Oxford Energy Comment
September 2007

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 in the council of ministers and European parliament 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. Transparency – equalising access to market-moving information – is therefore important.

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 promise may not be kept, but it is at least plausible. For the new package pushes the existing requirements 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 the latter's decision could be reviewed and overturned by the Commission. The ISO would be responsible not only for running the transmission business, but also expanding it. The ISO would therefore take investment decisions on behalf of the owner(s) of the network, whose role would be to "finance the investments decided by the ISO and approved by the regulator" (proposed new Article 9b in EU directives).

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, Scottish Power and Scottish and Southern Energy, 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. But while PJM is considered a very "deep" ISO and runs the regional market as well as the grid, it has taken many years to build up – and even then it does not have total say on investments.

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. It is a commonplace among energy utilities that the steady regulated rate of return from a network (even one in which you are a passive investor) is a useful stabiliser to the roller-coaster returns from the unregulated wholesale energy supply business. However, there is an argument about whether OU would expand investment, especially across borders.

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. Because their only income comes from transporting energy, they want to transport as much as possible of it, no matter who it belongs to. EU officials also cite figures showing that - of companies using auctions to ration congested capacity - unbundled companies re-invested 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 low-voltage 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.

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 European bogeyman, but also state investment funds from countries like China or the Middle East. As far as Gazprom itself, 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 as well as in Brussels 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. The fear in Brussels is that, outside the EU and in Russia in particular, such corporate links that could sidestep EU unbundling rules are hard to detect. 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; in the absence of the Commission's proposed international agreement, he complained, Brussels had "no real leverage" over countries that did not give the EU equality of investment opportunity. 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.

Gazprom's immediate reaction was relatively mild. And it may be that the Russian gas company is less interested in maintaining and expanding its investments in the regulated margin business of EU transmission networks than in moving into the higher profit area of direct sales to final customers in the EU. But with the approach of presidential elections in Russia, the country's politicians may be more nationalist and consider some kind of retaliation in the form of extra restrictions on EU investment in Russia.

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:

- 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.
- 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.
- 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.