CHAPTER 5

GOVERNMENTS BEHAVING BADLY

It is time again to stop the countries of the European Union from erecting national barriers. If not, we will risk an August 1914 effect … with at the end, a war that no one wanted.

Giulio Tremonti, Italian finance minister, speaking on energy protectionism, February 2006.

In reacting in this way to the efforts of Paris to thwart an Italian bid for a French energy company, Giulio Tremonti appeared to be going over the top. Any such reference to the guns of August 1914 seemed quite implausible in today's Europe; for all its failings, the European Union has made war unthinkable between its members. But there was an economic relevance to his comments. For August 1914 brought to an end the world's first period of globalization without tariff barriers and currency controls, and what Mr Tremonti was really warning of was the risk of globalization going into reverse again. Nor was it implausible that the reverse might come in energy, though the greater setback was to occur in finance.

For energy was again becoming a sensitive issue for governments. In 2006, oil and gas prices were continuing their run-up since 2000. A month before Mr Tremonti spoke the supply of Russian gas had been briefly cut, in January 2006, as a by-product of Moscow's dispute with Ukraine over pricing and payment. In addition to this revived worry about energy security was the rising concern about energy as the main culprit in causing climate change. As Mr Tremonti was speaking, not only was the French government decided to push Suez into a merger with Gaz de France to keep it out of the hands of Italy's Enel, but Germany's Eon had made a counter-bid for Spain's Endesa, which the Madrid government declared itself determined to stop.

Even the UK, which had usually taken a *laissez-achêter* attitude to prospective foreign buyers of its energy companies, had fretted about Gazprom's interest in acquiring Centrica, the last sizeable UK-owned energy retailer. Newer parts of the EU energy sector have not been immune from this protectionist virus. Aided and abetted by its politicians, Hungary's MOL went to the limit of EU law, and probably beyond, to fight off a takeover bid from Austria's OMV. All this did not amount to the beggar-my-neighbour trade policies of the years after 1914, but it did constitute a sort of block-my-neighbour attitude to energy investment even from fellow EU states.

Championing national companies

Liberalization means letting go, which governments, like parents, often find hard to do. They often remain over-protective of their former energy monopolies and unwilling to surrender control over the energy sector. 'The energy sector, especially electricity, is the last tool left to governments, and they want to keep it for reasons of security of supply and environmental protection', according to Rafael Miranda, the CEO of Endesa. 'Yet in this global economy, if governments try to avoid things like unwelcome foreign bids, the strength of the market wins through in the end.'[1]

Mr Miranda should know. He was at the middle of a long corporate tug of war that started with an attempt to make Endesa part of a Spanish national champion, then nearly landed it in the German grasp of Eon, and finally put it into the hands of Italy's Enel utility and of Spain's Acciona construction company. The Endesa affair highlighted the degree to which Spain had never really accepted the consequences of its relatively early move to energy liberalization and the lengths to which it was ready to go to keep Spanish companies Spanish. It also underscored important shortcomings in EU merger controls.

The saga started in 2005, when Barcelona-based Gas Natural, prompted by Catalan nationalist politicians in alliance with

1 Author interview, 2007.

the socialist government in Madrid, bid for Endesa, a Madrid company considered to be more aligned with the conservative opposition. In January 2006, the Spanish competition tribunal recommended to the government that the bid should be blocked. Instead, the government overruled the tribunal and conditionally approved the Gas Natural bid. This happened just as Eon – to some extent, solicited by Endesa itself – made a considerably higher offer for Endesa. It fell to the EU merger control authorities to rule on the Eon bid by virtue of the size and trans-national character of the German company.* Brussels quickly gave its approval, because of the lack of competitive overlap between Eon and Endesa. Frantic to thwart the German bid, the Spanish government quickly passed a law to increase the national energy regulator's powers over takeover bids by foreign companies. The regulator subsequently used these powers to impose on the Eon bid a series of onerous conditions. These included obligations to use Spanish coal, to maintain the Endesa brand and to retain Endesa assets in Spanish islands and enclaves for five years.

The European Commission could not overrule Madrid's clearance of a Gas Natural–Endesa combination because it clearly came under national jurisdiction. This is a shortcoming. For national energy mergers can be clearly bad for competition, even – or one might say especially – where one company is in electricity and the other in gas. Such companies overlap, or interlock, because gas is a prime fuel for power generation and control of it tends to give an electricity company an advantage over rivals in the power business that have no gas assets.

A notorious example of such national concentration, and of Brussels' powerlessness to prevent it, came a few years earlier. Ironically it concerned Eon, which in 2001 made a takeover bid for Ruhrgas. The German cartel office blocked the bid, but was overruled by the German government, which allowed

* The EU vets mergers where the combined world-wide turnover is over Euros 5bn and the EU portion of this turnover is over Euros 250m for each of at least two of the companies involved, unless each of the companies does more than two-thirds of its EU turnover within one and the same state.

the bid to go ahead. And Brussels could only stand helpless on the sidelines, given its lack of jurisdiction in deals where the companies merging each do more than two-thirds of their EU business within one and the same EU state.

But Madrid overplayed its hand in the Endesa case. The Commission took the Spanish government to the European Court of Justice in two cases, one for infringing the EU merger regulation by imposing conditions on a bid by Eon that was within the sole purview of Brussels, and another for breaching EU rules on free movement of capital and freedom of establishment. In 2008 the Court upheld the Commission in both cases.

This will have sent out a wider signal of displeasure about governments shutting out companies from other EU states. For its part, the Spanish government has been chastened by its failure to keep Endesa out of foreign hands, because the company is now partly owned by Enel. Prime Minister Jose Luis Zapatero admitted ruefully in June 2008 that 'we cannot all aspire to have national energy champions.'[2] The Italian company, with its Acciona ally (a construction firm flush with cash from Spain's 20-year building boom), eventually cut a deal with Eon. It sold a quarter of Endesa (including bits in Spain and Italy that might otherwise have raised competition issues) to the German company Eon and kept the rest. So Enel got some compensation for its frustration over Suez that gave rise to Mr Tremonti's dramatic complaint and warning.

For France, there has been no such chastening experience in the construction of national champions. Despite all Paris' complaints about liberalization, its two energy giants have, on balance, gained from it. They have lost a little market share at home; according to the CRE regulator, EdF lost 6.3 percent of its customers in 2004–7 and GdF 7.4 percent over the same period. At the same time, EdF has expanded abroad with acquisitions in the UK, Germany, Belgium, Italy and Poland. The fact that EdF could expand abroad, while benefiting from a lower cost of capital stemming from its state ownership and credit rating and from the assurance of a relatively protected

2 Financial *Times*, 4 June 2008

Table 5: The Endesa-Eon-Enel saga

2005	
September 5	Gas Natural bids for Endesa
2006	
February 21	Eon bids for Endesa
February 24	Spain gives own regulator power to stop merger
April 25	European Commission approves Eon bid
July 27	Spanish regulator imposes conditions on Eon bid
September 25	Acciona buys 10 percent of Endesa
September 26	European Commission says Spanish regulator's conditions illegal
2007	
February 3	Eon raises bid for Endesa
February 27	Enel buys 10 percent of Endesa and increases this to 22 percent
March 23	Enel and Acciona announce joint bid for Endesa
March 25	Eon raises bid again for Endesa
April 2	Eon drops bid and carves Endesa up with Enel and Acciona
July 4	Spanish regulator imposes conditions on Enel/Acciona takeover of Endesa
July 5	European Commission approves Enel/Acciona acquisition of Endesa
October 19	Spanish govt modifies Spanish regulator's conditions
December 5	European Commission says modifications still breach EU law
2008	
	European Commission files legal suit against Spain for not lifting modifications, and is upheld in the European Court of Justice.

home market, provoked a hostile reaction in some quarters. Italy and Spain passed what were effectively anti-EdF laws – restricting the voting rights of foreign state-owned acquirers of their companies' shares – that were eventually ruled illegal by Brussels. So, to an extent, some of the recent economic nationalism

can be seen as an adverse reaction to EdF's early expansion (in the same way that Napoleon helped stir, by the act of invasion itself, political nationalism within the countries he conquered). EdF executives admit that their company gained a first mover advantage, partly by creating a protectionist reaction that has probably hampered rivals such as Eon more than EdF itself. As for GdF, Paris' defensive manoeuvre has succeeded, with President Nicolas Sarkozy presiding over a merger with Suez that is effectively a partial nationalization of Suez.

Retail price control: rigging liberalization's outcome

There is another area in which many more governments have difficulty in letting go – and this is retail energy pricing. Even as the day of full liberalization supposedly dawned on 1 July 2007 – with the opening of all retail power and gas markets to cross-border competition – several EU governments were still imposing an arbitrary lid on retail energy prices to keep them lower than market forces otherwise would.

Clearly, a few prices need regulating, but *only* those fees that owners or operators of transmission grids or pipelines charge for access to their natural *monopoly* infrastructure, and *not* those retail prices supposedly set where *competitive* supply meets demand. But many governments require their national regulatory authorities to regulate retail prices as well as access fees. In Slovakia, in 2008, a more direct approach was threatened. Its prime minister, Robert Fico, said he would renationalize the main power company, Slovenske Electrarne (now owned by Enel of Italy), if it did not curb prices increases.

The debate over energy price regulation can be dressed up in philosophical terms. In France and some other continental countries, such regulation is justified as part of the conception that energy is a special public service. This is in contrast to a more Anglo-Saxon view, which the Commission in Brussels shares, that energy is simply an ordinary commodity with a market price that should run free like any other. Yet another way to see the issue is simply in terms of political courage, or lack of it. Fearful of voters' reaction, the politicians, in the words again of Mr Miranda of Endesa, 'are not prepared to let the market work, or only when prices go down'.

The problem for the EU is not just that its 2003 directives specifically require free energy pricing, except where governments notify Brussels that regulation is necessary to fulfil public service requirements such as street lighting and to protect vulnerable communities such as the poor, unemployed or remote populations. Rather, the problem is that the EU's entire strategy needs – and is predicated on – higher prices for all conventional energy in order to stimulate energy saving and alternative energy development. Market economies need relatively high energy prices – which can be kept high by taxes whose receipts can go to the poor – in order to spur greater efficiency.

For it is the logic of Europe's emission trading system (ETS) that the cost of carbon permits should be passed on to consumers so as to discourage the use of carbon-intensive fuels. But utilities get criticised when they do pass on this cost. Only if this cost is passed through into retail prices will low carbon sources of energy, such as renewable and nuclear power, become competitive with hydrocarbons like gas or coal that otherwise benefit from a liberalized market. As Jan Horst Keppler of Paris-Dauphine university points out, 'many people are unaware of the fuel choices of liberalization which pushes companies into going for technologies, like gas and coal generation, with relatively low fixed (plant) and high variable (fuel) costs, and which disadvantages those technologies – renewables as well as nuclear – with a high ratio of fixed costs to variable costs.'[3] The only way to correct this bias of liberalization towards fossil fuels is to ensure that fossil fuel prices include the cost of the pollution they cause.

Regulating end-user tariffs has pernicious effects. To give their energy-using industries a competitive edge over others and to curry favour with consumers, many governments are setting retail prices close to or even below wholesale energy costs. Retailing power has generally been a low margin business, but regulated tariffs make it zero margin, or even a loss-maker. In several countries – Spain and France, for example – free market prices coexist with regulated prices, and customers are free to move from regulated to free prices (though there is sometimes a restriction on moving back). In Spain and France again, companies supplying customers with power at the (generally lower) regulated tariffs get reimbursed with state subsidies for any loss in supplying the cheaper power. These subsidies tend to go to incumbent suppliers (because they are the ones with regulated-tariff customers), and not new entrants (who tend only to be able to pick up customers on the freely-priced market). This discourages new entrants. Their absence in retail markets hampers liquidity in the wholesale power markets, robbing the industry of accurate pricing signals when the need for investment in new supply is particularly pressing. Ultimately, this could force governments to start dictating investment in generation and grids, sounding the death knell for liberalization.

In launching legal proceedings in 2006 against more than half the EU membership for failing to implement the 2003 directives properly, the Commission specifically went after Spain, France, Estonia and Latvia for regulating tariffs too widely and at too far below market prices; after Italy and Ireland for granting the right to supply power at a regulated price on a discriminatory basis to incumbents; and after Germany, the Czech Republic, Poland, Slovakia, Lithuania, and Italy (only in gas) for failing to provide sufficient information on regulated tariffs.

In 2007 the Commission tried another angle of attack against two major offenders. It accused first Spain, and then (waiting until the French elections were almost over) France, of possibly violating EU state aid rules in using regulated tariffs to give their energy-using companies artificially cheap power and, as we have seen, subsidizing incumbent electricity suppliers. This weapon of a state aid investigation carries more menace, because if the governments lose the case, the corporate recipients of their largesse have to repay all of the state aid. But it is a more complicated procedure, requiring the Commission to prove that not only do the regulated tariffs constitute state aid, but that they have also distorted cross-border trade. All these procedures, too, are very long. It can take five to six years for a Commission complaint against a government to reach the stage of a European Court of Justice ruling.

3 Author interview, 2007.

Regulating the regulators

As governments have, through liberalization and privatization, reduced their direct control of European energy companies, so measures to protect the public interest and ensure fair competition, through regulation, have been developed. As one of the first to liberalize and privatize, the UK was also one of the first to set up an energy regulator, today known as Ofgem. Most other national regulators had, and still have, less power and independence than Ofgem.

At the EU level, regulation was initially little more than self-regulation. After the First liberalization package of 1996–8, the Commission set up the Florence Forum in 1998 for regular discussions with all the stakeholders in the electricity industry, and a year later the Madrid Forum to do the same for the gas industry. Lacking any law-making or regulatory enforcement powers, these forums have been essentially regulation by cooperation. The Second package of 2003 required every member state to have a specific national regulator for energy, which by that date they all did except for Germany. The Third package of 2007 called for the creation of a new semi-federal network of regulators at the EU level – an Agency for the Cooperation of Energy Regulators – as well as an upgrading and harmonization of the powers and independence of national regulators in their own countries.

EU governments have mouthed support for regulators to have stronger national and EU powers. It will be interesting to see how the politicians adjust to this in reality. The practice of farming out control of network industries like railways or communications to specialist regulators goes back to the 19th century in the USA, whose Interstate Commerce Commission (created in 1887) is the grand-daddy of them all. But it is new in Europe. Many European politicians have found it hard to swallow the idea of putting control of something as vital, and so in a way political, as energy in the hands of technocrats. Even in the UK governments tend to respond to any sharp rises in energy prices by leaning on Ofgem, the regulator, to inquire into the state of competition in the energy sector.

Naturally, the issue of regulated prices is often an irritant between government and regulator, and most acutely in countries where the tradition of independent regulation is youngest. Such tensions came to a head in Portugal in December 2006 when Jorge Vasconcelos resigned as the country's top energy regulator in protest against government intervention. In fact, Mr. Vasconcelos points out that the Portuguese energy regulator had had, from its inception in 1996, the power to fix tariffs. But, when it tried to order a price increase in 2006, the government intervened and overruled the regulatory agency by decree. 'This has created a huge tariff deficit [between electricity's generating cost and its retail price], and totally killed the free market for electricity', notes Mr Vasconcelos. 'In 2005 the free, unregulated part of the total retail power market was 25 percent, now in 2007 it is 8 percent of the total and most of the Spanish players have left.' [4] As we have seen, across the border, Spain's CNE energy regulator found itself a pawn in the government's battle to keep Eon's hands off Endesa. The latter's chief executive, Mr Miranda, complains that 'in Spain we do not have the culture of independent regulators.'

Curiously, countries' accommodation to regulation has had little to do with their degree of political centralization. For instance, France, the centralized state par excellence, has adapted quite well to regulation. Its CRE energy regulator has shown a certain independence of spirit. It has publicly complained about regulated prices, though none of its members have followed Mr Vasconcelos' example. And, during its bid in 2007–8 to ward off further structural reform from Brussels like ownership unbundling, French governments have vaunted the CRE as a model of rigorous independent regulation that the rest of Europe should follow.

By contrast, one might have thought that Germany's political decentralization would predispose it to easy acceptance of independent regulation. Not at all. Germany was the last EU state to set up an energy regulator, and what it set up, the Bundesnetzagentur, can only devote limited resources to energy because it is also responsible for the other network industries of post, telecommunications and railways. Part of German

4 Author interview, 2007.

regulatory reluctance in this area is that, unlike other EU states, energy has always been a private or (where publicly-owned) local affair with rules set by industry insiders, not politicians. These rules are not easy to set because the German energy industry also has far more energy networks (800 in electricity) than any other EU state. As one (non-German) executive working in Germany for a big German utility put it, 'the German system takes time to adapt, because Germans like to discuss and negotiate everything.'[5]

So, where other EU governments need to let go of their energy companies and their regulators, there is a sense in which Germany's government has needed to take charge of rationalizing its energy system. This system is important because Germany is Europe's biggest economy and main conduit for gas from the east. But Germany has constantly tried to delay any new EU reform, on the grounds that it was still digesting the last EU reform. No wonder therefore that the groans from Berlin were among the loudest when in 2007 the Commission unveiled a Third package of market reforms even before the Second package was fully in force.

5 Author interview, 2007.

CHAPTER 6

UNBUNDLING – UNAVOIDABLE OR UNNECESSARY?

This would be the greatest expropriation since the Bolshevik revolution.

Bruno Wallnöfer, chief executive of Tiwag, an Austrian utility.

What would people say if Heathrow were managed by British Airways?

Claude Mandil, former head of the International Energy Agency.

Of the European Commission's 2007 reform proposals, the most controversial was on ownership unbundling (OU) of energy networks. It gave vertically integrated companies a stark choice: either sell off your networks or put them under the management of separately owned 'independent system operators' (ISOs).

The potential for collective measures in Europe's internal energy market is, as discussed in earlier chapters, high, and higher than in some other federal systems, such as the US. But ownership unbundling proposals clearly pushed this potential to its political limit. Any suggestion of forced divestment was bound to raise issues of public and private property rights, and the spectre of privatization in France and of expropriation in Germany. It was, therefore, on the face of it, somewhat puzzling that the Commission should have pushed so hard. So this chapter analyses the motives and justification for the Commission's proposals, while the following chapter tracks how far the proposals got.

The Commission's Third legislative package was not, as sometimes suggested, an Anglo-Saxon plot born out of UK government pressure to spread its gospel of market liberalization. In recent years, the UK has become more interested in its continental partners' energy market structure, and in that structure conforming more to its own liberalized model. But this view was shared by all the other member states that had taken