

APX Energy Trading Symposium Reducing Market Concentration – Session Two

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What is the role of regulation in delivering competitiveness, sustainability and security of supply in EU power and gas markets?

Introduction

Europe faces a daunting set of energy challenges. Achieving “security, sustainability and competitiveness” is not a choice but an imperative. The foundation stone for responding to these challenges is the single market. A number of policy responses are needed in order to develop competition and investment. The stringent application of competition powers, for instance, to address instances of market abuse; and removing barriers to investment caused by planning rules. But the regulatory response is also vital. From British experience in recent years we know that well-designed, competitive markets backed by strong and independent regulation can and will deliver. The regulatory challenge, therefore, is how to take the lessons learned at national level (Britain and of course other countries) and apply them at the EU-level: to create a comprehensive regulatory framework for integrated EU energy markets.

Current weaknesses – why do we need an EU regulatory framework?

The Commission’s authoritative Sector Inquiry, published in January 2007, showed clearly that competition was not working in all EU energy markets. The key issues raised were: market concentration; collusion between incumbents; vertical integration; lack of access to infrastructure; and lack of or delayed investment. Putting structural remedies in place to overcome these issues – both through the current proposals and the rigorous application of competition rules – is vital and the Commission are right to remain strong in the face of opposition from the EU’s energy giants. But the problem goes deeper than a handful of large companies not playing by the rules: it is that the rules themselves for integrated markets are inadequate and incomplete.

The fragmentation of national markets is caused in part by a “regulatory gap”. This itself has many causes. The implementation of existing EU rules has been mixed and at times ineffective, as the Commission’s benchmarking reports have identified. There are significant variations in the powers of national regulators: we do not all have the same tool box to work from. For instance in some countries the relevant Ministry makes the final decision on network tariffs (ie. Greece, Hungary, Slovenia, Spain, Luxembourg). This also emphasises

that political involvement in regulatory decisions and appointments at national level remains a major concern. There is a clear need for a levelling of the playing field.

The gap is also, however, created by the limitations of the current system. Within their own jurisdictions national regulators oversee the investment activities of the monopoly networks: ensuring the interests of the consumer are protected whilst providing certainty on a fair rate of return for the networks. As statutory bodies national regulators are only able to act within their national duties and legal framework. There is no equivalent framework to establish a “regulatory contract” for cross-border investments. As a result, interconnectors and similar projects are seen principally as national and for bilateral issues. They are generally funded through long term capacity contracts and ad hoc inter-governmental arrangements. As the “Sector Inquiry” identified, the lack of investment, particularly in the infrastructure needed to facilitate cross-border trade, is a major impediment to the development of single energy markets. Put differently, joining together national grids better than they are today to create an integrated EU grid is a prerequisite of integrated markets. The aim of the current proposals must also therefore be to promote competition by filling the regulatory gap – hence the need for an EU-level regulatory framework to supplement, and complement national rules. Without a well constructed regulatory framework Europe will not be able to provide the climate of predictable, effective and independent regulation that is fundamental to the creation of the sound investment climate that is central to the achievement of the goals of competitiveness, sustainability and security.

The starting point for an EU regulatory framework: national models

Clearly, we must be careful not to reinvent the wheel. The building blocks for a European regulatory framework are the existing national regimes. The first principles to be applied at EU-level are those we have learned through the process of liberalisation at national level: the importance of regulatory independence to create a stable and predictable climate for investment; strong regulatory oversight to ensure the protection of consumers and promotion of competition; the active participation of all market players to ensure the rules work.

Energy markets are complex, but their basis is the networks. Monopoly transmission grids are the market place upon which trade takes place, and as such the two key players in enabling the market to function properly are the regulators and the Transmission System Operators (TSOs). The key features of the current, nationally-based approach are:

- High level public interest objectives to ensure the security, reliability and efficiency of national networks established in law by national governments;

- Detailed security and operating standards developed by national TSOs aimed at meeting the high level objectives whilst fulfilling the technical requirements relating to the national grid;
- National regulatory approval of the proposed standards to ensure that they meet the high level public interest objectives in the best available way;
- Ongoing review of the standards by TSOs and regulatory oversight by national regulators;
- National regulatory monitoring and oversight to ensure compliance with the standards;
- Public reporting, normally by the national TSO and the national regulator;
- Penalties on the TSO for non-compliance with the requirements which are applied by the regulator;
- Market monitoring and market oversight.

This interaction must broadly be replicated at the European level in order to facilitate investment in European grids and oversight of integrated EU energy markets. The purpose is not however to create an EU framework that replaces national regimes, but rather one that allows them to integrate properly and that “fills the gap”. Applying the principle of subsidiarity to EU rules is critical to ensure there is not unnecessary over-harmonisation, which would bring confusion rather than clarity. As will be explored, this is one aspect where we have concerns with the Commission’s proposals.

The ERGEG model

Many national regulators would have preferred a much more independent, self-financing model but recognised that at EU-level inter-institutional issues come into play. Our model therefore is not an ideal but a compromise that we believe recognises political and institutional realities. So what does that regulatory model look like? It was by building on national experiences and bringing together the issues discussed above that ERGEG put forward preliminary advice to the Commission in April. The proposed model contained 5 key elements, all of which are vital, interrelated parts of a coherent package:

(1) Powers and independence of national regulators

Strong and effective regulation is paramount to functioning markets, and as we have seen an EU model must be created by first ensuring a level playing field at national level. National regulators must be given an equivalent toolbox – raised upwards to the levels of the highest – if they are to properly perform their function in protecting consumers. Powers that are currently lacking include the ability to enforce non-discriminatory network access and

allocation of capacity and unbundling arrangements. The sharing of confidential data between national regulators, which is increasingly important as markets become more integrated, is also an issue. Additionally, energy regulators in all EU Member States should be in a position to exercise their powers impartially and transparently, and to act independently from market and political interests, with appropriate assurances in terms of appointments, budget and accountability. National regulators also need a new and enhanced empowerment to deal with cross-border investment and market operation issues.

(2) Effective unbundling

Again, it is essential to get the right market structures in place at the national level, in order to be able to build a European framework upon them. Clearly this issue will generate much political heat, but from the regulators' perspective the essential principles are absolutely clear. If a company wants to compete in the gas or electricity markets it has to have access to the monopoly networks. The network operators must therefore act, and be perceived to act, in a non-discriminatory way. Perverse incentives and the risk of undue discrimination will always exist where monopoly and competitive aspects are held in the same vertically-integrated company. We believe that the model required in EU legislation is, in principle, ownership unbundling; and that this should be applied in equal measure in both gas and electricity.

(3) Co-ordinated network operation

With effective national arrangements in place, the question then arises as to how to ensure they are properly integrated. The aim is to build a "network of networks": national TSOs should still have primary responsibility to build, operate and maintain their individual networks to domestic standards; but EU rules should also ensure that, to consumers, the integrated grid appears as a single EU grid. In the first instance therefore EU TSOs require an obligation to co-operate and a formal organisation through which to do so. Secondly, the tasks of these new organisations should be to draw up draft, EU-level rules on issues such as operating and security standards, where these are necessary for cross-border trade, and the allocation of costs (and risks) for cross-border investments. And thirdly high level public interest objectives must be established eg. to ensure the operation of a secure and efficient EU grid, as the benchmark which the EU rules should be drafted to meet. This is where regulators at EU-level must play a critical part in ensuring that the public interest is safeguarded.

(4) EU regulatory function

The essential next step is then to ensure that there is an appropriate EU body in place to regulate the activities and draft rules of these EU TSO bodies. Independent regulation is vital for two reasons. Firstly, because as a public body primarily designed to safeguard the interests of consumers, an effective regulatory function is necessary to ensure the high level public interest objectives are met in practice in the development and operation of secure and efficient EU grids. And secondly, because it is through stable and predictable decision-making in the application of the high level principles that a sound climate for efficient investment is created. In well-functioning markets investors will have the certainty of a fair rate of return, and will therefore be incentivised to bring forward investment in a time and place to meet customer needs. Again, the key principles for establishing such an agency are to build upon and carry through lessons learned at national level. A European regulatory function should be based on the collective decision-making of the national regulators, as an enhancement of the existing ERGEG arrangements; and it must uphold the principle of regulatory independence from commercial and political interference at EU as well as national level.

(5) Market Transparency

Information, finally, is the lifeblood of energy markets and competition will only become a reality in Europe when real-time information is made available across Member States. Transparency and near real-time availability of information is a vital measure to ensure that markets are able to work properly both within and between Member States. Information must be made available both in terms of infrastructure eg. system load and forecast in electricity, or storage/LNG capacity in gas, and the commodity itself eg. balancing market and supply/demand data, so as to realise the opportunities for aligning supply and demand.

The EU Commission's Proposals

Much of the model put forward by the European regulators has been adopted by the Commission in their third package proposals:

- There is a significant enhancement of the powers and independence of national regulators. The proposals here are exhaustive and address both the “what”, the substance of regulatory standards, as well as the “how” of regulatory governance.
- The proposals to require either ownership unbundling or the establishment of an “independent system operator (ISO) are a major step forward in ensuring non-discriminatory

access to the EU's pipes and wires. The ISO model – where the vertically-integrated company retains ownership of the network assets, but an independent company is responsible for their management and development, including investment decisions – can be a viable alternative to full ownership unbundling. We have a similar, if shallower model in Scotland, and there are others globally. But the limitations and implications of such a model must be understood. The level of regulation required is proportionate to the scope for discrimination, hence an ISO model will necessarily require more complicated, burdensome and intrusive rules than ownership unbundling. And here national regulators will be called upon to play a paramount role. By way of example, in Scotland alone, where the system and impact of discrimination is relatively small, the regulatory contract between the transmission owners and system operators (the SO-TO code) runs to over 200 pages.

- Co-operation amongst TSOs will be greatly enhanced by the creation of the two new EU network organisations – although, as is explored below, the Commission's proposals do seem flawed in this area with insufficient regulatory oversight.
- Similarly, the creation of an Agency for the Co-operation of Energy Regulators, with a Board of Regulators built on ERGEG at its heart, is, in principle, welcome – though again how the model is to work in practice still requires significant consideration and amendment.
- And the proposals on transparency, which to a large extent follow existing ERGEG advice on eg. LNG and storage, are clearly a major advancement.

As is apparent, however, we cannot give the proposals an unqualified endorsement. At this stage of the proceedings, too many serious questions remain to give a clear “yes” to any of the 5 tests above. Serious faults in the proposed framework and in our regulatory independence and powers need to be fixed in the forthcoming negotiations. Moreover, they need to be fixed in a way that ensures coherence across the package, and the 5 separate pieces of legislation that it comprises – not, in itself, a straightforward task, but an essential one if the package is to deliver.

To highlight two of our main concerns:

- The scope of the new EU “technical and market rules” appears too broad and to be essentially self-regulation by the EU TSOs (which would amount to cartelization if there were not full and proper implementation of the unbundling rules). These bodies are asked to draw

up such rules in a wide number of areas, with no obvious limit or focus on cross-border issues, or any clear high-level, public interest objectives that they must meet, which is at the heart of the regulatory model delivering eg. secure and efficient monopoly networks. This risks both over-harmonisation; unnecessary and inefficient investment, at a high cost to consumers; and “double jeopardy”, where it may be unclear which set of rules TSOs and market participants are expected to comply with, those at EU or national level, thus raising compliance costs and the prospects of legal challenge. The interaction between the EU and national frameworks must be clarified, and subsidiarity properly reflected. And a proper process for sufficient regulatory oversight of the EU TSOs bodies, including an *ex ante* regulatory approval of EU codes and investments, must be established in the proposals.

- Secondly, the guarantees of political independence of the new EU Agency must be strengthened. The principles that the Commission have rightly required at national level must be similarly upheld with the Agency. The Commission’s grip on the process (but not, strangely, and as above, the outcome, which is left with the EU TSOs) appears very strong and whilst we appreciate the constitutional and legal constraints at the EU level, political and other interference in regulatory decision-making will ultimately lead to uncertainty and therefore a higher cost of investment, costs which will be borne by EU consumers.

Conclusions

European consumers have waited long enough for properly functioning, open and competitive EU energy markets, and have paid the price for their absence. Without them, “security, sustainability and competitiveness” will remain noble intentions rather than delivered reality; and the full benefits of the single market project and the Lisbon Agenda as a whole will remain unrealised. The Commission’s proposals are not perfect – but they are a very significant step forward. An appropriate balance must still be struck within the proposals between national and EU-level decision-making; the principles of strong and independent regulation must be delivered at both national and EU level; and of course, industry unbundling must be seen through. But above all, the major opportunity that the proposals represent must now be seized.