

# Criteria for success in creating a regulatory framework

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The market’s natural response is to treat regulation as a compliance issue. But according to Volker Heck, RWE’s Vice President of Group Public Affairs, simple compliance is unlikely to be the best strategy and dealing effectively with regulation can be a source of competitive advantage.

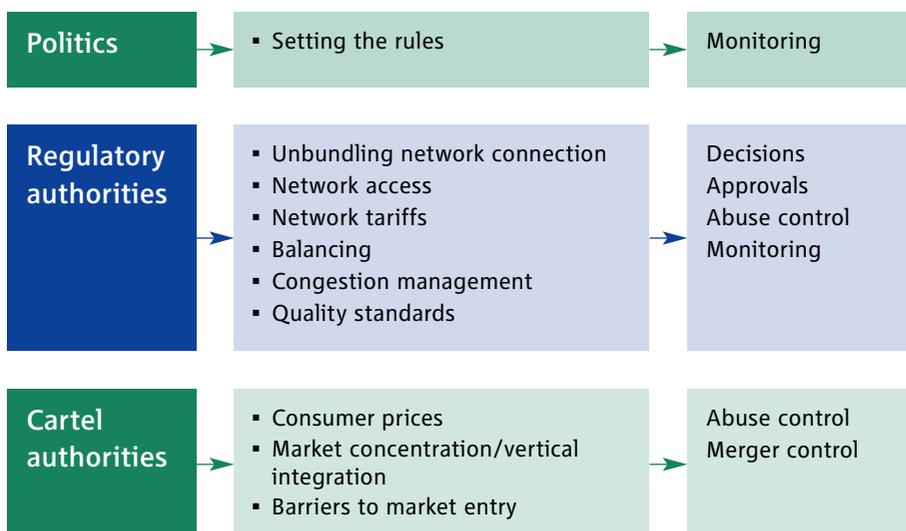
### Objectives and challenges of regulation

Security of supply, efficiency and environmental liability are without doubt the most important goals of energy policy. Liberalisation and open markets are the best means to enhance competition and, thereby, to force companies to improve efficiency and to contribute to achieving the Lisbon targets. Additionally, a well-functioning, open and liquid market will help to ensure security of supply in so far as it delivers clear price signals on the need for future investment. It is like Helmut Schmidt, a former German Chancellor, pinpointed: ‘Markets are like parachutes: they only function if they are open’.

The key for open, contestable markets is whether there is real customer choice in generation, trading and supply and free market access for new entrants. Markets must have sufficient liquidity such that non-integrated participants can source or sell their requirements. Dealing with these issues, regulatory authorities have to work closely with the cartel authorities with each party being responsible for specific tasks (see Figure 1).

So regulation has to ensure that the network as a natural monopoly functions as a neutral administrator of competition in generation, trading and supply. Market participants must have the ability to obtain network capacity on a transparent and non-discriminatory basis. This includes clear and unambiguous rules for grid tariffs without cross-subsidies as well as a definition of long-term quality standards for network operation. If any congestion exists, this has to be managed in a market-oriented way. As far as these issues are concerned, they are already covered by the respective provisions in the EU acceleration package which should have been implemented by the Member States by July 2004. After July 2007, when all markets should be fully open to competition and all relevant network companies should be unbundled, these rules will offer a consistent and well-balanced framework.

Figure 1 – Distribution of tasks



**Figure 2 – Indicators used to evaluate competition**

<b>Wholesale and retail prices</b>	Market-related prices vs. Monopolistic pricing
<b>Customer choice</b>	Customer switching and Renegotiation with current supplier
<b>Cost-reflective network tariffs</b>	Reflecting structural differences vs. Cross-subsidised
<b>New market entrants</b>	Foreign-owned companies and National companies

### Criteria for successful regulation

Indicators used to evaluate the success of market opening and regulation (see Figure 2) (e.g. in the latest Annual Report on the Implementation of the Gas and Electricity Internal Market of the EU Commission) show that the liberalisation process has delivered significant benefits to the European economy.

As an indicator of regulatory success, the fall in prices suggests that competition amongst large users has risen markedly since the beginning of the liberalisation process in 1998. As a result, efficiency improvements fuelled by strong productivity growth have been passed on to consumers<sup>1</sup>. If, as now, we see an increase in electricity and gas prices on European power exchanges, this has to be interpreted carefully. As long as price rises occur under competitive conditions and are caused, for example, by an overall rise in primary energy prices or by state interventions, this development is not a failure of regulation or an indicator for a lack of competition. To quote former EU Commissioner Monti: 'Competition not always implies lower prices but market-related prices.'

Often customer switching analysis is used to demonstrate that there is no real customer choice and that specific markets are not sufficiently competitive. For example, in its latest benchmarking report, the Commission came to the conclusion that, under competitive conditions, large users 'might have all been expected to have changed supplier'. This is misleading because this indicator ignores the fact that customers might renegotiate a contract with an existing supplier in response to lower price offers from competitors. In the case of RWE, all our wholesale customers have either switched their supplier or renegotiated supply contracts to obtain better tariffs.

Non-discriminatory access to transmission and distribution is a precondition for new suppliers to be able to enter new markets. Without the removal of cross-subsidies and cost-reflective network tariffs, vertically integrated incumbents would be able to close markets to competitors. Nevertheless, network charges, which in one country can be markedly higher than in another, can reflect both unjustified cross-subsidies or structural differences, such as varying supply densities, public levies or different tariff systems. Therefore, the basis of tariff differentials needs to be evaluated carefully before arguing for tariff reductions based on international comparisons<sup>2</sup>.

Another key issue is the opportunity for both national and non-national suppliers to enter the market. The market share of foreign owned companies in a specific market is one indicator but it does not reveal the full picture. It has to be supplemented by an analysis of the market share of new national companies.

### No further legislative measures

The EU Directives propose a harmonised framework with basic rules and these have to be adapted in national legislation to meet the different conditions in the Member States. Therefore, uniform rules for all Member States or a central European regulatory authority would be the wrong approach.

The creation of a level playing field between the EU Member States will not be concluded until July 2007, when the electricity and gas markets will be fully opened to competition. Up to this point, market distortions will persist because some residential markets, comprising more than 100 million customers across Member States, will not be open to new entrants. Additionally, as many as ten Member States, including Germany, have still not yet implemented the acceleration package. Altogether, it is too early to make a final appraisal of the results of this initiative. Therefore, before deciding on the need for further legislative action, we will need to learn more about the impact of the existing regulations.

<sup>1</sup> E.g. on the German market, net electricity prices in 2004 for wholesale customers were down 18% compared to 1998 and net prices for household customers went down by 16%. These positive effects of the opening of the markets have been largely compensated by increasing charges imposed by the federal government.

<sup>2</sup> Take the example of Germany and Norway: while the specific network tariffs for residential customers in Germany are on average about 3 ct/kWh higher than in Norway, the full amount a customer has to pay in Norway is twice as high as in Germany due to a higher electricity consumption per capita.

### Reduction of barriers to competition

The EU Benchmarking report does not show the full picture since an effective market not only depends on its formal opening but also on the removal of so-called red-tape barriers to entry, such as language requirements, obligations to establish a national subsidiary or pre-allocation of interconnection capacities to long-term contracts of affiliated companies (see Figure 3).

In some EU Member States – e.g. Spain, Portugal, Italy and the accession countries – such barriers seem to be welcomed in order to keep new entrants out of the market. As EU Commissioners Piebalgs and Kroes announced, these discretionary market barriers should be addressed in the more ambitious report on the functioning of the market which is due out before January 2006.

While the aforementioned hindrances will be addressed in due course, other obstacles to competition will still be in force as governments seek to protect national champions. Under an ecological or social disguise, various legislative measures (e.g. the promotion of renewables and CHP, energy taxes or public service obligations) are imposed to alleviate competitive pressures on incumbents when foreign companies are trying to enter new markets.

Hindrances to competition may also arise from disproportionate rules governing capital markets. These rules are currently under discussion in the European institutions. Initially designed for the banking sector, the energy market also comes within the scope of these rules. They establish high capital requirements which can be easily met by the banking sector but certainly not by small and medium-sized companies like the average energy trader. As a consequence, the development of energy trading, which is vital to an effective internal market in electricity and gas, is put at risk.

It is evident that the next challenges facing European legislators and regulators are the removal of red-tape barriers to market entry and the harmonisation of secondary policies to create a real level playing field.

### Challenges: vertical integration and market concentration

Obviously, vertical integration can be another major obstacle to liberalisation and competition in network industries since – without clear unbundling rules – it can permit highly effective forms of discrimination against third-party entrants. It is fair to say that some Member States, like Spain and Portugal for instance, have yet to take suitable action to break up industries and reduce the market power of incumbents.

Market concentration caused by national as well as international acquisitions is often seen as a threat to competition. But in reality, cartel restrictions on acquisitions should be relaxed to the extent that regulation and competition pressure increases. The principle consideration should be whether cost pressures caused by regulation force energy market participants to realise possible efficiency improvements via economies of scale. These economies can be achieved by horizontal mergers and co-operation as well as through increased vertical integration.

Nevertheless, regulation must be complemented by strong competition rules to prevent the abuse of market power. Measures like divestment or capacity releases must be scrutinised to reduce incumbent generator and supplier dominance, to enhance transparency and, therefore, to overcome a lack of market liquidity. In this way, markets which are still relatively closed to competition because of large incumbents – e.g. France, Italy, Spain, Belgium or the new Member States – would be more open to new entrants.

### Figure 3 – Removal of barriers to competition

There is no need for further legislative measures before the acceleration package fully comes into force, but there is still a need to...

	Because of...
...reduce red-tape barriers to entry	...discretionary barriers e.g. linguistic requirements, obligation to establish national subsidiaries or capacity blocked by long-term contracts
...remove competitive distortions because of legal action	...alleviation of competitive pressures by legal action under an ecological or social disguise
...better control of vertically integrated incumbents or large players by cartel law	...discrimination of new participants by vertically integrated incumbents or barriers in terms of scale
...raise market liquidity	...lack of interconnection capacity, insufficient congestion management and long-term contracts

### Increasing market liquidity

To increase market liquidity, the Commission advocates more interconnection capacity between Member States, although it also acknowledges that long-distance transmission of electricity resulting from more interconnections is costly and potentially less reliable. Furthermore, an increase of interconnection capacity does not, as such, lead to more competition since customer demand is the final arbiter. Since it can take between ten to fifteen years for planning and building new transmission, it is also a long-term solution. At the moment, we need clear and market-oriented mechanisms for congestion management on the existing network.

The liquidity of national gas markets is often limited due to long-term take-or-pay contracts. These contracts are closely linked to the massive long-term investments in exploitation and long-distance transmission networks for gas, which would not have been made without the security of a minimum turnover. Whenever these contracts are released for liquidity reasons, the incentives for new investments in gas infrastructure which are needed to keep up with rising demand have to remain intact.

### Better regulation: continuity and stability

The economy has its own rules; whenever policy interferes, it will lose its balance. Politicians and regulatory authorities should limit themselves to setting the necessary rules and framework to control monopolies and stimulate investment. Trusting in competition, they should allow the market forces in generation, trading and supply businesses to take effect.

Better regulation does not necessarily imply more regulation! This is certainly true for the draft directive on security of supply and infrastructure on which the European Parliament takes the view that the 'intervene and micro-manage approach' will not add to the objective of securing energy supply.

In this context, we are looking with great interest toward the strengthening of impact assessments and cost-benefit analyses announced by the European Commission. This tool may also help prevent further attempts by DG TREN to intervene in national energy policies through the regulation of international energy trade or comitology procedures.

As experience shows, wherever markets have been liberalised there is no clear correlation between the intensity of regulation and competition. To avoid major regulatory disruptions (e.g. California), we have to recognise the economic and technical requirements of various energy markets. A long-term well-defined regulatory strategy without major swings will create the continuity and stability investors badly need to realise their plans and, as a by-product, to guarantee security of supply (see Figure 4).

### Regulation as an opportunity

From the industry perspective, it is easy to see economic regulation simply as a bundle of technical inconveniences, or obstacles to the pursuit of competitive advantage. The natural response is to treat regulation as a compliance issue. But simple compliance – conforming with regulation without changing anything else – is unlikely to be the best strategy. Economic regulation will affect all the players in a market and, on occasions, it may completely change the nature of competition in a market. However, if one company can deal with a regulatory constraint better than another, it may be able to gain a key competitive advantage.

#### Figure 4 – Complementary regulation and competition: three insights

- Trust in competition: no 'intervene and micro-manage' approach
- Take into account economic and technical requirements of energy markets before striving for political objectives
- Take regulation as an opportunity to be able to gain a competitive advantage