

European energy security of supply under renewed pressure despite governments' focus on energy agenda and industry investment

Paris, October 12th 2006 - The average margin between electricity supply and demand fell to its lowest ever figure of 4.8% in 2005 and early 2006, a full percentage point lower than the 5.8% margin in 2004¹, finds the latest version of Capgemini's European Energy Markets Observatory². The fall in margin was driven by an increase in consumption that was not matched by sufficient new operating plants, as well as more extreme weather conditions. These included record-breaking high temperatures in the summer of 2005 - which led to a much greater demand for air conditioning systems across Europe- severe cold spells and low rainfall in Spain and France.

This low power margin is a wake-up call to the energy industry, governments and regulators that security of supply in Europe is now under severe pressure, despite the steps that they have taken to address the problem, such as investing in generation and transmission infrastructure and attempting to introduce a common European energy policy .

The electricity capacity margin was most under pressure in Spain, where real capacity margins decreased to -4%, despite an increase in generation capacity of +8% or 5,500 megawatts. Other countries have addressed the margin issue through greater investment in generation capacity. They include the UK, which increased its generation capacity by 13%, achieving a margin increase of +1% and Ireland, which increased capacity by 36% and achieved an increase in margin of +21%.

Colette Lewiner, energy, utilities and chemicals global sector leader at Capgemini, said: "As our report shows, investment in generation is not growing fast enough and even the surge in electricity and gas prices did not give a strong enough signal to boost these investments at the right level. Spot electricity wholesale prices surged by 70% compared to the previous year with peak prices up to 270 Euros/ MWh. This followed large increases in oil prices (a 53% increase in 2005 prices compared with 2004) and gas prices (a 38% rise), high prices for CO2 emission rights and tight supply and demand conditions.

¹ UCTE regions only

² Capgemini's European Energy Markets Observatory (EEMO) is an annual report that tracks the progress in establishing an open and competitive electricity and gas market in the 25 European countries. This 8th edition – built from public data sources combined with Capgemini methodology and knowledge - is based on 2005 and winter 2005/06 data sets.

Despite the implementation of the European Greenhouse Gas Emission Trading Scheme in 2005, it is highly unlikely that the EU will be able to meet its Kyoto protocol obligations. The EU-15 countries were 300 million tons of CO₂ away from their target even though almost all countries were long compared to their National Allocation Plans.

The regulators have also taken note of the supply issue, but progress is slow, says Lewiner. “The EU’s March 2006 Green Paper stated that energy efficiency must improve and could result in a 20% reduction in demand by 2020. This would have a very beneficial impact on security of supply and CO₂ emissions reduction. These ambitious objectives should translate into national plans and hopefully we should see these plans being launched in 2007”

Other key findings from the report include the following:

- The increase in retail prices has driven customer dissatisfaction, triggering higher customer churn in fully deregulated countries. The highest level of customer churn during 2005/early 2006 was in the UK, which experienced an average churn of up to 25%. High levels of churn were also seen in Norway, the Netherlands, Sweden and Finland.
- A second Merger & Acquisition wave has started in the European energy industry, with the notable examples of E-ON’s bid for Endesa and the possible Suez/Gaz de France merger. These mega deals are hiding a handful of smaller transactions, including the desire by larger players to start investing in ‘new frontier’ countries such as Russia.
- Gas wholesale market liquidity and storage capacity expansion did not improve enough to play a significant role in mitigating security of supply risks. Overall traded volumes remained very low compared to European gas demand.

Lewiner concludes: “We have stressed the importance of the security of supply issue for the past five years and it is now becoming critical. Looking forward, the regulators and the industry must redouble their efforts to revisit their energy mix, invest in infrastructure, encourage energy saving initiatives and reduce CO₂ emissions. We predict interesting times ahead as the EU continues with its strong desire to create an open pan-European market, implement unbundling of the value chain and decrease the influence of large incumbents - , contrasting with the large utilities’ oligopolistic views and desire to spend their ‘war chests’ on European acquisitions, while new and ambitious players such as Gazprom set their sights on the lucrative European retail gas market.”

- Ends -

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An abstract of the report can be downloaded at www.capgemini.com/energy

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