Germany debates ownership unbundling

'Nobody knows if this is a good deal for the consumer'

The European Commission has proposed an extensive overhaul of Europe's energy market with the aim to improve competition, spark infrastructure investments and create a cross-border European power market. However, ownership unbundling (OU), the Commission's key plank in the new competition initiative, has been met with bitter resistance, particularly in Germany, where four powerful energy giants rule over an oligopoly that many say is causing excessively high energy high prices. So will OU significantly drive down prices? Most experts European Energy Review talked to have serious doubts. They add that the Commission is fighting a monster it has created itself.

By Stefan Nicola

It was a wet yet mild day in Brussels in late November 2007, and EU Energy Commissioner Andris Piebalgs was angry. Together with Neelie Kroes, Europe's competition queen, Piebalgs is fighting for a functioning liberalised European energy market. Over the past weeks, however, politicians and energy company officials all over Europe had harshly criticized Brussels' proposals, which Piebalgs says are aimed at spurring competition, driving down energy prices, boosting investment and encouraging new firms to invest in the energy grid. Especially Brussels' key plan, ownership unbundling (OU), which requires energy giants like Germany's Eon and France's EDF to sell off their transmission infrastructure or hand over control to an independent system operator, came under severe fire. On November 27, it was time to hit back.

'These proposals are more necessary than ever,' Piebalgs said in a statement. 'At the end of the day, they have only one objective: the interests of the EU's citizens, as energy customers and as employees of companies for which competitive energy prices are essential.'

He insisted the reforms were vital for EU countries, many of which suffer from an obvious lack of competition.

'Although there are many reasons why companies' profits change, it is impossible to ignore that the profits of some of the EU's electricity and gas companies have doubled or more than tripled at a time when European citizens are facing higher bills,' Piebalgs said. 'It is impossible not to raise the question whether this would have been possible if these companies faced effective competition.'

Effective competition - that's what Piebalgs and Kroes want to achieve with the Commission's extensive reform package for the electricity market (and for the gas market, but that's a chapter the Commission is careful not to open yet, because it will probably stir up an even greater hornets'nest). Apart from OU, the package includes measures for greater transparency, greater harmonization among the 27 EU states' national regulators, and a new body, the Agency for the Cooperation of Energy Regulators, that will be given the task to tackle cross-border supply and congestion problems. The package also contains what experts have dubbed the "Gazprom Clause" - a safeguard that bans non-European companies from buying into the continental grid unless an agreement is struck between that company's government and Brussels. The provision would only clear a foreign buyer if it played by the EU's market rules, meaning that the likes of state-controlled Russian energy monopolist Gazprom would also have to be unbundled, which everybody knows is never going to happen.

The Russians aren't exactly happy about that clause, to say the least. But the most controversial aspect of the package remains OU. After a thorough sector inqury, the Commission found that despite the fact that many national markets had moved significantly toward legal unbundling, competition in Europe remains primitive.

The plan to split off transmission networks from production assets caused European energy company officials to scream in pain. Bruno Wallnöfer, the head of the Tiwag AG, an Austrian hydropower company, has called OU the 'greatest expropriation in Europe since

> *'One would like to have numbers to fall back on'*

the Bolshevik revolution.' While 13 EU states openly back OU, Austria is one of nine countries opposing it. Bulgaria, Cyprus, Luxembourg, Greece, Latvia, Slovakia and nuclear energy powerhouse France have also voiced their opposition. The fiercest protests, however, have emerged from Germany, the land of the "big four," as the country's dominant energy companies are called.

Eon, RWE, Vattenfall Europe and EnBW pretty much "own" the German energy market. The networks and over 80 percent of the generation capacities are in their hands, and so are most of the country's customers. Essen-based RWE dominates the north-western part of the country, and EnBW the state of Baden-Wuerttemberg; Eon controls central Germany, with Vattenfall Europe being the main player in the north-eastern states.

Since 2000, the big four spent billions to gobble up competitors in Germany and all over Europe. They managed to significantly reduce costs and multiply their profits. During the same time, however, electricity prices rose by over 50 percent. While the companies blame high government-imposed taxes and the rising oil price for the price hike, that same hike has helped them earn quite a lot of cash. Duesseldorf-based Eon, the world's largest utility by sales, in November 2007 reported record third quarter net profits of 1.35 billion. No wonder Wulf Bernotat, the company's ceo, wants things to remain the way they are. He said the European Commission with its OU plans is more dangerous than Russia. 'You are always talking about Russia but the real threat is coming from the European Commission', he told the Financial Times in November.

Unter den Linden

Gerhard Sabathil doesn't look threatening; but maybe the way to his office in Berlin does to industry officials. If you want to enter it, you have to pass under a giant European flag that flies over the entrance of a 20th century sandstone building. You might be on Berlin's famous Unter den Linden Boulevard, but inside the building, you're in EU territory. Just a few steps northwest towers the Reichstag building, which houses the German parliament, and the Chancellery, where Sabathil – the Commission's extended arm and its top representative in Germany - wants to get Brussels' message heard.

'Expropriation?' Sabathil shakes his head in disbelief. 'Sometimes you have to revert to robust measures to improve the price situation on the market, but this has absolutely nothing to do with expropriation,' he says.

OU, Sabathil says, is essential to improve competition and drive down prices on the European energy market. For Germany, he adds, this is especially true.

'The abuse on the European energy market is so obvious that a regulatory policy intervention is deeply necessary,' he says. 'In Germany alone, there are six cartel proceedings against the big generating companies. We want to introduce a competition between generation and transmission that doesn't exist in Germany and in some other EU countries.'

The European Commission has long eyed potential market abuse in Germany. In May and June 2006, EU and German cartel investigators raided the offices of the German energy giants and confiscated computers and paper files. Competition watchdogs have accused Eon and RWE of having agreed not to interfere with each other's customer base - allegations that so far haven't been proven. What has been proven, however, is that the big four have met on several occasions behind closed doors. Competition officials say they are convinced that the companies have used those meetings to fix prices, a move all of them vehemently deny.

'This is also about driving down power prices for the industry, which will make Germany a more attractive place to invest in,' Sabathil says.

With OU, the Commission wants to eliminate several conflicts of interest inherent in vertically integrated companies. Brussels argues that bundled firms have a built-in incentive to under-invest in infrastructure, especially in cross-border interconnectors, because these would open the home turf to foreign competition. Bundled firms are also likely to privilege their own sales companies when it comes to network access and to delay market entrance of new rivals, Brussels says.

'This damages the EU's competitiveness and its security of supply and prejudices the attainment of its climate change and environmental objectives,' the Commission said in a statement upon presentation of its reform plans in September.

The industry denies this, arguing that much has been achieved in terms of access for new competitors, and that it is already planning massive new investments. RWE announced in late 2007 it wants to build 600 km worth of new power lines.

An RWE spokeswoman says that not only the Commission, but also the industry has good reasons to build more interconnectors to link Europe's national and regional energy markets.

'If we want to grow by acquisition, we need a relevant European market,' she tells European Energy Review in a telephone interview, adding that too much bureaucracy makes it hard for energy companies to build interconnectors. 'We have to wait 10 to 15 years until we get a permission.'

Moreover, the RWE spokeswoman points to the regional cooperation already happening between Belgium, the Netherlands, France and Germany, and adds RWE is in favour of further cooperation.

Experts, however, don't trust the companies just yet. 'If it had been the

Photo: Kai Senf

case that the dominant companies in Europe in a bundled form had been pursuing interconnection, we would have a much better grid than we do,' says Dieter Helm, an energy expert at the University of Oxford. 'And the truth is, the European grid is primitive. It's a series of bilateral links between large oligopolies, and this isn't what we need if we want security of supply.'

Authorities have also accused the big four of having shut down power plants to drive up power prices at the German electricity stock exchange in Leipzig, which they obviously dominate with 80 percent of the country's total production capacity.

The RWE spokeswoman strongly denies those allegations. 'We only run power stations that are cost effective but never shut them down in order to drive up the price.'

Wrong way

The industry says not everything is bad in the Commission's package. 'We also want to promote competition,' the RWE spokeswoman says. 'We fully support that.'

But OU is the wrong way to achieve the Commission's goals, she adds. 'There is no causal link between OU and investments in the grids nor is there a link between OU and security of supply.'

That's why Eon ceo Bernotat doesn't believe OU will fly. 'I am pretty sure unbundling is not coming,' he said in the Financial Times. 'Such processes in Brussels take time especially if important member states such as France and Germany are against it.'

In Germany, however, the tide may be slowly turning. Berlin at first was unwilling to break up its national champions, but when the big four in October announced yet another 10-percent price hike for 2008, consumer groups unleashed a wave of protest. Suddenly, senior German government officials began to issue supportive statements of the Commission's OU plans.

Environment Minister Sigmar Gabriel, of the Social Democrats, after the recent price hike, for the first time threatened the big four with OU.

'The power companies now need to come up with proposals how to make pricing more transparent,' he told German news magazine Der Spiegel. 'If they don't do that, we will have no choice but force through a separation of network and production together with the European Commission.'

In the state of Hesse, conservative Economy Minister Alois Riehl has even gone a step further. He wants to force energy giants to sell off their power plants to competitors wanting to enter the market - a move so radical that not many politicians have dared to back it.

Since then, the energy giants have launched a public relations campaign to put oil on troubled waters. They have announced massive investments in renewable energy sources, promised greater transparency and additional investments in the grid. So far, most conservative politicians are still on the side of the industry.

But apart from the politics - what do the experts think about OU? Do they believe it can help achieve the Commission's goals? In other words, will OU improve competition, spark investments and drive down prices? In other words, will it be worth the trouble?

Those are questions difficult to answer given the current state of research, says Gert Brunekreeft, professor of energy economics and head of the "bremer energie institut," an energy think tank at the Jacobs University in Bremen.

'The discussion about OU remains incomplete. Many good arguments are discussed, but others are not touched,' Brunekreeft says. 'Nobody knows if this is a good deal for the consumer and for society as a whole. OU is such a big undertaking, and not exactly knowing what's going to happen is very distressing. One would like to have numbers to fall back on.'

That's why Brunekreeft together with colleagues from partner universities in Germany, the Netherlands and Austria created Unecom, an interdisciplinary research project studying the effects of ownership unbundling with the help of theoretical and empirical insights from economics, law, technology and politics. Financed 50% by the industry and 50% by academic research grants, Unecom tries to be as independent as possible, Brunekreeft promises.

Brussels argues the numbers are there. It has published an impact assessment of OU, which among other things lists increased investments in infrastructure and R&D in unbundled markets, increased shareholder values for unbundled firms and likely price cuts as a result of OU. 'In OU markets, the electricity price for industrial consumers decreased from 1998 until 2006 by 3 percent, while in markets without ownership unbundling this price increased by 6 percent,' the Commission said in the impact assessment. 'In countries with OU, household electricity prices rose from 1998 until 2006 by 5.9 percent, while the price increase in countries without OU was 29.5 percent.'

Yet the numbers published by the Commission do not satisfy Brunekreeft. Many of them are too steep and the overall study lacks a balance, he says.
'The impact assessment is incomplete because it concentrates very heavily on the benefits of OU,' Brunekreeft says. 'It picked up a couple of good points, but left aside completely the cost aspects. So you cannot actually make a trade-off. If you just focus on the benefits, any project is going to look good.'
Brunekreeft warns that it is too early to judge whether OU will be helpful or not; but already, given the research Unecom has done over the past year, he is willing to make guesstimates, he says. 'As for competition, the effects will be long-term and presumably very small. And the thing is: there is so much more to competition than just OU. You need regulation, you need different players, you need excess supply.'
That means prices may not drop significantly, he adds. 'From what we have calculated, the magnitude for price differences might be disappointingly low - below 10 percent.'

'OU is the greatest expropriation in Europe since the Bolshevik revolution'

Other experts have even lesser hopes. 'Better infrastructure and thus better market access costs a lot of money,' says Chris Peeters, head of the Policy Research Corporation, an independent consulting firm from the Netherlands. 'So OU will only have a price increasing impact.'
But what about the argument that more competitors drive down prices because they fight for their customers?
'It doesn't work in this type of infrastructure-driven sector,' Peeters says. 'It's not really a market because no private company can do the entire job at low cost. At first, a lot of companies will be coming in, but only temporarily, because they will see that they cannot make too much money unless they become larger. And that's a tendency you already have now.'
The same is true for already unbundled Britain, Dieter Helm argues, where four or five companies now dominate the market after a period of frenzied competition by new entrants and low prices in the late 1990s. 'That was in time of excess supply, so it is perfectly possible to point to other explanations for the low prices,' he says. And as for investments – those will only rise substantially with the help of rigid regulating, all experts agree.

Brunekreeft points out there are more issues to consider when it comes to investments. 'Surely OU will have an effect on the investment activities within the now independent networks. In a bundled world, you would normally see that these investments are internally coordinated. But if you have different firms, there are different interests: So a power plant may be built at the wrong position considering the grid infrastructure, and then you may have to expand the network after the event. That may eventually result in higher costs.'

Unattractive

The Commission does offer an alternative to OU - the model of an Independent System Operator (ISO). Under this proposal, big energy companies would hand over control of their transmission networks to an entirely separate operator, but retain ownership of their network assets.
For the industry and for many governments, this is not a better option. 'If you just own the assets without any entrepreneurial influence, there is no real interest in keeping them,' the RWE spokeswoman said.
Some experts have even argued that the ISO model has been deliberately designed to be unattractive so as to make countries go for OU. 'You loose a leg, but at least you can walk again', says Brunekreeft.
Sabathil denies that. 'The ISO model is an offer and is intended to make it easier to find a solution after all.'
Brunekreeft adds that having a two-way solution may not be the worst situation after all.
'Then, you'd have two parallel systems, and after a few years, you could compare them and see: Which one works better?'

Any 'solution', however, will certainly be hard-fought. If OU goes through, the companies are expected to file lawsuits challenging what they see as a move that infringes property rights.
Sabathil says this is the usual strategy of companies unwilling to go along with necessary change. While he admits that few proposals of the Commission go through 100 percent unchanged, 'no one is ever 100 percent altered,' he warns.

Neither should that be necessary, the experts agree, citing several positives OU

Gert Brunekreeft

Gerhard Sabathil

Wind turbines near Berlin. Photo: Kai Senf

may very well achieve: improved trans-border cooperation and regulation, the creation of a functioning European grid and, despite the companies' denials, improved security of supply. The experts also warn, however, that for all of these positives, OU is just the first step of many that have to be taken.

Helm still blames the Commission for much of the downfalls that rattle today's energy markets. He says Brussels is fighting a monster it has created itself. 'In less than a decade, the Commission has presided over the greatest wave of mergers and acquisitions in Europe,' he says. 'We now have four or five energy giants, and they have de-facto franchises in their markets, meaning hat the prospects of any serious competitive markets have basically gone. So OU can't be about competition, because the things you need for competition to take place have been undermined by the Commission itself.'

Helm adds that if the Commission meant it seriously with competition and lower prices, it needs to break up generation, 'but that's never going to happen' he says. 'It may turn out that the right time to do unbundling was about 1980; it was probably a very good way of running the system in times of excess supply in the 1980s and 1990s. But in the world of excess demand, climate change and renewables, the arguments for doing this may well have begun to erode.'

> *'For real competition you have to break up generation'*

Meanwhile, German and French government officials are lobbying for a third way besides OU and ISO. First options will be tabled in early 2008, Paris and Berlin said. The Commission, however, has made clear it wants ownership separation and will settle for nothing less - so a hard and lengthy struggle still lies ahead. ■