# Development of the IEM

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# Traditional paradigm

- Model of government-energy industry relations that emphasizes stability, reliability of supply, and public service; a model of technical organization involving the central control over a synchronized network.
- The certain way of organizing government relations with electricity and gas industries, a set of ideas about the scope of competition and the appropriate legal and institutional methods to achieve public policy aims.

# Traditional paradigm

- Essential characteristics:
  - Exclusive rights to build and operate networks
  - Closure to competition
  - Detailed regulation
  - Remuneration based on historical costs
  - Centralized control over planing
  - Limited participation of consumers.

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# Incentives for change

- European economic downturn in the 80s, free market atmosphere of the UK under PM Thather.
- Fall in energy prices of commodities in the mid-80s not followed by prices of energy (electricity) – local or national obligations. Questioning of the realisation of political goals via state-controlled industries.
- Over-investments in production capacities due to the expected demand. High costs of new plants = the performance of the (state-runned) industry was suffering.

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# Internal Energy Market

- trade area with common policies on product regulation and free movement of energy, where the maximum competition between suppliers and providers of different types of energy is essential. The barriers among the MSs are removed to maximum.

# Prerequisites for the IEM

- Liberalisation and competition – withdrawal of the state from the energy sector, removing the barriers.
- But also regulation – to limit the power of (natural) monopolies and to remove the legacy of pre-liberal paradigm – regulation to competition.
- Interconnectors.

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# Liberal paradigm

- Liberal paradigm stresses a greater reliance on markets. It sought to introduce competition whenever possible, encouraging openness, decentralized production with network access, and profit based on the market prices, not costs (regulation for competition)

- Some basic characteristic:
  - Separation of activities to facilitate the competition (unbundling)
  - Freedom of entry and investment into competitive activities, instead of a centrally-planned approach
  - Freedom of contract and competitive formation of prices
  - Access to the network and infrastructure
  - Supervision of the model by an independent regulator

# Initial goals of the EC

- Since 1988, the Commission focused on:
  - Harmonization of indirect taxation
  - Price and investment transparency
  - Competition for public procurement
  - TPA
  - Integration of electricity and gas grids
  - Application of competition legislation to the upstream part of oil and gas exploration and production.

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# First legal acts

- 1988 Working Document on the Internal Energy Market.
- First activities of the Commission date from 1989:
  - Communication from the Commission: Transparency of consumer energy prices. COM (89)123, 1989.
  - Towards completion of the internal market for natural gas. Communication from the Commission. Proposal for a Council Directive on the transit of natural gas through the major systems. COM (89) 334, 1989
  - Increased intra-Community electricity exchanges: a fundamental step towards completing the internal energy market. Proposal for a Council Directive on the transit of electricity through transmission grids. COM (89) 336, 1989.
  - And the others …

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# First liberalization package

- Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity
- Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 concerning common rules for the internal market in natural gas

| | Unbundling of networks | Access to networks | Market opening | National regulation |
|---|---|---|---|---|
| First legislative package | Separate management and accounts | Negotiated or regulated terms of access | Power: 35% open by 2003<br>Gas: 33% open by 2018 | Mechanism for regulation |

# EU regulatory framework: basic principles

- Differentiation between competitive parts of the industry (= supply) and non-competitive parts (= operation of the networks).
- Obligation on operators of the non-competitive parts of the industry to allow third parties to have access to the infrastructure.
- Free up the supply side of the market – removing barriers preventing alternative suppliers from importing or producing energy.
- Free choice of consumers to choose their supplier and removal of restrictions on customers from changing their supplier.
- Creation of independent regulators to monitor the sector and enforce TPA.

# Second liberalization package

- Unsatisfactory pace as well as targets, new legislation introduced in 2003.

- „European national gas markets are characterized by high prices and tariff differentials, a high degree of market concentration, insufficient unbundling, a lack of market based balancing regimes, and ex ante regulation ... The prices of gas and electricity are especially of concern. In some European countries, natural gas increases its share in electricity generation. During the 1990's the European industry was paying 40% more for its electricity than its American competitors" (2001 common market report).

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# Second liberalization package

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| Second legislative package | Separate subsidiary | Regulated terms of access (but TOP in gas) | Power and gas markets 100% open by July 2007 | Specific regulator for energy |

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# Unbundling in the Second package

**Accounting Unbundling:** relevance for DSOs which are not legally unbundled (given the new requirement of legal unbundling); no derogation is possible from accounting unbundling for smaller DSOs.

**Functional Unbundling:** where the network operator is part of a vertically integrated undertaking, it shall be independent in terms of its organization (management separation) and decision making rights from the other activities not related to that network.

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# Unbundling in the Second package

**Legal Unbundling:** the transmission and distribution activities have to be done by a separate "network" company; the network company must not necessarily own the network assets but must have "effective decision making rights" in line with the requirements of functional unbundling (no change of ownership).

# The following steps of the European Commission

- EC sector inquiry (2005 - 2007) highlited some serious shortages:
  - The persistence of great market concentration (vertical foreclosure, just a few interconection).
  - Too little integration between MS markets (e.g. limited common auctioning).
  - Absence of transparent market information.
  - Unsatisfactory level of unbundling.
- Solution = market transparency and caps on incumbents' market shares, closing the gaps between the responsibilities and competences of national regulators, structural (ownership) unbundling.

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# Non-functioning market: Utilities' reactions

- Vertical foreclosure - the process where incumbent wittingly or unwittingly foreclose, or close in advance, the availability of crucial inputs or assets to potential rivals. Long-term upstream, capacity and downstream contracts.
- Market segmentation (LTC in gas, physical interconnectors in electricity)

# EC enforcing new rules

- Just in 2006 EC court proceedings against 17 states for inadequate transposition of the 2003 directives.
- In 2007 anti-trust investigations against Eni, RWE (underivestments, capacity hoarding, high prices for access to network etc.).
- Unexpected inspections of 25 companies in Austria, Belgium, France, Germany, Hungary, Italy.
- 2/2008 E.ON to sell-off its grid (€1bn/y) to settle EU antitrust inquiries.
- 6/2008 RWE to sell off its gas grid to avoid anti-trust actions by Commission.

# Non-functioning market: Governments' reactions

- Championing national companies – preventing foreign companies to buy domestic ones.
  - Hungary (Moll) vs OMV, Great Britain (Centrica) vs Gazprom...

- Regulating the regulators.

# Non-functioning market: Governments' reactions

- Retail market - regulated vs. free pricing in case of energy.
  - EK objected in case of Slovakia, where PM Fico threatened to renationalize Slovenske Elektrarne, if they did not stop raising the prices.
  - In 2006, EK went after Spain, France, Estonia and Latvia for regulating tariffs.
  - Then EK went after Italy and Ireland for granting on discriminatory basis the right to an incumbent to supply power at regulated price.
  - And again it went after Germany, Czech Republic, Poland, Slovakia, Lithuania and Italy for failing to provide sufficient information on regulator tariffs. The same situation repeated in 2007, in case of Commission against Spain and France.

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# Third liberalization package

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| Second legislative package | Separate subsidiary | Regulated terms of access | Power and gas markets 100% open by July 2007 | Specific regulator for energy |
| Third liberalisation package | Ownership unbundling, ISO, ITO. | Regulated terms of access | Already achieved | Upgraded and harmonized powers for national energy regulators |

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# Unbundling

Ownership unbundling - OU means separating the ownership or the operation of gas and power networks from other parts of the energy business

ISO – energy supply companies may still formally own gas or electricity transmission networks but must leave the entire operation, maintenance, and investment in the grid to an independent company.

ITO model – energy supply companies may still own and operate gas or electricity networks but must do so through a subsidiary. All important decisions must be taken independent of the parent company.

# Sources


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