Energy and Climate Change

Europe at the Cross Roads

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CHAPTER 3

LIBERALIZATION: TRY, TRY AND TRY AGAIN

Energy was fundamental to the initial foundations of the EU. It has recently returned to the top of the political agenda.

Andris Piebalgs, EU energy commissioner, 2007

Given the importance energy has now assumed, it seems improbable that Europe's politicians should have left energy liberalization as a postscript to the single market blueprint launched in 1988. Yet they did so, and for a reason. Electricity and gas industries depend on networks that in turn can be considered natural monopolies. (This is in contrast to oil and coal whose physical characteristics – storability, higher energy density and flexible transport – have allowed an international market in these commodities to flourish with relatively little government intervention). Brussels left to last liberalization of these network industries – electricity and gas, but also telecommunications and parts of transport (rail) – because they all contained this element of natural monopoly on grids and pipelines and of government involvement, either in ownership or regulation.

However, in the early 1990s the Commission began to agitate against monopolies, both national and natural. National legal monopolies, generally held by state companies, had played an important part in European energy. But where they extended to legal monopoly on the import and export of energy they were clearly incompatible with a single market. And in 1991 the Commission launched a series of cases against member states that was eventually successful.[1]

At about the same time, the Commission began the search for

1 Peter Cameron, *Competition in Energy Markets: Law and Regulation in The European Union*, Oxford University Press, Oxford, 2007 (2nd edition), 16.51 p. 478.

a solution to natural monopolies in energy, by pushing the idea of third party access (TPA) to these grids and pipelines. TPA, which just means open access to all customers on a network, is still the spearhead principle of EU liberalization. Almost all of the other proposals emanating from Brussels are simply designed to make TPA happen. The greater powers that the Commission sought in 2007 for national regulators are largely to ensure that owners or operators of networks do not abuse their natural monopoly and give fair and equal access to other energy suppliers. The Commission's deeply controversial 2007 proposal to unbundle or separate not just the operation but also the ownership of transmission from other parts of energy businesses is just a final attempt to make TPA work, by removing once and for all the temptation for integrated energy groups to keep rivals off any networks they own.

By the mid-1990s, the Commission was making some progress, at least in the electricity sector. This eventually bore fruit in the 1996 electricity directive. This directive posed no problem to several EU states, such as the UK and Scandinavian countries that had already, through national legislation or regulation, opened up their energy markets. But it was only grudgingly accepted by France and Germany which, as we shall see, have acted in tandem to resist Brussels reshaping the structure of their energy industries.

The TPA concept was modified to allow France to keep a so-called 'single buyer' system, whereby outside suppliers could make a contract with end-user customers in France but the energy supplied had to pass through the conduit of France's 'single buyer' (at the original contract price minus network access tariffs charged by the 'single buyer'). The 'single buyer' was of course state-owned Electricité de France which was thus able to retain its lock-hold on the downstream retail market at the price of tolerating a small dose of competition from generators.

The 1996 directive was further modified to offer a choice between 'regulated' TPA, which provides access to the network on the basis of firm published tariffs approved by national regulators, and 'negotiated' TPA in which indicative prices are published, but are not binding and are not necessarily approved by regulators. Most EU member states chose the first option. But

Germany insisted on the 'negotiated TPA' option, in tune with its tradition of settling energy rules through private negotiation rather than public law. (Germany became the last EU state to set up an energy regulator, when in 2005 it established the Bundesnetzagentur which also deals with other network industries). In 1998, with the delay reflecting the somewhat greater inherent difficulties in liberalizing the gas market, a similar directive was passed 'concerning common rules for the internal market in natural gas'.

But the 1996/1998 directives did not linger long on the EU statute book. Within a few years a mood to replace them developed. One reason was the directives' unsatisfactory nature. Their timetable was ludicrously slow for market opening. For electricity, 35 percent of the market was to be open by 2003, but for gas it would be 2018 before a similar share of the market would be open to cross-border competition. Negotiated TPA proved something of a farce in Germany. Its market was theoretically 100 percent open but effectively closed to foreign suppliers who found it impossible to 'negotiate' their way in. In other states regulation of cross-border liberalization and TPA proved very weak. At the same time, buoyed up by the dotcom economic boom, EU leaders came up at their Lisbon summit in 2000 with the so-called 'Lisbon agenda' for growth and competitiveness (nothing to do with the Lisbon treaty). Accelerated energy market reform was stated to be a key component of this programme. Thus were born the two 'acceleration' directives for electricity and gas of 2003 that, in the absence of subsequent legislation, are still in force today (2008):

a) *Electricity*
The gradual exposure of customers to free cross-border choice was speeded up with full market opening for all customers set for 1 July 2007, except for a couple of smaller new member states that were given a later deadline. Only regulated TPA was allowed. Any transmission system operators (TSOs) or local distribution system operators (DSOs) that are part of larger groups must be legally unbundled, or put into separate subsidiaries. Smaller DSOs may escape this constraint, provided their operation is unbundled functionally or put under separate management. Alongside the directive is the 2003 electricity regulation (a regulation is applied directly and in identical form in all EU states, in contrast to a directive that allows member states to translate EU legislation into their own national statutory form). Designed to foster cross-border trade, this sets out provisions on inter-TSO compensation systems, access fees and interconnectors.

b) *Gas*
This directive lays down the same market-opening timetable, by mid-2007, as the electricity directive. It also has the same unbundling provisions – legal for all integrated TSO/DSOs and functional for smaller DSOs. But there are some modifications specific to gas. Access to storage can be restricted when TSOs need to do so in order to carry out functions related to the system or to production, but not for market purposes. TPA can be refused if it raises problems for take or pay contracts. Again the gas directive is accompanied by a 2005 regulation on rules for TPA services, and open and fair balancing (see Glossary) systems.

Still, however, there were doubts that the 2003 directives would be sufficient or sufficiently implemented. So the Commission decided to make use of a new power it had been given to launch a competition inquiry into a whole sector of the European economy without having any specific suspicions or indications of infringements. It had already done this with retail banking and telecommunications, and in June 2005 decided to do this with energy.

At the outset of this inquiry, Brussels had no 'smoking gun' in the form of proof of anti-competitive wrongdoing. But it was concerned about the 2004–5 rise in electricity and gas prices which appeared to go beyond the upward trend in other energy prices, and worried about the lack of competitive market conditions to reverse this rise. 'Cross-border flows seem insufficient to constrain price differences between most member states and integration between national markets has been slow in many regions', complained the Commission in announcing the sector inquiry. 'In addition, new market entry has been limited, and market concentration remains very high.'[2]

The 'sector inquiry', as it was known, involved Commission

2 Commission press release, IP/05/716, 13 June 2005.

officials sending out questionnaires to several thousand energy companies (which were legally obliged to respond), trawling through a massive amount of data, and carrying out some subsequent interviews. The energy expertise gained during this sector inquiry paid off in two ways. It laid the groundwork for some anti-trust cases. When the Commission opened investigations in May 2007 against Italy's Eni and Germany's RWE for allegedly shutting competitors out of their home gas markets, it claimed these investigations were not based on the sector inquiry, but were instead the result of surprise inspections carried out on company premises in May 2006. The EU competition authorities carried out surprise inspections – which the press likes to dub 'dawn raids' – on 25 companies in six states (Austria, Belgium, France, Germany, Hungary and Italy) in pursuit of allegations of foreclosure (shutting out competitors) in the gas market. In December 2006, it carried out similar inspections looking for possible abuse by companies of withholding power to manipulate prices in wholesale electricity markets.

The Commission's real reason for minimizing the sector inquiry's role in the launch of anti-trust investigations was to avoid giving the defendants an excuse to demand access to the enormous amount of general data gathered by the inquiry. Rather more truthfully, the Commission did state, at the time of the Eni and RWE inquiry announcements, that the inquiry had given it 'an in-depth understanding of the functioning, and in some cases malfunctioning, of the energy sector'. This knowledge had helped the Commission 'draw conclusions as regards where Commission investigations based on competition law could be appropriate and effective'.[3] In other words, it showed Brussels where to look, and what to look for.

More broadly, the sector inquiry provided ammunition for the Commission to make another legislative assault on the energy sector. In a 328-page report it identified 'serious shortcomings'. These are dealt with in more detail in the next chapter. The chief characteristic revealed by the inquiry was the high degree of market concentration by incumbents (generally defined as the

3 Commission press releases Memo/07/186 percent Memo/07/187.

pre-liberalization monopolies or dominant companies) in their home states arising from two factors. One is so-called vertical foreclosure – the use by vertically integrated energy groups of their networks and long-term upstream gas contracts to shut rivals out. The other is lack of competition because of the European energy sector's continued segmentation into national markets with too few interconnecting wires and pipes to link them.

The main remedies proposed by the sector inquiry were more market transparency to help new entrants; caps on incumbent market shares and gas release programmes to increase liquidity in the market; closing the gaps between the responsibilities and competences of national regulators; and, most controversial of all, structural unbundling so as to create genuinely independent transmission system operators interested in acting as a real common carrier of energy.

This proposal of ownership unbundling was then endorsed by the full Commission, in its January 2007 package of proposed legislation, as 'the most effective means to ensure choice for energy users and to encourage investment'. The Commission said this was because 'separate network companies are not influenced by overlapping supply/generation interests as regards investment decisions. It also avoids overly detailed and complex regulation and disproportionate administrative burdens.'[4] At the same time, the Commission suggested as a second best option a 'full independent system operator where the vertically integrated company remains owner of the network assets and receives a regulated return on them, but is not responsible for their operation, maintenance or development'.

The Commission knew it was inviting trouble in proposing fresh legislation before the existing legislation was properly in place. Not only did the deadline for full market opening only come in mid-2007 according to the 2003 directives, but these current directives were not being correctly implemented. The Commission had highlighted this fact in 2006 by starting court proceedings against no fewer than 17 states for inadequate transposition of the 2003 laws. So why hurry? This was the

4 European Commission, *An Energy Policy for Europe*, COM (2007)1, p. 7.

Table 2: Re-regulating Energy

	Unbundling of networks	*Access to networks*	*Market opening*	*National regulation*
First legislative package 1996–8	Separate management and accounts	Negotiated or regulated terms of access	Power: 35 percent open by 2003 Gas: 33 percent open by 2018	Mechanism for regulation
Second Legislative package 2004	Separate subsidiary	Regulated terms of access	Power and gas markets 100 percent open by July 2007	Specific regulator for energy
Third legislative package proposed 2007	Separate ownership or operator	Regulated terms of access	Already achieved (see above)	Ungraded and harmonized powers for national energy regulators

Source: Author

cry from governments like that of France and from the big incumbents. They advised Brussels to wait for all member states to implement the 2003 legislation before making any judgement. Yet, while those governments criticising Brussels for being hasty had a common sense argument – no experiment should be pronounced a failure until fully tried – most of them had undermined their case by dragging their feet on the 2003 directives.

A more important counter-argument by the Commission was that the 2003 directives were fatally flawed. As Philip Lowe, its director general for competition, told a conference in January 2007, 'the existing legislation is simply too weak to have an impact.' [5] Its unbundling provisions were too open to manipulation. Some ostensibly unbundled independent system operators

5 Philip Lowe and others at Claeys–Casteel conference, Brussels January 2007

(ISOs) had proved just to be shell companies with all the work contracted back by the vertically integrated parent. And in many cases, Commission officials claimed, it had proved impossible to have functional (separate management) unbundling without legal (separate subsidiary) unbundling. National regulators had also pointed out the difficulty of monitoring legal unbundling across borders when a transmission system operator in one state has links to a supplier in another country.

Furthermore, the scale of market abuse uncovered in the sector inquiry was felt to warrant new legislation across the board. Asked in January 2007 why the hurry for new legislation, one competition official who had worked on the energy sector inquiry replied incredulously: 'You mean give the companies more time after their ten years of doing nothing?'

In the end, the competition directorate's involvement was decisive to the Third package of internal market reform. To say this is not to ignore the considerable role played by Andris Piebalgs as energy commissioner 2004–9. He got off to an unpromising start to his job. He was not the first pick as commissioner by the Latvian government, whose original choice for commissioner ran into opposition in the European Parliament. Nor was he initially intended as energy commissioner by José Manuel Barroso, who switched Mr Piebalgs to this portfolio after the Hungarian candidate for this commission job performed so poorly before the European Parliament. But Mr Piebalgs took to the energy job with gusto and talent, and made a considerable success of it.

Yet, though Mr Piebalgs was to prove a doughty fighter for energy market reform, this issue was by no means the only one on his plate. So, if the Directorate-General for Competition (DG Comp) had not involved itself in energy across the board, it is likely the Third package would never have been proposed at a time, 2007, when liberalization had been overtaken as an issue by climate change and energy security. But fortuitously it did get involved. This not only stiffened the resolve in the Commission for further legislation. It also weakened governments' resistance, in the view of a senior Commission official. 'Member states realized they could either negotiate [on legislation] or face the competition directorate which they couldn't control.'