OPINION

European Energy Markets: The Next Round

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Eighteen months after the Commission's inquiry into the European gas and electricity sectors was launched, it appears that the real debate over effective energy liberalisation is only beginning. While European Commission President Barroso and Competition Commissioner Kroes are firmly in favour of '*full ownership unbundling*' (that is, severing all links between the network operators and the supply and generation companies), key Member States, including France and Germany, have outlined fundamentally different alternative 'unbundling' visions.

The Commission's inquiry concluded that the current degree of vertical integration leads to foreclosure in both the gas and electricity sectors by hindering market entry by new entrant energy suppliers and removing investment incentives in a manner that potentially impedes security of supply (for example, the construction of additional interconnector capacity). The Commission's Communication regarding the inquiry and its 'Prospects for the Internal Gas and Electricity Market' strategy paper clearly state that the Commission considers that it is unlikely that behavioural remedies (such as energy release programmes) would be sufficient to address the perceived structural problems in the market.

The President of the Commission and Commissioner Kroes appear to be contemplating an extreme form of structural separation. However, the Commission is not apparently proposing to institute Article 82 abuse of dominance investigations immediately. Rather, it refers to the potential for such action in response to future abuses. As such, the Commission could legitimately be read as warning energy companies and Member States alike that bigger steps towards liberalisation must be taken (and be seen to be taken) in the short to medium term, to avoid the sword of Damocles of structural separation.

However, the response of the French and German Governments confirms that their vision of the appropriate level and form of European energy liberalisation is still materially different from that of the Commission (and from each other). While all of the Member State Energy Ministers have accepted that energy transmission systems must be more accessible to new entrant market players, their views as to the appropriate approach to improve access make it clear that the Commission is far from achieving consensus support for its proposal. The German Government's preference is for an Independent System Operator, involving an energy company retaining the ownership of its network assets, but receiving a regulated return on those assets. Both the Commission and the French Government have expressed reservations about the efficacy of the German proposal. The French counter-proposal is to create a system of 'regulated unbundling', under which the prices that energy network operators could charge for use of their infrastructure would be set by an independent authority. The French Government believes that this approach would lead to higher levels of infrastructure investment than either the German approach or the Commission's proposal.

Stepping back, it should be noted that structural separation, let alone divestiture, is unusual in Europe, even in network industries.[1] To date, only the United Kingdom has 'forced' separation (in the fixed communications and gas sectors). However, even in the communications sector, BT's 2005 agreement with Ofcom to implement *full functional separation* (and third-party access based on the 'equivalence' concept) followed years of pressure on BT to restructure, and did not involve divestiture.

Perhaps the real issue for European energy companies is whether the Commission has essentially fired a 'warning shot' intended to force sector players (and the relevant Ministries) to commit themselves to achieving improvements in access, and make short- to medium-term changes that might be persuasive in demonstrating that less extreme forms of separation would be sufficient.

Energy companies are currently required to *structurally separate* their regulated and competitive activities, using distinct legal entities for each type of activity, and to maintain accounting separation. In principle, structural separation should preserve the important benefits of vertical integration, such as economies of scope, co-ordinated (and consistent) investment decisions, and the avoidance of double-marginalisation. However, such structures can be porous in terms of information exchange between regulated and competitive elements of a broader group. Further,

1 While Council Regulation (EC) No 1/2003 provides for the adoption of structural measures, where behavioural measures would be less effective and overly burdensome, it has largely represented a dormant threat to date.

they preserve the incentives to engage in discrimination. Only 'ownership' separation addresses these two concerns. Currently, only seven (out of 27) Member States have implemented ownership separation for their national champion's transmission assets, and no Member State has done so in relation to its distribution assets. Might increases in the number of legally separated distribution assets, and in ownership separation of transmission assets, combined with effective regulation of the sector, address the Commission's incentive-related concerns?

The Commission's other avenue of attack in its bid to improve access (and to drive pan-European market integration) is long-term transmission contracts, particularly contracts concerning cross-border access. The Communication expressly refers to the review of long-term contracts, particularly those entered into prior to liberalisation, to analyse the competitive effects of such contracts and their compatibility with competition rules. Further, the Commission sends a stark warning that one of the goals of the review of long-term contracts would be to improve liquidity in the short term. The Communication expressly refers to release programmes and control swaps as likely approaches to addressing what it characterises as a chronic lack of liquidity. In this context, the Commission is clearly looking to the competitive undertakings extracted in a number of relatively recent energy sector mergers (including *EdF/ EnBW*, *Verbund/ EnergieAllianz*, *E.ON/MOL* and *DONG/Elsam/Energie E2*).[2]

For non-infrastructure-based energy companies in Europe, the potential for voiding of long-term supply contracts, and the potential application of a 'use-it-or-lose it' approach to infrastructure and suitable generation sites could raise both short-term concerns and opportunities. Even as the debate over structural separation continues, we can expect that the drive to increase liquidity will push ahead in 2007, given the 1 July date for full retail market liberalisation.

2 Case Nos COM)/M.1853, COMP/M.2947, COMP/M.3696 and COMP/M.3868.