

European Energy: The Rise of Markets and Economics

According to Martin Brough of OXERA Consulting, the most noticeable feature of the latest energy package is the fact that markets are at centre stage. While the role of the Commission across all sectors, and more specifically, its jurisdiction, revolves around the creation and enforcement of a single market in Europe, the confidence with which the Commission asserts the primacy of the role of markets in energy policy represents a step change in attitudes.

A key part of the energy package from the Commission is the assertion that meeting aspirations on all aspects of energy policy, from the environment to security of supply and competitiveness, depends on the use of markets. Where markets have not existed (for example, in carbon emissions, or Continental gas) they should be created (for example, through the Emissions Trading Scheme, or through freeing up gas for hub trading). Where markets exist, the Commission argues, enforcement of competition law is needed to make competition effective.

A fundamental and helpful distinction made by the Commission is the difference between ex post and ex ante regulation. Energy policy involves using the assets we already have efficiently, but, given the capital intensity of the sector, it also depends on creating the right assets for the future. The Commission asserts that markets can do both, but recognises that the regulatory drivers for the two aspects are different.

Ex Post Regulation

When it comes to ex post regulation, the Commission can arguably take a tough line—assets that are already on the ground reflect investments which are sunk. The sector inquiry highlighted a

number of areas in which the Commission asserts that markets are not functioning well and assets are not being operated competitively. A large number of enforcement actions are being perused under competition law, alleging anti-competitive practices (breach of Article 81) or abuse of dominance (breach of Article 82) by the owners of current assets.

On these issues there is clearly considerable value at risk for incumbents. It is one thing to collect evidence to make a general case in a sector inquiry, but it is quite another to demonstrate before a court that



particular behaviour is in breach of competition law. The next few years will be a real test of the ability of evidence-based economic assessments to prove (or disprove) these allegations of illegality, and to demonstrate the minimum required remedies to correct any failings.

Ex Ante Regulation

Ex ante regulation of the energy sector involves creating the right conditions and markets to ensure that the assets needed to meet future energy (and environmental) requirements are built. Regulators, including the Commission, need to use a carrot as much as a stick since someone (often in the private sector) is needed to provide the capital for investment.

One aspect of this is to maximise the available pool of investors by ensuring open access to markets, by freeing up gas for new entrants, and by enforcing some form of further unbundling of network ownership or operation. Another is to create the credible expectation that future returns on assets will relate to market conditions rather than state aid.

An unavoidable fact, however, is that market pricing is based on marginal costs, and that the marginal form of generation in a single European power market is almost certainly going to be gas-fired. Creating the conditions for investment in power stations, therefore, may involve a convergence of European wholesale power market prices to levels consistent with new gas entry. This does not mean lower prices for all European consumers.

Gas and Security of Supply

A further consequence of the application of gas market prices to electricity as well as gas customers may be to highlight the dependency of Europe on gas supplies from a small number of countries outside Europe. The Commission has yet to demonstrate to every Member State's satisfaction how the efficient use of markets in allocating gas use within Europe can help in ensuring the cheap supply of gas to Europe.

The use of competition law to change the way gas is bought and sold in Europe might well undermine the use of long-term, oil-indexed contracts. The attraction of this is that such contracts do not reflect the value of gas to Europe, or within Europe — market prices might ensure that tight gas is used wisely and surplus gas is used rather than hoarded. However, it also means for producers that securing an attractive price for gas depends on ensuring scarcity, and the Commission's jurisdiction does not include taking action on abuse of dominance outside Europe ■

