CHAPTER 7

CONFRONTATION AND COMPROMISE

The coincidence of these events, at a moment when the Commission is trying to force through a very sharp position against a minority, is a very questionable game...

Peter Hinze, deputy German economy minister, on learning the Commission had pressured Germany's Eon into selling its power grid just as he walks into an EU energy council to oppose ownership unbundling.

The potential for collective restructuring of Europe's energy market may be high. But, with the concept of energy market liberalization already more than 20 years old in Europe, there were unlikely to be many more member states willing to bow to an EU directive to adopt full ownership unbundling (OU), if they had not already done so of their national volition. So the Commission knew it could not take a rigid template approach.

The EU executive's usual role is to act as a good shepherd in trying to keep its flock of member states together, though the exercise is more like herding cats than sheep. Often, in the EU legislative process, opt-outs and opt-ins are created to satisfy one or other recalcitrant states, partial forms of closer integration develop over time such as in monetary union or judicial cooperation, and some states, usually the less economically advanced ones, are granted temporary exemptions from new EU laws in the form of derogations. Sometimes, too, individual member states so exploit the degree of national discretion and flexibility allowed them in a directive that the legislation ends up as more loophole than law; a case in point is the EU directive on corporate takeovers.

But what was unusual was the Commission's decision, from the outset, to offer governments a choice between separating the ownership or the operation of gas and power networks

from other parts of the energy business. This, too, could be a permanent choice. OU was clearly considered the default mode that any rational government should want to choose, and the 'independent system operator' (ISO) was clearly considered the second best option that came with additional red tape and was referred to as a derogation from the OU norm. But there was no indication that the ISO derogation would be limited in time.

So the Commission recognized the need early on to cater for two irreconcilable camps (on OU). Its January 2007 energy proposals contained the two options, which then reappeared in the draft legislation formally unveiled in September 2007. Not a lot changed over that nine-month period. The two camps could agree on the need for 'effective' unbundling without defining what effective might entail. This was the vague formula endorsed by energy ministers meeting in February, and repeated by heads of government at their March 2007 summit in Brussels. OU enthusiasts in the Commission chose to declare that the March summit had basically backed the only option that they themselves judged effective. In fact, the March summit really did not advance the debate one way or the other, because it devoted all its time and energy to issues of climate change and renewables (see Chapters 10–12).

During the first part of 2007, the electricity industry did make a serious effort to deflect the Commission away from its proposals. Superficially, it was surprising that this effort should have been made by the electricity sector rather than the gas industry, for the latter had always been more rooted in its opposition to unbundling its networks. But partly because of this, the gas sector tended to take a more head-in-the-sand view of the Commission's proposals, hoping that somehow they would just go away. The Eurelectric industry association, by contrast, was more proactive. It came up with idea of the regional independent operators (RIOs), claiming that this would kill two birds with one stone, by achieving independence and integration simultaneously. It was a clever approach, because it seemed to tackle the integration issue more directly than unbundling. But initially, Commission officials argued that RIOs would make the situation worse. If energy groups were allowed to retain their vertical integration and band together in RIOs, Brussels officials said, they would have a mechanism for collusion.[1]

In public at least, there was only one serious wobble on the part of the Commission, or rather from Andris Piebalgs, the energy commissioner whose departmental officials had, mostly, never been as keen on the OU option as their counterparts in DG Competition. The wobble came after the June 2007 energy council, the first and only time that Germany had allowed serious discussion of energy reform during its presidency of the EU in the first half of 2007.

To widespread surprise, even among his own officials, Mr Piebalgs told a press conference after the meeting that 'I can clearly conclude the majority [of member states] is not with me', and that this 'very uneasy situation…has become much more serious for me.' Yet officials from states on both sides of the ownership unbundling all agreed that Mr Piebalgs was over-reacting to his opponents. The latter had not grown in number. Indeed there was one switch in that evenly-split energy council meeting as Poland moved from the negative to the positive camp.

Mr Piebalgs may have been daunted by the more formidable display of Franco-German opposition to ownership unbundling on that day in June 2007. France fielded a former prime minister Alain Juppé, who was briefly its energy minister. Meanwhile Germany departed from the studied neutrality it had shown earlier during its six-month presidency of the EU. German economics minister Michael Glos first encouraged his deputy Joachim Würmeling to voice Germany's national opposition to unbundling and then, in his own supposedly balanced summing up as council chairman, was himself dismissive of ownership unbundling.

But Mr Piebalgs' public doom and gloom galvanized his ministerial supporters. A fortnight later, ministers from eight pro-OU states wrote him a sort of 'anti-depressant letter', sent by Danish energy minister Flemming Hansen and co-signed by his counterparts from Belgium, Finland, Netherlands, Romania, Spain, Sweden and the UK.[2] It told Mr Piebalgs and fellow

1 Commission press conference, 19 September 2007.

2 Author copy of letter from the Danish energy minister and others to Piebalgs, 22 June 2007.

competition commissioner Neelie Kroes that the eight ministers believed the June 6 council displayed 'a clear majority in favour of ownership unbundling at transmission level'. This last phrase was a reference to the fact that several countries which had been sitting on the fence, such as Poland, had said they could support ownership separation provided, as the Commission had promised, it only applied to main transmission networks and not to smaller final distribution systems.

OU would 'ensure the best possible incentives for investments in infrastructure and non-discriminatory behaviour', the eight ministers wrote. No alternatives had been proposed that would 'eliminate built-in conflicts of interest' and 'avoid overly detailed and complex regulation', they added.

On receipt of the letter, a spokesman for Mr Piebalgs said the Commission was pleased to see 'substantial and outspoken support' for OU. Its opponents, however, did not take this lying down. At the end of July Mr Piebalgs got a letter from France, Germany and seven smaller countries (that included Mr Piebalgs' own Latvia, as well as Austria, Bulgaria, Cyprus, Greece, Luxembourg and Slovakia). Many of these countries were worried about the suitability of OU in small or isolated markets. The letter questioned how OU would help lower prices or raise investment, and said 'the idea of complete separation of production and transmission as the only key to the development of the internal energy market for electricity and gas should be avoided.'[3]

However, this apparent impasse in the Council was not paralleled in the European Parliament, which under the co-decision procedure has an equal say in legislating on single market matters. Most MEPs leaned towards unbundling, as shown in a vote in July 2007 on a non-binding resolution approving a pro-ownership unbundling report by Spanish conservative Alejo Vidal-Quadras. In spite of the fact most MEPs usually follow the voting line decided by their trans-national political grouping, on unbundling a number sided with their governments. One of those to take a line very different from his government was Claude Turmes, a Luxembourg Green, who like the rest of

3 Author copy of a letter from the nine energy ministers to Piebalgs, 27 July 2007.

his group, suspected the big utilities of discriminating against renewable energy on their networks. After the vote on the Vidal-Quadras report, Mr Turmes crowed: 'The mobilization of French and German [MEP] colleagues by energy giants EdF, Eon and RWE to defend their own financial interests has failed.'

These, then, were some of the political forces that shaped the package of draft legislation that the Commission unveiled on September 19 2007. This had the following main elements:

- Unbundling: emboldened by the support of national energy regulators, more than half the MEPs and at least half Council members, the Commission stuck to its preferred prescription of ownership separation, but with an opt-out for states to let their energy groups retain title to their networks but cede their day to day control to 'independent system operators'. Eurelectric's proposal of regional independent operators figured nowhere.
- Safeguards against unwelcome foreign investment. The Commission proposed a two-step safeguard against companies from third countries seeking to acquire a significant stake or control over EU energy networks. Such third countries would have to have an agreement with Brussels explicitly allowing this kind of investment by their companies in the EU. Even then, national regulators and the Commission could still review, and possibly block, their investment. This was designed to take care of the growing concern about Gazprom.
- Regional solidarity agreements by groups of EU states to plan sharing of stocks in the event of energy supply cut-offs. Pressure from East European states for better energy security arrangements thus appeared to have partially paid off.
- A series of measures to promote cross-border trade and investment. These included strengthening and guaranteeing the independence of national regulators who would also get a new coordinating body (the Agency for the Cooperation of Energy Regulators or Acer). Transmission system operators would also get a new body to plan new investment.
- Greater transparency in the flow of information relating to network operation and supply.

Predictably, and despite the real importance of the regulatory and transparency reforms, attention focussed on the unbundling proposals and particularly on the Commission's impact assessment justifying its proposals. The Commission's opponents, notably France and Germany, set to work to criticise the impact assessment, and with some effect. They briefed MEPs, particularly French and German ones, on the perceived shortcomings of the impact assessment (discussed in detail in the last chapter), and in an autumn hearing the Parliament's energy committee gave Commission officials a rougher ride than they had been used to on the unbundling issue.

If the Commission had hoped that the hard line opponents of OU such as France, Germany and Austria would grasp at the ISO option, it was quickly disabused. For while the opponents might regard the ISO option as the lesser evil (because it did not involve forced sale of network assets), some of them regarded it as an even bigger nonsense, reducing a network owner to nothing more than a financial holding company.

Initially, France and Germany asked the Commission to come up with 'a third way'. Finding the EU executive unwilling to do so, Paris and Berlin then decided to work out their own alternative, together with the seven countries that joined them in signing the July 2007 protest letter about OU. Along the way, they lost Cyprus as an ally because the Commission had promised Nicosia that as a small and isolated market it could have a derogation. Nonetheless, on 29 January 2008 the band of eight tabled their proposal for what they called 'effective and efficient unbundling':

- The 'effective' part related to organizational independence of the transmission system operator (TSO) subsidiary from its parent group. This was to be achieved by ensuring the TSO had all the necessary assets to carry out its network responsibilities and would not be a shell company sub-contracting work back to its parent; that the TSO should have a different auditor to its parent company; that the TSO have a separate board with several independent non-executive directors; that a TSO chief executive could not go on to work for the parent company for a certain period of time; and that the TSO have a compliance officer to ensure these and other rules were obeyed.

- The 'efficient' part related to grid investments and market integration. TSOs would develop a 10-year investment plan, but if for some reason they did not carry it out, national regulators could step in to force them or third parties to do so. This was designed to make it hard to under-invest for the purpose of cordoning off home markets. The Commission might, at the request of TSOs, appoint a regional coordinator to promote cross-border interconnections.

The Commission's immediate reaction was that the Franco-German Third way would not lead to effective separation of networks from supply/production. But a more open attitude soon prevailed. It began to dawn on the Commission that, once the group of eight had signed up to a public position, it would probably stay intact as a blocking minority within the Council of Ministers. Thus it could stall any progress until spring 2009, at which time the EU's other co-legislator, the European Parliament, would be dissolved ahead of the mid-2009 elections. So at least a year might be lost, with no surer prospect of getting ownership unbundling through in 2010, and all the other proposals in the Third package would be jeopardized. So the Commission began to work together with Slovenia, which held the EU presidency for the first half of 2008, towards a compromise.

But the anti-OU camp suffered a setback, when, on the morning of 28 February 2008, Energy Ministers Council, Eon and the Commission announced that they had come to a preliminary deal in which Eon would sell off its German electricity grid and Brussels would drop its anti-trust investigation into alleged power market manipulation by the German utility. Peter Hinze, Germany's economics minister, learnt about this as he walked into the Justus Lipsius council building in Brussels on 28 February. He rounded on the Commission for its 'very questionable game', effectively accusing it of timing the announcement to humiliate him and weaken his bargaining position.[4] The Commission

4 Report by Reuters, 28 February 2008.

denied any such motive on the deal's timing, which it claimed was dictated by the pace of negotiations with Eon. As it happened, however, announcement of the very similar deal on gas between Germany's RWE and the Commission also came just before the June 2008 Energy Council ministerial meeting.

The U-turns by Eon and RWE did not alter the stance taken in council meetings by German ministers, who were also angry at being made to look foolish by their companies. As the practical reasons for defending their companies from OU slipped away, German ministers elevated opposition to OU even more to a matter of principle. But the sight of Brussels forcing Germany's two biggest utilities into plea bargains over unbundling had an impact of some of Germany's allies. 'The Eon announcement was very important', said a senior Commission official some months after. 'It changed the dynamic because whatever the German government said, there was no longer a unified German position.'

The essence of the June 2008 compromise was that it contained an option for an 'independent transmission operator' (ITO), allowing the network management to stay within the integrated parent group, as the French and Germans wanted. Nor was it treated as an inferior option, but given the same status as OU. In a further concession to the Franco-German camp, ITO status could apply to electricity as well as gas.

What did the opponents of OU concede in return? Essentially to wrap themselves in red tape and conditions and to authorize national regulators to impose substantial fines – which never figured in the Commission's original proposal – on parent companies and network subsidiaries found guilty of discrimination.

Among the main conditions were that an ITO must have sufficient financial, physical and human resources so that it does not need to contract everything back to its parent company. Top management could move from the parent to the network, but only after 'cooling off' periods of three to four years to prevent people taking commercially sensitive information with them. Parent companies could crown their ITOs with a supervisory board, but nearly half these board members had to be subject to the 'cooling off' restrictions, and national regulators could step in to prevent any board member being 'unfairly dismissed'. Regulators must authorize ITO investment plans, and could force changes in them.

This compromise is likely to be the basis of the Third package that is expected to pass into law in spring 2009. In autumn 2008, the outcome was still complicated by the schizophrenia of the European Parliament, which had in its first votes sided with the Council of Ministers' gas compromise but on electricity went for ownership unbundling pure and simple. But the prevailing mood among MEPs as well as governments was a desire to get the Third package of energy market reforms on to the EU statute book, and to 'change the subject' to the other energy issues of security of supply and of climate change.

Speaking after the basic compromise reached at the June 2008 energy council, energy commissioner Andris Piebalgs said he had mixed feelings. 'Sadness, because the Commission proposal for ownership unbundling was a very good one. But political life in the EU needs member states to endorse proposals, and now that the way has been paved for final adoption of the package is a reason for satisfaction'.

For his successors as energy commissioner, a key task will be to ensure proper implementation of the Third package so that there is no need for a Fourth one. Yet even the Third package – for all its lengthy preparation – may have only had a narrow window of opportunity through which to slip on to the statute book. The deal on unbundling might not have been possible until the anti-trust investigations began to have an effect on German companies in spring and summer 2008. But by that time, France signalled clearly it would use its presidency of the EU in the second half of 2008 to focus on what it – and most other governments – regarded as more pressing business: energy security and climate change. And it is to these issues we now turn.

CHAPTER 8

ENERGY SECURITY: THE WEAKEST LINK

Europe managed to carry on sleep walking [into excessive dependence on imported gas] for many years before any alarm bells rang.

Paolo Scaroni, CEO of Eni speaking to the World Energy Congress, November 2007.

It may be valuable to consider proposing the creation of a more central role for the European Commission in the external energy relations of the EU, beyond its existing legal competences, by providing in particular for stronger coordination of member states.

The International Energy Agency, 2008 Report on EU Energy Policy.

When Paolo Scaroni talked of 'alarm bells', he was referring to Russia's transit disputes with Ukraine and Belarus of 2006–7, leading to brief interruptions in the westward flow of Russian gas and oil through those countries. He could not have known that in just over a year, Russia's military conflict with Georgia and two-week cut-off of gas through Ukraine would give its European Union energy customers a much more serious fright. Although the Russian–Georgian conflict was not motivated by energy, it had a big impact on perceptions about Europe's energy security. For it was seen to put the only energy corridor providing a non-Russian outlet for Caspian oil and gas right under the shadow of the Russian military. The implications of this will be dealt with in the next chapter. First, however, some general context is needed to understand what the EU can – and cannot – do to provide energy security for its members.

Energy security is a complicated issue, and becoming more so because of climate change. One day we may reach a stage where we still have enough fossil fuels, particularly coal, but are too scared to continue using them for fear of triggering climate