Proposals European Commission

Crusading against vertical integration

By David Buchan

The European Commission has stuck to its guns in proposing structural reform of Europe's electricity and gas markets, in the draft legislation it laid before legislators on September 19. Brussels has maintained the 'clear preference' that it stated last January for 'ownership unbundling' (OU) of networks from suppliers. But to placate those member states that have complained since January about such radical restructuring, the EU executive is proposing an alternative of 'independent system operators' (ISOs). This would allow their integrated energy groups to keep ownership of networks, but at the price of abandoning any day-to-day control of these networks to independent operators.

The Commission is also proposing other measures: an upwards harmonisation of the powers and independence of the 27 EU states' national regulators, and a new body (the Agency for the Cooperation of Energy Regulators) in which they can collectively tackle cross-border issues; a new network of European grid operators to set standards and plan investment; and new rules on market transparency. These proposals are not insignificant. New organisations for regulators and grid operators, and the relation between them, could create an institutional dynamic of great benefit to the European energy market. Likewise, the problem of concentration is undeniably made worse when dominant companies are not required to reveal basic supply information (about, say, gas import volumes or power plants going offline) to smaller market players.

But this comment focuses on unbundling – not only because it causes the most controversy, but also because Brussels sees it as the best way to break down a broad series of barriers to cross-border energy trade, investment and competition. These barriers include the temptation of bundled groups to use their networks as a weapon against rival suppliers. Another barrier to new entrants is the difficulty of preventing supply and network subsidiaries in integrated energy groups from privileging each other with potentially market-sensitive information. To sweeten the pill, the Commission is promising that its latest market reform package of September 2007 will be its last. This seems plausible. The new package pushes the existing equirements for functional (separate management) and legal (separate subsidiary) unbundling of network from supply to their logical extreme. Separate ownership is as separate as you can get. And the Commission argues that this is the only sure way to remove the conflict of interest inherent in owning transmission and supply together. In its formula for ownership unbundling, the Commission takes an absolutist view of separation: companies in supply and transmission would not be allowed 'any interest in or influence over' each other. Neutral investors like pension funds could own shares in both sides of the energy business, but only as minority stakes that could not be used to block or control the companies. Nor would the alternative of ISO status be easy to get, either. Such operators would have to certified as independent by national regulators, and

José Manuel Durão Barroso, president of the European Commission. Photo: Sion Touhig/Corbis

the latter's decision could be reviewed and overturned by the Commission.

Hobson's Choice

So the Commission has deliberately made the ISO option as close to OU, and as unpalatable, as possible. In a way, the ISO option is worse, because it involves more red tape and monitoring by national regulators. Jose Manuel Barroso, the Commission president, said this was the 'inevitable trade-off' for companies or countries not choosing the cleaner solution of OU. His officials say they want 'deep ISOs' with maximum powers over their networks, and that the only current ISO in the EU – the Scottish one – falls well short of what they want. This is because National Grid operates the network of two vertically integrated electricity companies, but the latter have a real say on investment. EU officials have looked with some admiration at the PJM (originally Pennsylvania-Jersey-Maryland) ISO that runs the grid for a large portion of the eastern US. Many big utilities have reacted by saying that the ISO option (owning something you cannot control) is almost worse than OU (not owning it). However, talk of any voluntary sell-off of networks should be taken with a pinch of salt because network investments provide valuable risk diversification for energy suppliers.

Welcome investment

The Commission contends that vertically integrated companies are particularly disinclined to expand networks they own into markets in which they do not compete, such as in a neighbouring EU state. For such expansion would merely enable rivals to enter their own markets. By contrast, the Commission claims that in states that require OU – 13 EU states have done this in electricity and 7 in gas – network companies are far more likely to invest for expansion. EU officials also cite figures showing that – of companies using auctions to ration congested capacity – unbundled companies reinvested 33 per cent of congestion auction revenue into building new capacity, while bundled companies only re-invested 17 per cent. In addition, far more LNG terminals are being built in states that have unbundled their gas networks. However, even Commission officials concede there is 'no scientific proof' of OU's beneficial impact on investment. They also admit that there is evidence that transition periods leading to OU produce a decline in network investment. This makes sense. Why would you step up capital expenditure in a network that you are about to have to sell off? It may also be that the Commission may have misinterpreted some of the investment data from unbundled markets such as the UK. According to Philip Wright of Sheffield University and also of the Oxford Institute for Energy Studies, investment in transmission, as distinct from lowvoltage and low-pressure distribution, actually declined in real terms after unbundling in the UK, and that the fate of networks depends more on how they are regulated than on who owns them.

Neelie Kroes, European Commissioner for Competition. Photo: Thierry Tronnel/Corbis.

Unwelcome investment

The prospect of a sell-off of EU energy networks led the Commission to include some safeguards against possible buyers – in particular Gazprom, the favourite bogeyman. Such safeguards would not strictly be necessary. The Commission's proposals contain their own defence mechanisms against a vertically integrated company with a monopoly on Russian pipeline gas exports buying EU networks. In EU states choosing OU, networks would be off limits to any energy supplier of whatever nationality; in states opting for ISOs, a non-EU or EU energy supplier could invest in, but not control or operate, an EU network. But there is a concern in some EU capitals about potential network purchases by state investment funds with not entirely economic motives.

Such an entity, maybe a Russia state investment fund, might appear separate from an energy company like Gazprom, but could be related to it through common state ownership. This concern is understandable, but the Commission's proposed two-step safeguard defence is an over-reaction.

First, any non-EU buyer of an EU network would have to come from a country that has an international agreement with the EU 'which explicitly allows for this situation'. At present, there are no such agreements, and EU officials do not seem to have any precise idea about what sort of agreement could 'allow for this situation'. Indeed the whole idea seems to be a political negotiating ploy to get Moscow's attention on the issue of reciprocity, whenever negotiations resume to replace the current EU-Russia partnership and cooperation agreement. Barroso said as much on September 19. Energy commissioner Andris Piebalgs also rationalised the requirement for agreements with third countries in general, and Moscow in particular, in political terms, when he said 'we cannot let people feel naked against the biggest supplier'. The second safeguard step would be that, even where a foreign investor's home state had an enabling agreement with the EU, this investor would have to conform to EU unbundling rules.

Risks

It may be that the Commission has calculated its unbundling proposals so that they get approved without significant change and that they do foster the right kind of new investment. But there are risks. First, the market liberalisation push could work against other EU policy goals of combating climate change and achieving energy security. A disruptive transition towards more unbundling could reduce spending on electricity grids when more investment is needed to link renewable sources of generation, as well as complicating relations with outside gas suppliers. Second, the need to draft policy for as many as 27 states has led the Commission – for the first time in any significant sector of the European economy – to give states a choice between two different structures: OU or ISO. The Commission wants to keep the differences as small as possible in the interest of market unity. But if EU legislators were to weaken the ISO option appreciably, the result would be to accentuate the two-tier nature of the European market.

Third, in making a last push on unbundling, the Commission might be wasting political capital that would be better preserved for the coming battles over national targets for greenhouse gas emissions and renewable energy development. In both cases, the Commission is called upon to be the arbiter of burden-sharing among the member states. It may need all the goodwill it can muster for those tasks. ■

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- Column -

More roads to Rome?

Coby van der Linde

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The Commission's 3rd energy package has, after a long descend, finally landed on our desks. Elements of the 3rd package had already reached us through newspapers and orphaned electronic bits and bytes that mysteriously found their way over the summer, preparing us for the landing on 19 September. After the spectacular show of the 10 January 2007 package, announcing the onset of a new industrial age, the presentation of the 19 September package was done with the same broad smiles but with a firmer undertone: here was the Commission speaking with an austere headmaster's voice to make the new schoolyard discipline be understood by the rough and tumble boys and girls of the sector.

Yet, being fierce is not always a sign of strength or a sign of confidence. The package does contain a number of controversial proposals, such as ownership unbundling, the extension of powers of the regulators, and the investments of third country (semi) state companies. Contentious stuff that will keep us busy for a while. It will take energy policy watchers some time to sift through the documents and ponder on the integrated impact of the proposals. That is why the odd bits and bytes that we received beforehand are so important, because relatively early in the process, it becomes clear in which way the Commission might be swayed by arguments delivered in the consultation process. On the internal market the Commission has displayed great consistency with few deviations from its course. The consultation can sometimes be seen as a very clever process of 'line, hook and sinker' that obliges stakeholders to the outcome by the virtue of participating in it.

The 3rd package is meant to be 'the package of all packages' and complete the establishment of an internal market for electricity and gas in the EU. Yet, the unbundling discussion could become the quagmire in which the completion of the internal energy market sinks. This discussion has the propensity to suck out both time and energy of the stakeholders. Moreover, it could draw away attention from the other priorities of energy policy, the environment and security of supply. In my country, the Netherlands, the energy discussion for years was paralysed by the ownership unbundling discussion in the distribution sector. Moreover, the intellectual level of the discussion deteriorated quickly, basically ending up in a principled shouting match for or against. Nobody listened to any of the arguments and subtleties of certain opinions, let alone that the debate was influenced by radically different market circumstances that appeared during the debate. And that is in a country where transmission is already unbundled in state companies' hand, and where some of the market players are not private companies. Everyone ended up accusing everyone of being self serving in the name of the public interest. The end result was a deep divide between the public authorities and market players, and a deep distrust of each other's motives. Although politically, the Dutch government has made the decision to enforce ownership unbundling, the debate has now moved to the court room. Not very firm ground on which a new industrial revolution can be built.

The promise of efficiency gains for the consumer remains appealing. But many small consumers will wonder with me if, like in the Netherlands, the small consumer will end seeing the pockets of lawyers, consultants and other advisors lined with the efficiency gains that were promised to me. At the same time, my energy security has not improved nor do I see how the efficiency gains will end up in cleaner energy. Sometimes I wonder whether the entire operation was worth it and that perhaps by hindsight other roads also lead to Rome.