

Role of the regulator in facilitating competition and trading

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According to Jorge Vasconcelos, Chairman of the Council of European Energy Regulators, creating a single EU energy market is a complex process which may result in some competitive distortions in the short- to medium-term. Therefore, it is crucial to ensure both a level playing field for all market participants and the convergence of all regional markets into one single energy market.

Setting the scene

Independent energy regulators are new in Europe – in fact, they are as new (or as old) as free energy markets in the European Union (EU). Both are children of the 1987 Single European Act which actively promoted integration of national markets into one single European market and invented the '1992 Internal Market' agenda.

Most energy regulatory authorities were created in the 1990s: a few before the first internal electricity market directive was approved,¹ others in 1996,² more following the entry into force of this directive, in February 1997.³ With the second internal electricity and natural gas market directives⁴ energy regulatory authorities became mandatory in all Member States. Norway and Iceland, who belong to the European Economic Area, have adopted these directives too and established independent energy regulators.⁵

I was invited to discuss the role of regulators in facilitating competition and trading and I would like to do so from two different perspectives: first from a broad historical and general point of view and second from the point of view of the current developments of the internal energy market. Of course, as the German philosopher Hans Blumenberg rightly pointed out, 'Background is no indicator of value, just as foreground is no disqualification.'⁶

The role of independent regulators – some historical remarks

As regards the historical perspective, I believe one of the best descriptions of the regulator's role was delivered by US President Theodore Roosevelt a century ago.

The Interstate Commerce Commission – the archetype of all regulatory authorities – was established in the USA in 1887 in order to avoid discriminatory pricing and other forms of destructive competition among railway companies. However, the powers initially given to the Interstate Commerce Commission were not sufficient to solve the

complex problems created by the railway industry to railway users – in particular, to the Mid-West farmers – and to the US economy as a whole.' In 1906, the Hepburn Act changed the Interstate Commerce Commission statutes and reinforced its powers. In a communication to Congress on 5 December 1905, President Theodore Roosevelt supported these amendments as follows:

'... The first consideration to be kept in mind is that the power should be affirmative and should be given to some administrative body created by the Congress... I do not believe in the government interfering with private business more than is necessary. I do not believe in the government undertaking any work which can with propriety be left in private hands. But neither do I believe in the government flinching from overseeing any work when it becomes evident that abuses are sure to obtain therein unless there is government supervision... I regard this power to establish a maximum rate as being essential to any scheme of real reform in the matter of railway regulation. The first necessity is to secure it; and unless it is granted to the commission there is little use in touching the subject at all.

¹ Offer, the UK electricity regulator, started its activity on 1 September 1989.

² Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996.

³ Portugal, Spain, Finland, Sweden, Hungary.

⁴ Respectively, directives 2003/54/EC and 2003/55/EC of the European Parliament and of the Council, both of 26 June 2003.

⁵ In Norway, independent electricity regulation had been already introduced in 1992.

⁶ Hans Blumenberg, *Matthäuspassion*, Suhrkamp, Frankfurt am Main, 1988, p. 8

⁷ Bernhard Schwartz (ed.), *The economic regulation of business and industry – a legislative history of U.S. regulatory agencies*, vol. I, Chelsea House Publishers, New York, 1973, p. 17

... All private-car lines, industrial roads, refrigerator charges, and the like should be expressly put under the supervision of the Interstate Commerce Commission or some similar body so far as rates, and agreements practically affecting rates, are concerned. The private-car owners and the owners of industrial railroads are entitled to a fair and reasonable compensation on their investment, but neither private cars nor industrial railroads nor spur-trucks should be utilized as devices for securing preferential rates... There should be publicity of the accounts of common carriers; no common carrier who engages in interstate business should keep any books or memoranda other than those reported pursuant to law or regulation, and these books or memoranda should be open to the inspection of the government.

... I urge upon the Congress the need of providing for expeditious action by the Interstate Commerce Commission in all these matters, whether in regulating rates for transportation or for storing or for handling property or commodities in transit. The history of the cases litigated under the present commerce act shows that its efficacy has been to a great degree destroyed by the weapon of delay, almost the most formidable weapon in the hands of those whose purpose is to violate the law.

... It is because, in my judgement, public ownership of railroads is highly undesirable and would probably in this country entail far-reaching disaster, that I wish to see such supervision and regulation of them in the interest of the public as will make it evident that there is no need for public ownership. The opponents of government regulation dwell upon the difficulties to be encountered and the intricate and involved nature of the problem. Their contention is true. It is a complicated and delicate problem, and all kinds of difficulties are sure to arise in connection with any plan of solution, while no plan will bring all the benefits hoped for by its more optimistic adherents. Moreover, under any healthy plan the benefits will develop gradually

and not rapidly. Finally, we must clearly understand that the public servants who are to do this particularly responsible and delicate work must themselves be of the highest type both as regards integrity and efficiency. They must be well paid, for otherwise able men cannot in the long run be secured; and they must possess a lofty probity which will revolt as quickly at the thought of pandering to any gust of popular prejudice against rich men as at the thought of anything even remotely resembling subserviency to rich men. But while I fully admit the difficulties in the way, I do not for a moment admit that these difficulties warrant us in stopping in our effort to secure a wise and just system.⁸

This founding text clearly describes the separation between the economic and the political spheres and the role of independent regulatory authorities as a link between them. Regulation is seen as a multi-disciplinary field combining technical, economic and legal knowledge in order to supervise a specific sector of economic activity exhibiting some monopolistic characteristics. To use a contemporaneous Wagnerian concept, regulation is seen as a kind of 'Gesamtkunstwerk', a new style in terms of State intervention.

In the early 20th century independent regulation was extended to other economic sectors in the USA, namely communications and energy. The Federal Power Commission was established in 1920 to regulate the electricity sector (at that time, mainly hydroelectricity).

Following the crises of the 1920s and in particular the 1929 crash, anti-trust control and the powers of regulatory authorities were reinforced. In 1929, President Herbert Hoover asked for the powers of the Federal Power Commission to be upgraded. In January 1930, Representative Celler justified in the following terms a proposal he submitted to the House of Representatives:

'Criticism is being leveled at the prevalent practice of creating commissions.

'... Why this multiplicity of commissions? Is there a trend in the modern practice of Government toward commission regulation to supplement the inadequacy of the three constitutional branches to look after public affairs?

'The answer to this question may be found in the honest recognition of the single factor that there are some problems of their very nature so technical that neither the courts nor the legislatures are competent to handle them – problems such as utility rate making – that require specialized knowledge by trained experts.

'It is because both courts and legislatures have singularly failed in their attempts to regulate and adjust technical matters that we have today realised the need for these tribunals of trained experts.

'... What the Federal Power Commission needs first of all is three full-time competent commissioners. The present members are out-and-out figureheads. With all due respect to them, Congress might just as well have put the King of England, Mussolini, and Albert Einstein on the commission as far as any spontaneous, decisive action originating with the commissioners is concerned.⁹

Independent regulation of public utilities (transportation, communications, energy, water, etc.) became a reality in the USA almost a century before it was applied in Europe. However, some Europeans realised very early the need for independent regulation and provided detailed descriptions of the necessary institutional arrangements. Among them was Walter Eucken, one of the fathers of the social market economy.

⁸ Ibid.

⁹ Bernhard Schwartz (ed.), *The economic regulation of business and industry – a legislative history of U.S. regulatory agencies*, vol. III, Chelsea House Publishers, New York, 1973, p. 2049

The German Government has recently decided to set up an independent regulator in charge of post, telecommunications, electricity, gas and railways. This idea was perceived as very new and perhaps even as strange by part of German public opinion. Therefore, I believe it is interesting to recall what Walter Eucken wrote in the old days of the Weimar Republic:

‘Strict observance of the principles can’t prevent the fact that competition rules contain certain aspects that are not compatible with the system. And just as important: even where full competition is achieved, there are weaknesses and shortcomings which need to be corrected.

‘Therefore, there is a need for certain ‘regulating’ principles to be used to ensure that the competitive system functions well.¹⁰

‘... In the competitive system there will be ... monopolies, which do not help to maintain, but rather disrupt and endanger this. Some positions of power also develop when the principles are fully applied. For example, a gas works in a town, which in its own market has a supply monopoly... Such monopoly positions have arisen as a result of genuine cost advantages – i.e. these are compatible with the system... This provokes the question: what should happen to these monopolies?

‘This question is not identical to the well-known question of monopoly (or just cartel) regulation... The problem of monopoly regulation is only relevant for those monopolies that are mentioned, and which are inevitable.¹¹

‘Monopoly regulation should therefore be assigned to a state agency for monopoly regulation. In order to prevent the influence of interested parties, which is always dangerous (even if this is weakened by the competitive system), this should be an independent agency, subject only to the law. For example, it should not be a department of the Economics Ministry, which is much more open to the pressure of interested parties.

‘This monopoly office should be solely responsible for all questions concerning monopoly regulation. This therefore requires a completely new central bureau, whose creation is as essential as it is realistic. The large, central figure of a monopoly office should appear within the context of a modern, industrial state. Without this, the competitive system and with it the modern constitutional state is threatened. The monopoly office is just as indispensable as the Supreme Court.¹²

‘Full competition leads to a constant, long-term pressure to rationalise production capacity. There should be a price control on monopolies which also exerts long-term, competitive pressure.¹³

‘Monopoly regulation also works defensively, and this aspect is of great importance. Mankind’s pursuit of monopoly positions, which is otherwise so strong and which – as has been shown – is a central fact in economic history, will be substantially weakened or will cease, if such an authoritative monopoly regulator is effective.¹⁴

These historical notes show that neither the theory nor the practice of independent regulation is new. What is new is its application to specific sectors in Europe, including energy.

The internal energy market and the role of regulators

The relationship between regulators and the internal energy market may be seen from at least three different perspectives:

- a) What regulators have done in order to promote the achievement of efficient electricity and natural gas markets in the European Union.
- b) What the current legal framework foresees as the role of regulators in the internal energy market.
- c) What regulators are doing at present in order to facilitate the development of efficient and truly integrated electricity and natural gas markets in the European Union.

Careful reading of the internal energy market directives provides the answer to point b) above. Therefore, I will focus on points a) and c).

The role of regulators: 1996–2003

The first internal energy market directives defined some common rules to be applied by all Member States in order to open up their energy markets. For instance, the directives defined minimum unbundling requirements applicable to vertically integrated undertakings, minimum eligibility thresholds, a menu of network access regimes, etc. However, these directives provided little guidance as regards cross-border energy trade, development of regional markets, interaction with non-EU markets, development of interconnectors, supra-national integration of energy markets, etc.

The European Commission realised the difficulties arising from these omissions and decided to convene the so-called European Electricity Regulation Forum and the European Gas Regulatory Forum – the first started in 1998 in Florence, the second followed one year later in Madrid. The main aim of these fora was to facilitate integration of national energy markets into one single European market. The method applied was voluntary cooperation: first of all, cooperation between national energy regulatory authorities and the European Commission; secondly, cooperation between the European Commission and national regulatory authorities, on the one hand, and system operators and network users (producers, traders, suppliers, consumers, etc.) on the other hand.

¹⁰Walter Eucken, Grundsätze der Wirtschaftspolitik, J.C.B. Mohr, Tübingen, 6th edition, 1990, p. 291

¹¹Ibid. p. 291–293

¹²Ibid. p. 294

¹³Ibid. p. 297

¹⁴Ibid. p. 298

The first important result was delivered by the European Electricity Regulation Forum in Spring 2000, when the European Commission, regulators and network users succeeded in convincing transmission system operators to accept a mechanism for cross-border electricity trade. This very simple mechanism enables consumers located anywhere in Europe to get access to any supplier connected to the interconnected network. The consumer – and the supplier – only have to inform the local transmission system operator to which they are physically connected; afterwards, transmission system operators communicate among themselves and enable the commercial transaction to take place from the physical point of view. Of course, if that transaction crosses any congested border it has to go through appropriate congestion management mechanisms. Implementation of this mechanism was delayed until 2003 due to the reluctance of some transmission system operators and because of new political developments.

In March 2000, the European Council approved the 'Lisbon Agenda'. Energy was considered one of the critical fields to improve competitiveness of European undertakings and the European Council asked the European Commission, inter alia, to present new directives to accelerate liberalisation and integration of electricity and natural gas markets. These directives were presented by the Commission in 2001 and approved in June 2003.

Meanwhile, the number of independent regulators was growing and cooperation among them was increasing. Informal cooperation had started in March 1997 involving the regulatory authorities of Italy, Spain and Portugal. In March 2000, ten energy regulatory authorities decided to sign a memorandum of understanding whereby the Council of European Energy Regulators (CEER) was created. The main aim of the CEER was to increase cooperation – among regulators, on the one side, and between regulators and the European Commission, on the other side – in order to contribute to a more efficient internal energy market.

The CEER provided support to the European Commission both within the framework of the Florence and Madrid fora and in preparation of the new internal energy market directives and regulations. Some further voluntary agreements were reached both in electricity and in gas, introducing more transparency (e.g. regular publication of available transmission capacities) and facilitating cross-border trade. However, voluntary agreements proved difficult to reach, to implement and to monitor because some transmission system operators were not properly separated from other interests (generation, trade, supply) and also because some countries, namely Germany and Switzerland, delayed the introduction of independent regulators¹⁵ – regulated network access does not yet exist in these two countries whose geographical position is critical for the development of the internal energy market.

In order to cope with a growing number of issues and improve cooperation at the operational level, regulators decided in 2003 to adopt a not-for-profit statute under Belgian law and to set up a small office in Brussels.

The role of regulators today

The new internal electricity and natural gas market directives came into force in 2003 and were transposed into national law before 1 July 2004; however, some Member States have not yet fully implemented these directives.

The 2003 directives and electricity regulation (EC) No. 1228/2003 of 26 June 2003 provide a clear and comprehensive legal framework for the development of the internal energy market. Serving 450 million EU citizens, this is the largest integrated energy market in the world, offering new perspectives both to energy consumers and to European energy undertakings. Regulators are committed to facilitating the development of the internal energy market through two major lines of action:

1. Developing a comprehensive and transparent regulatory framework for the internal energy market according to the principles and procedures established in legislation.

2. Cooperating with the European Commission and with competition authorities in order to ensure consistent application of competition law to the energy industry.

Developing the EU regulatory framework

Directive 2003/54/EC concerning common rules for the internal market in electricity and Regulation (EC) No. 1228/2003 on conditions for access to the network for cross-border exchanges in electricity provide the legal framework for the development of the EU electricity market. They foresee several regulatory actions to be undertaken by the European Commission and by energy regulatory authorities, such as:

- Regulation (EC) No. 1228/2003 foresees that '[w]here appropriate, the Commission shall... adopt and amend guidelines', according to comitology procedures, on three issues:
 - the inter-transmission system operator compensation mechanism;
 - principles for the setting of transmission network tariffs; and
 - the management and allocation of available transfer capacity of inter-connections.
- Regulation (EC) No. 1228/2003 also foresees that '[t]he safety, operational and planning standards used by transmission system operators shall be made public [and] shall include a general scheme for the calculation of the total transfer capacity and the transmission reliability margin ... subject to the approval of the regulatory authorities.'
- On the other hand, Directive 2003/54/EC assigns to national regulatory authorities the responsibility for 'fixing or approving' transmission tariffs and balancing service tariffs.

¹⁵ As of 2005, Germany and Switzerland have not yet officially set up independent energy regulatory authorities.

Clearly, all these issues – transmission tariffs, inter-transmission system operator compensations, balancing service tariffs, operational rules, reliability standards, calculation of available transmission capacities, management and allocation of available transmission capacities – are closely inter-related. Some ‘operational’ issues have a strong economic impact and some ‘economic’ issues raise complex technical questions. All issues have significant impact upon the information and communication infrastructure managed by transmission system operators, as well as upon the way they collect, process and disseminate data. Moreover, the way these issues can be handled depends on the way energy markets are organised, on a national or regional basis. Therefore, close cooperation between the European Commission and national regulatory authorities is essential to ensure consistency of the electricity regulatory framework.

In order to facilitate the discussion on, and ensure the consistency of, rules and guidelines on different individual issues, it is necessary to first discuss the ‘regulatory framework’. This framework must be built based upon a model of interactions between transmission system operators at planning and operational levels.

In each Member State, transmission system operators are subject to the supervision of the respective energy regulatory authority. However, in meshed interconnected systems, such as the continental European electricity system, the behaviour of transmission system operators is strongly influenced by the rules governing the interconnected system. Therefore, national ‘Grid Codes’ should reflect the rules agreed at European level. This set of rules governing interactions between transmission system operators should be agreed by the European Commission and by energy regulatory authorities – in close cooperation with network operators and network users and taking into account regional diversity in terms of density and technology of interconnections – and enforced nationally through national regulation and Grid Codes.

The present type of interaction between transmission system operators was inherited from the old days of vertically integrated, more or less self-regulated, monopolies. This old model is clearly not well adapted to the principles and rules of the internal electricity market, both in terms of contents (technical standards and procedures) and in formal terms (assignment of responsibilities, enforcement procedures, dispute settlement, etc.). Delays in introducing a new model, well adapted to unbundling and to other common rules, are responsible for unnecessary risks (e.g. the 2003 Swiss/Italian blackout), unnecessary losses of economic efficiency (e.g. too restrictive criteria for calculating available interconnection capacity) and unnecessary conflicts.

It is urgent to replace the old, technically and economically unsuitable self-regulated models with an appropriate, new ‘regulatory framework’. Currently within Europe there are a number of areas (Nordel, UCTE, etc.) applying different rules and procedures. Future guidelines and rules to be produced by the European Commission and by energy regulatory authorities, namely under the new Directives and Regulations, should be coherent with the commonly agreed ‘regulatory framework’ and should not be developed on an ad hoc basis. Such guidelines would provide a minimum set of reliability and security standards, including enforcement procedures, applicable across all of Europe.

Efficient regulation of the internal energy market requires not only a clear technical framework ensuring coherence of national, regional and European regulatory developments, but also transparent procedures allowing all interested parties to participate in the regulatory process. The European Regulators Group for Electricity and Gas (EREG), a consultative body established by a Commission decision of 11 November 2003,¹⁶ provides the appropriate platform to achieve these goals.

EREG’s objective is to ‘advise and assist the Commission in consolidating the internal energy market, in particular with respect to the preparation of draft implementing measures in the field of electricity and gas’.¹⁷ It is EREG’s mission to ‘facilitate consultation, coordination and cooperation of national regulatory authorities, contributing to a consistent application, in all Member States, of the provisions set out in Directive 2003/54/EC, Directive 2003/55/EC and Regulation (EC) No. 1228/2003, as well as of possible future Community legislation in the field of electricity and gas’.¹⁸ EREG Rules of Procedure and EREG Guidelines on Consultation Practices have been approved and are public.¹⁹

By way of example, some work currently being undertaken by the EREG is a review of the Commission’s draft guidelines on Congestion Management which will be put to public consultation before formal advice is sent to the Commission and the comitology process begins.

¹⁶Official Journal L 296, 14.11.2003, pp. 34–35

¹⁷Commission decision of 11 November 2003 establishing the European Regulators Group for Electricity and Gas, Article 1, No. 2.

¹⁸Idem

¹⁹www.ereg.org

²⁰Philip Lowe, Applying EU Competition Law to the new liberalised energy markets, Brussels, 13 May

Ensuring consistent application of competition law to energy

The 'Europeanisation' of energy markets leads naturally to mergers and acquisitions among energy companies – mainly historical incumbents. Since construction of the internal energy market is a step-by-step process, application of competition law in general, and merger control in particular, is a challenging task.

Creating, managing and ultimately integrating regional energy markets into one single EU energy market is a complex process. This process may imply some short- or medium-term distortions of competition. Therefore, it is crucial to address these risks and to design the appropriate mechanisms to ensure a level playing field for all EU players, as well as the quick and smooth convergence of all regional markets into a single EU energy market.

The European Commission's Director General of Competition, Philip Lowe, has indicated as a general remark, 'that mergers can have pro-competitive effects when they allow new operators to enter national markets dominated by former legal monopolies. They can, however, have negative effects on competition when they strengthen the dominant position of a former monopoly.'²⁰ It is not always easy to assess the positive and negative effects of individual cases. Therefore, further analysis and some joint action by the European Commission, competition authorities and energy regulatory authorities is urgently needed as regards the application of rules to the approval or refusal of mergers and acquisitions in the energy field.

Good regulation and a good regulatory framework are necessary but not sufficient conditions for competitive EU energy markets. A lack of robust, deep and liquid organised energy markets in most geographical areas – especially as regards natural gas – is a major obstacle to the achievement of a truly integrated and efficient internal energy market. Therefore, in-depth analysis of energy markets and assessment of effective competition is crucial, both at a regional and at a European level. Of course, to assess the behaviour of market participants and their compliance with anti-trust legislation is a difficult task in any sector. It is particularly difficult in the newly liberalised network industries. However, energy may benefit from recent experiences in telecommunications, namely for remedies, which moves away from sector specific regulation and more towards competition law principles.

Cooperation between the European Commission, competition authorities and energy regulatory authorities (through ERGEG) is also very important as regards the definition of 'energy markets', the assessment of market power and effective competition and the definition of appropriate regulatory and anti-trust remedies.

Some conclusions

In April 2005, Germany is the only EU Member State still awaiting the start of independent energy regulation.

Independent regulation was introduced in the USA at the end of the 19th century, in the field of railways. The regulator's job was perfectly described by US President Theodore Roosevelt in 1905. Since then, the regulatory function has been extended to several economic areas, in particular to the network industries. Regulation provides a modern and efficient interface between the public interest, the interests of consumers, the interests of those providing regulated services under monopolistic conditions and the interests of those using the monopolistic infrastructure.

The concept of independent regulation was also developed in Europe, namely during the Weimar Republic. However, its application to energy only started in the 1990s, following approval of the Single European Act in 1987. The ideas of independent regulation, liberalisation and supra-national integration of electricity and natural gas markets stem from the EU Internal Market project and are inter-related.

European energy regulators have actively contributed to the construction of the internal energy market, in close cooperation with the European Commission and through consultation with all interested parties. The Council of European Energy Regulators (CEER), created in 2000, and the European Regulators Group for Electricity and Gas (ERGEG), established by the European Commission in 2003, provide appropriate platforms for further developing the internal energy market through this cooperative model.

In order to ensure full coherence of national and European regulatory actions, EU energy regulators are currently involved in building a robust, stable, efficient and transparent EU energy regulatory framework. However, the 'Europeanisation' of energy markets causes some problems as regards the application of competition law. In order to ensure that EU energy markets will deliver competitive energy prices to energy consumers, energy regulators also have to cooperate with the European Commission and with competition authorities in monitoring, investigating and, where appropriate, designing and implementing remedies.