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Energy and competition

Liberalisation of Europe's energy markets - a new phase

*By **Jonathan Green,** Europe Economics**

Overview

The liberalisation of energy markets across Europe has come some way since the early 1990s when the first attempts to legislate for change met strong opposition in most EU member states. Today a strong legal framework for open energy markets is in place but that in itself does not guarantee that the old structure of national or regional monopolies will give way to competition. The vision of a single European energy market is still a long way from being realised and will require further change if it is to be achieved.

Recent developments in the European Commission's approach suggest that there is still a healthy appetite for progress and that there is a shift in focus from the essentially rule-based approach of the internal energy market directives towards market analysis and the use of competition powers to drive restructuring. Strong commitment to liberalisation at member state level will be required to make real progress.

Early days

The Commission's first attempt in 1992 to develop a directive that would open electricity markets to competition received little support except from those countries, such as the UK and Sweden, that had already embarked on the liberalisation journey. It took four years of negotiation and redrafting before agreement was finally reached on the first directive "concerning common rules for the internal market in electricity" in December 1996 *(Directive 96/92/EC)*.

In order to reach agreement, many compromises had to be made along the way and the final text did not represent a strong commitment to liberalisation by member states. The rules on access to networks were weak, the timetable for opening markets to competition was very extended, there was no clear distinction between distribution and supply, and there was very limited attention to the "unbundling" of networks – which as natural monopolies should be regulated – from generation and supply – which should be open to competition.

Nonetheless, this unpromising text proved to be a catalyst for change. In implementing the directive, many member states, facing pressure from consumers and growing political support for liberalisation, decided to go further than the minimum required.

More aggressive market-opening targets were adopted, independent regulators were developed and network unbundling was pursued. The "single buyer" option, which appeared to give an extended lease of life to national monopolists, was almost universally ignored, not least in France where the idea had originated. The negotiated third party access option was similarly ignored in favour of regulated access, which was more likely to encourage competition in generation.

By 2000, liberalisation of electricity markets had, in a number of member states and in varying degrees, outstripped the requirements of the 1996 directive. At one level this was a positive outcome, but it also resulted in considerable differences in market opening across the whole of the EU. Competition had increased in some national markets, bringing benefits in terms of lower prices, but the creation of a single electricity market, with common standards, was no closer to being realised.

The opening up of the electricity markets was followed by a directive for the gas sector *(Directive 98/30/EC)*. In this sector there was less inclination, either by industry or by governments, to push ahead of the basic requirements. Access to networks, access to gas storage facilities essential for balancing contract positions, and technical issues relating to interoperability between national systems have all proved to be obstacles to the development of competition. Dominant players and long term take-or-pay gas contracts have contributed to the reluctance to embrace change.

Impetus from Lisbon

Political support for liberalisation reached a high point in 2000 when a commitment to speed up the opening of the energy markets formed a key part of the Lisbon declaration on EU competitiveness "with a view to achieving a fully operational internal market." This initiated a second phase of work to define the requirements for an open market and to set a more demanding timetable for its achievement.

The drafting of new directives on both electricity and gas went on in parallel and was completed in mid-2003 *(Directive 2003/54/EC* – electricity, *Directive 2003/55/EC* – gas). These directives sought to codify best practice in liberalised markets as identified in benchmarking studies carried out for the Commission.

Clear separation of network activities with unbundling into separate legal entities, mandatory independent regulation (a particular issue for Germany), *ex ante* approval of network tariff methodologies and published tariffs were key elements in the new framework.

Finalisation of the directives was delayed by disagreement on the date for the final opening of both the gas and the electri-

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city markets to full competition. This was eventually set for 1 July 2007. By that date, all customers should be able to choose their electricity and gas suppliers. The implementation date for the other provisions in the directives was 1 July 2004.

A particular feature of this stage in the liberalisation process has been the development of a regulation on conditions of access to the network for cross-border exchanges in electricity *(Regulation (EC) No 1228/2003)* alongside the main directive. A similar regulation for gas networks is still under discussion.

In contrast to the directive, which must be implemented by national legislation, the regulation has direct effect and must be implemented as it stands in each member state. As such, it is a potentially powerful tool in the hands of the Commission for driving forward the creation of the single market.

The regulation is focused on technical issues, such as transmission charging, congestion management and remuneration for cross-border flows, which are all absolutely central to the development of competition across national boundaries. The regulation is at the heart of making the high-level rules in the directive work in practice.

To take this forward the Commission will issue binding guidelines under the regulation and will draw on advice from the newly created European Regulators Group for Electricity and Gas – ERGEG *(Commission Decision 2003/796/EC)*. The guidelines will be subject to approval by a group made up of member state representatives.

How powerful the regulation will be in practice remains to be seen. A number of draft electricity guidelines have been in circulation for more than a year but the Commission appears unwilling to put these to the test of formal approval while there are unresolved issues between member states.

This slow progress in the electricity sector does not bode well for the use of the regulation route in gas, where resistance to change appears to be more strongly entrenched.

What has been achieved

Relative to a baseline of 1990, there has been substantial progress in opening up the EU energy market in both the gas and the electricity sectors. Competition at both wholesale and retail levels has developed and has been facilitated by the progressive separation out of the regulated network businesses.

The importance of non-discriminatory access to networks is now, largely, taken for granted. Industrial and commercial businesses and many domestic consumers can now choose their gas and electricity supplier and competition at this level has driven down the prices paid by end users.

However, the extent to which this represents a real opportunity for consumers varies considerably. In the highly liberalised markets in the UK and Scandinavia, more than 50% of large users have changed electricity supplier. In Germany and the Netherlands, the switching level is only about 35%. In Greece, there has been no switching of supplier at all by large users. Competition is less well developed for smaller users and domestic consumers.

Some cross-border trading does take place. There has, for example, been a significant growth in two-way trade on the France-England electricity interconnector and on the England-Belgium gas interconnector over the past five years. As a result there are some signs of convergence of wholesale electricity prices, for example between Belgium, Germany and France. But, to a large extent, the achievements of liberalisation are still set within the boundaries of national markets. There is still a wide dispersion of prices between member states both for industrial and for domestic customers.

However, if we were to bank the achievements of the 1990s and take a more recent baseline as our starting point, then the picture is less good.

The 2003 directives set out clear requirements for reforms that should have been in place by July 2004. The *Fourth Benchmaking Report,* published by the Commission in January 2005, highlighted a range of concerns about progress both at the national level and on the integration of national markets *(Annual Report on the Implementation of the Gas and Electricity Internal Market, SEC(2004)1720).*

The Energy Commissioner, Andris Piebalgs, has indicated that the implementation of the existing directives, nearly a year after the original deadline, is his priority before considering whether any new legislation is necessary. In March 2005, the Commission initiated the second stage of infringement proceedings with ten member states for failure to implement the directives.

Full implementation of the directive and endorsement of the associated detailed guidelines issued under regulations, while necessary, is unlikely to be sufficient for completing the internal energy market. The *Benchmarking Study* highlighted market structure issues as now being the most important obstacle to the further development of competition in both the electricity and gas sectors. This points to the need for a third phase of work if further progress is to be made.

The next phase

The liberalisation process to date has focused on the establishment of appropriate rules that will allow competition to develop in the electricity and gas markets. This is largely a permissive approach.

The extent to which competition actually develops once the new rules are in place depends on the reaction of incumbent companies and new entrants. If incumbents retain a dominant position in their national market, then new entry may well be deterred or unsuccessful. That is a generic competition policy issue and not one confined to energy markets.

The *Benchmarking Report* recognises this distinction. Increased use of competition policy at national level and co-operation between national regulators, competition authorities and the Commission are identified as having the potential to deliver significant improvement.

Since publication of that report, Neelie Kroes, the Competition Commissioner, has announced an initiative for the Competition Directorate to conduct sector investigations where competition does not appear to be functioning as well as it might. Energy is identified as one of the first targets for such an investigation. This is likely to be carried out jointly by the Competition and Energy Directorates. The methodology has not yet been specified but comparison between member states is likely to be one element. For this, the UK market will be an important comparator.

United Kingdom markets

In past Commission reports on energy markets, the UK has usually stood out as having one of the most highly developed levels of competition and as having a favourable market structure. With six major electricity and gas companies, the Commission has not identified dominance by any one company as a concern.

But it is necessary to look beyond the high-level measures on concentration if lessons are to be drawn from the UK experience that are relevant to other markets. Concerns about price setting in both the gas and the electricity markets in the UK continue to exist.

The present market structure in the UK has evolved over 15 years. In the early years, new entry in both electricity and gas was important at the wholesale level. Cross-entry between the gas and electricity markets stimulated competition at the supply end of the chain. But the original post-privatisation incumbents retained significant market power.

It required government intervention to impose gas release programmes, to force divestment of generation plant and to bring about a complete restructuring of market trading before there was a major increase in competition.

At the same time, in the electricity sector, there was a rapid move to vertical integration between generation and supply. That is now the predominant model in the UK market with the disappearance of independent supply companies and an illiquid wholesale market.

Whether a reduction in horizontal market power accompanied by an increase in vertical integration of this sort is a desirable trade-off remains an open issue and should be reviewed as part of the Commission's investigation.

Conclusion

The changes in the UK market have required significant political commitment to market opening over a period of years. They are still the subject of close scrutiny.

Commitment at the Commission level to carrying through further change may lead to radical proposals, but the levers for change, particularly if this requires ownership change, remain at national level. Commitment by individual governments to use those levers to restructure nationally dominant companies is by no means guaranteed.

Single energy market for the island of Ireland

On 31 March, the energy regulators for Ireland and Northern Ireland published a paper on the creation of a seamless energy market for the island. It is called a "high level design" and is open for comment until 27 May.

The two regulators are the Irish Commission for Energy Regulation or CER (An Coimisiún um Rialáil Fuinnimh) and the Northern Ireland Authority for Energy Regulation or NIAER (also known as "Ofreg").

For present purposes, "energy market" means the wholesale electricity market. Two models are put forward – a "central commitment" option and a "self commitment" option. The paper concludes that the first is the best for Ireland.

The design specifications are inaccessible to the uninitiated. Those with an interest are recommended to go to the document itself: *www.cer.ie/cerdocs/cer05044.pdf*

Ireland's transitional trading arrangements provide for a bilateral contracts market with a mechanism for participants to trade energy and balance their uncontracted energy needs through ESB Power Generation (ESB is the Electricity Supply Board). ESB National Grid performs the market and systems operator functions.

Northern Ireland's electricity market, privatised in 1992, is run by the system operator, SONI. Generators contract with SONI and it dispatches power also by bilateral contract.

Two interconnectors play an important role – the North-South and Scotland-Northern Ireland Moyle interconnectors. The ESB National Grid and SONI allocate capacity on north-south and south-north flows at an annual auction.

North-south connectivity is of very recent origin. The first interconnector was completed in 1996, but its use was marginal. In 2000, electricity began to be transported commercially over it. Four major companies have invested hundreds of millions of euro in new plant with cross-border trading in mind. It is therefore time to replace the transitional market arrangements with a regular structured market.

Last year, the flow measured 1.40 TWh (terrawatt-hours). Next year, this is expected to rise to 2.63 TWh. About a tenth of Ireland's electricity needs will be met from the North.

Gas connectivity has improved with the building of the Carrickfergus-Coolkeragh pipeline. Gas companies are crossing the border to serve consumers, but the real importance of gas is as the feed for electricity generation. Two gas pipelines will connect Great Britain with both parts of Ireland next year, making the island's gas supply part of a seamless line, with Russia and Algeria at the far ends.

There is no nuclear generating capacity on the island. Three wind farms have been built, two in Northern Ireland and one in Ireland but supplying the North. Many more are awaiting planning permission. Ireland did develop some hydropower capacity, but it is of little significance.

Once the present move has been made, the focus of concern is likely to shift from competition to security of supply and environmental damage in coming years. The two parts of Ireland have at last realised that their problems and opportunities are identical and call for common solutions, starting with a common electricity pool.