
- There are 6 larger and 3 smaller undertakings operating in gas distribution. These undertakings have local monopoly positions. Among them the possibility of competition is limited to attainable markets only. These firms have not been integrated to gas transmission
- Retail gas market has not developed in Hungary. Nevertheless, there are some signs of initiations as far as organisation of separate undertakings for works aiming at connecting households to the network is concerned.

Foreign ownership is characteristic to a great extent of leading firms of the Hungarian gas sector. Undertakings are operating in the form of public limited companies. The organisation, governance, and management operate like in private undertakings as well as the incentive on management and managerial discretion are closer to that of the private sector. Legal status of employees are also closer to that of a private corporation.

Firms of the gas sector have not pursued electricity, heat, water, telecommunications or cable television services. However, some of these firms have begun to analyse these markets in order to give chance to penetrate to these markets after a future liberalisation process. It is a fact, nevertheless, that MOL has taken certain steps aiming at restructuring its organisation, in order to make entry possible to the electric power generation within a relatively short period of time.

Key Features of the Regulatory Regime

(1.5) Parallel, competing pipelines do not exist in Hungary. According to the regulation being in force at present, if an exploration becomes resultful and the exploring undertaking becomes producer, it may establish own pipeline depending on its own business strategy. Access to the pipelines has been made possible by the regulation being in force at present. Access has to be negotiated by the interested parties.

- In theory, competing sources of gas production are permitted by the Hungarian regulations. However, in practice this competition does not exist, since MOL has service obligation. That is why importers have to offer the gas they are intending to import to MOL and it buys the gas in order to meet domestic demand. Until the present rules remain in force, access to pipelines of gas producers domiciled abroad in order to transmit gas to Hungarian consumers is not possible, since overall service obligation entailed on MOL does not allow it.
- There is only one pipeline in operation in Hungary, nowadays. Today, a foreign undertaking is not allowed to construct a pipeline for direct supply of a large gas consumer. (This would be allowed for domestic producers, if they managed to explore and produce gas.) In Hungary, acquisition of ownership by the transmission firm in a gas distributor is possible. Acquisition of more than 25 percent of the stakes requires the preliminary approval of the regulator - Hungarian Energy Office, while acquisition of more than 50 percent of the stakes require the clearance of the Office of Economic Competition.
- Competition does not exist in gas storage. Regulations make access to storage and pipelines by third parties domiciled in the country possible - through negotiations.
- In Hungary gas "retailing" has not existed so far.

Entry Regulation

(1.6) New domestic gas producers can enter the market with permission. The primary condition of the permission is based on the domestic resources of the natural gas. A foreign firm can enter the Hungarian market also with a permission, however, the primary licensing condition is to have a storage with certain capacity.

During the last few years new service providers entered that part of the Hungarian market where gas supply was not existed yet and they had to apply for prior authorisation of different authorities.

Access Regulation

(1.7) As mentioned above there is no access requirement in Hungary. Primary requirement is that all customers' requests must be satisfied by the licensed undertakings. If some extra capacity (in the storage or pipelines network) above the demand remains it could be exported following a negotiation process. Publication of access conditions is not binding in these cases.

Price Regulation

(1.8) The price of import gas is based on contracts and follows the price of substituting products. Price setting of domestic gas production is based on costs including VAT.

Gas prices are regulated in Hungary and those are maximum prices. Different prices are charged for different consumers, however, prices within the certain categories are the same. within the country. Prices are set by the Hungarian Energy Office and published in a ministry regulation by the Minister of Economic Affairs. Prices are defined under consideration of the principle of the lowest costs based on the previously defined and announced price formula. The price formula involves also an efficiency factor which is defined by the regulator from time to time.

The price regulation considers the "interruptible" supply.

The quality of service is maintained by a control mechanism, built in the regulatory regime. Further, the consumer protection department of the regulator has competence to give legal remedy in cases of unsatisfactory quality.

Non-commercial Service Obligations

(1.9) In Hungary there are no non-commercial service obligations.

If someone cannot pay the bill for service the supply can be interrupted under the existing regulation.

Service providers are not obliged to distribute gas on unprofitable areas. On these areas customers may establish pipeline network on their own and conclude contracts with gas supply firms for the purpose of supply.

Separation and Unbundling

(1.10) To set prices it was necessary to define the gas industrial activities in each segment (production, transport, supply) and costs must be separated according to this and have to be notified to the regulator. The separation on accounting and the possible ownership is the subject of the current regulatory preparation work.

Trade and Investment Issues

(1.11) There is an import monopoly on the Hungarian gas market justified by the service obligation.

As far as the ownership or investment are concerned, the Hungarian regulatory regime is neutral for both Hungarian and foreign firms.

Miscellaneous Issues

(1.12) The questions of stranded costs and the possibility of stranded contracts are just on the agenda of the preparatory work for regulation. At this moment there is no information available yet on this topic.

(1.13) Costs arisen by the stricter environmental rules gradually become a part of the prices.

Gas receives the same tax treatment as other fuels since the VAT is universally 12 per cent.

(1.14) Two third of the Hungarian demand of gas is originated from import. Similarly to other European countries, in Hungary, there are long term contractual commitments to satisfy the demand. There are several similar contracts with different time periods of termination. These will be reviewed during the establishment of the new regulatory regime. There is no tendency towards shorter-term contracts. There is no area in Hungary where contracts are made for trading of gas on the spot or futures market. According to our knowledge no undertaking from Hungary took part in similar kind of foreign system so far.

II. Key Competition Issues

Application and Enforcement of Competition Law

(2.1) The national competition law fully apply to those parts of this sector which are not regulated specially. For instance the market entry or prices are regulated where according to specific Acts, the Hungarian Energy Office and other authorities, like Mining Bureau of Hungary and National Inspectorate for Environment and Nature Conservation etc., have competence to take measures.

As far as other competition issues, like merger control or abuse of dominant position are concerned, on the not-regulated part of this sector the competition authority has competence to enforce the competition law.

During competition proceedings the competition authority requests the opinion of the regulator and takes it into consideration in its decisions.

The competition authority and the regulator are working together on the development of the new regulatory regime.

Market Definition Issues

(2.2) Defining the relevant markets in competition cases is relatively easy. Market entry is allowed only with the permission of the regulator. The permitted activities, the geographical areas the customers and to whom service must be provided are defined in the licenses of undertakings.

Abuse of Dominance

(2.3) The competition authority investigated the abuse of dominance in this sector especially in the following fields: (i) application of incorrect assessment methods when time-period for reading the meter in households was changed from quarter year to a half as a basis of making out a bill, (ii) overcharging for connection from households into gas pipe line network, (iii) delay of investment on the areas where service were not provided yet or overcharging the contribution for investment, (iv) reluctance to make contract for operating services and delaying time for own interest. The competition authority took measures effectively in these cases.

Other Competition Enforcement Issues

(2.4) Under the privatisation process, taken place in an earlier period, the gas distributor (MOL) was not allowed to take part in this privatisation of the gas service providers, which covered the majority part of the country, to prevent vertical integration. Following the privatisation process a few small gas service providers

established businesses on the undeveloped areas of Hungary where no gas supply had existed yet. Because of the lack of capital these undertakings were unable to improve which was obvious after some years when they tried to sell their businesses. MOL was the only potential buyer. The transactions became the subject of notification requirement under the Competition Act.

The competition authority cleared the transactions. Since the gas price is regulated at this moment there is no gap for the abusive market conduct.