Market Players Support Ownership Unbundling and more Transparency

The majority of our panel of market participants believe ownership unbundling (OU) of TSO power and gas networks and more real-time disclosure of supply data will reduce the market influence of dominant incumbents, encourage competition and lead to greater market liquidity. However, on OU, "political" opinions are deeply divided and some form of compromise solution seems likely in order to maintain progress towards a single energy market. These are some of the main conclusions of Moffatt Associates' latest European Energy Trends Survey.

Setting the Scene

This year was to be a defining moment in the liberalisation of the European energy markets. From July 1, all gas and power customers should in theory be free to choose their supplier, in line with the last EU energy liberalisation directive, Directive 2003/54/EC. However, as the European Commission's Competition Directorate's energy sector enquiry revealed in January, the European energy markets remain largely national, and there is a lack of competition.

As a result, earlier this year the European Commission produced a package of measures aimed at removing barriers to competition and establishing a genuine single energy market in Europe. These measures, revealed on 10 January 2007, are intended to create a genuine single energy market in Europe, accelerating the shift to low carbon energy and increasing energy efficiency.

Focus on Ownership Unbundling

Directive 2003/54/EC required legal, organisational and decision-making independence from other activities not relating to transmission, or distribution for a distribution system operator. However, realising that this legislation has not been sufficient to ensure complete separation of these activities, the Commission, led by the EU Competition Commissioner Neelie Kroes, has been calling for full ownership unbundling between energy supply and network activities. According to Ms Kroes, the continued bundling of generation, supply, pipelines, grids and distribution seems to be at the heart of the current market failure.

The Commission has argued that a lack of unbundling could give a TSO an incentive to use its monopoly position as network owner to prevent or limit competition in other areas of the value chain, for example by increasing its competitors' costs, withholding essential information and providing information only to affiliated companies. Networks could be seen as strategic assets serving the commercial interest of the integrated company, and not the overall interest of network customers.

Directive 2003/54/EC provided for the possibility of future amendments if its rules proved to be inadequate. On this basis, the Commission has decided that further legislation is needed if progress is to be made in this area. In its energy package, after strong opposition from a number of EU member states, the Commission stopped short of insisting on full ownership unbundling. Instead, it put forward two alternatives for network separation:

(1) A full independent system operator, where companies would be allowed to remain owners of the network but would receive a set price for allowing competitors to use it.

(2) Ownership unbundling, where the generation business is kept fully separate from distribution activities over the network.

The Commission has warned that the first option would require more regulation, but stopped short of calling for a European regulator, which is likely to be a highly unpopular move.

Promoting Integration and Liquidity

Other measures contained in the Commission's energy package include strengthening national energy regulators, improving the regulation of network access at national and EU level, reducing the scope for unfair competition by incumbents providing lists of suitable power generation or gas storage sites for competitors, and improved transparency and coordination between transmission system operators (TSOs).

The lack of investment in cross-border interconnection capacity is also regarded as a problem. According to Neelie Kroes, TSOs invested only 20% of the €1.3 bn collected in congestion revenues by auctioning spare capacity back into interconnector capacity. This is particularly worrying, since it is the incumbents who are failing to invest in the networks, and who are thereby strengthening their dominant position at the expense of possible new entrants.

Lack of information also represents a serious barrier to competition. For example, wholesale price movements are often caused by variations in production or in the use of import capacity by the largest electricity and gas companies. Smaller market participants are at a disadvantage if they cannot track the underlying causes of changes in market prices.

The Commission believes that more transparency would also allow for improved market surveillance.

In an attempt to improve the availability of information, ERGEG, the European energy regulators' association, has proposed guidelines for transparency and has advised the Commission that these should be legally binding. The EC plans to introduce binding guidelines for transparency either through new legislation or by modifying the existing electricity regulation EC 1228/2003, which relates to conditions for access to the network for cross-border exchanges in electricity.

A new EU directive will therefore be put forward later this year, based on the measures contained in the energy package, and following extensive consultation with EU member state governments, the European energy industry and other interested parties.

Opinions Divided on Ownership Unbundling

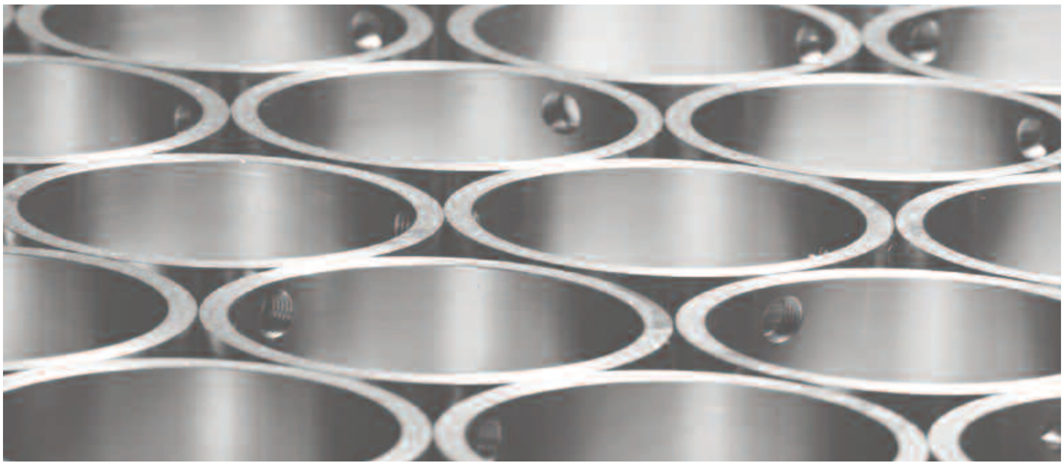
Of all the measures currently under discussion, the most contentious is the question of separation between the networks and supply. With the exception of the UK utilities, the European power industry has come out strongly against full ownership unbundling (FOU). EURELECTRIC, which represents the European power industry, has rejected FOU and the creation of an independent system operator in favour of a regional model involving TSOs linking up their activities on cross-border trade *(See Call for Regional TSO – Page 12).*

Such a model, the association believes, would act as a driving force for market integration, and at the same time limit the role of vertically-integrated companies to that of owners of the transmission assets.

France and Germany are the strongest opponents of full ownership unbundling amongst the member states. Although TSOs are independent entities in most EU power markets, the independence of grids from their parent utilities is a controversial issue in France and Germany, with their strong, vertically integrated utilities.

The French government has warned that ownership unbundling would mean dismantling its energy giants, EDF and GDF, and neither France nor Germany want to see any reduction in the power of their national champions.

Although the German government's current EU Presidency means that it is taking a lower profile than France on the issue, it remains opposed to full ownership unbundling. Joachim Wuermeling, secretary in the German economic ministry, has questioned the effectiveness of a full separation of grid operations and energy supply within energy companies, maintaining that "full ownership unbundling is no 'general cure' and is not enforceable throughout Europe."



The German power industry, which is strongly opposed to ownership unbundling, is trying to halt the Commission's plans by proposing an alternative solution. This would involve power companies merging their networks with other foreign competitors in order to create a regional network transmission and distribution system, covering Germany, France and the Benelux countries. The companies say that the networks would be managed independently, without their involvement.

Opponents of FOU warn that it will heighten the risk in retail and generation businesses, particularly for smaller integrated utilities like those in the Netherlands. They claim that these companies need a stable and solid cash flow such as that provided by network businesses, and if this is taken away, their future business will be compromised.

Those who are against ownership unbundling also say that it would weaken European companies when negotiating with dominant suppliers such as Russia. They point to the UK, where full liberalisation has led to price increases.

In contrast, other players in the German energy market are more supportive of the Commission's proposals. The VIK, which represents industrial energy consumers, believes that increased independence of network operations can prevent discrimination against new entrants accessing the network, while the BNE, the German association for new energy suppliers, also maintains that transmission and distribution should be independent in order to prevent market dominant companies from exploiting their position.

Commission Stands by to its Favoured Option

A few weeks ago, following the European summit of heads of government, France claimed that the European Commission had definitely dropped plans for ownership unbundling, largely as a result of its lobbying, and that EDF and GDF would not have to be dismantled by separating out their network activities.

However, any hopes that the Commission had abandoned its preferred option of full ownership unbundling were swiftly dismissed when the EC Competition Commissioner, Neelie Kroes, warned that ownership unbundling was still at the top of the agenda as one possibility. Shortly afterwards, this was followed by confirmation that the Commission was drawing up plans for the full ownership separation of networks from generation, a document which will be published later this year.

The question of compensation also looms large over the debate. If unbundling goes ahead, the power sector will insist on adequate compensation to reflect the negative effect of divesting network assets on their cost of capital. In Germany, the government has suggested that forced unbundling might contravene the country's constitutional property rights, and the power industry there believes that it could amount to an 'expropriation' of shareholders assets.

It is not only in the EU that ownership unbundling has resulted in a storm of protest. The Swiss power industry is disputing plans by the government to force power companies to relinquish ownership of the newly created swissgrid transmission system operator, which took over Etrans in December 2006, in return for shares in the new organisation.

The power sector believes that the plans amount to compulsory expropriation and that they are illegal. The battle could intensify in the next few weeks as the government finalises the detail of its new energy legislation, designed to bring Switzerland largely into line with the EU's market liberalisation rules.

EU member states are split over ownership unbundling, and France and probably Germany are likely to continue with their opposition. The Czech Republic, Austria and Hungary also have reservations, but the UK, Ireland and the Netherlands are supportive of the plan. Only qualified majority voting would be needed in the Council for any subsequent Commission proposal, which means that France would be unable to veto the plan.

APX Panel Supports OU and More Transparency

Most of our panel of experts in the Energy Viewpoints survey supported ownership unbundling as the best way to ensure that the networks will not continue to be controlled by the larger companies, to make sure that proper competition develops, and to move towards liquid markets *(See Market Survey results in detail on page 18).*

However, some respondents felt that solutions other than full ownership unbundling might be possible, for example the creation of regional independent system operators.

There was some support amongst our panel for enhanced cooperation between regional network operators, and indeed regional power markets are already in the process of being formed. ERGEG, the EU energy regulators' association, has proposed a framework for regional developments in electricity and gas and is working on the establishment of seven macro regions for electricity and four macro regions for gas.

As to whether full ownership unbundling will lead to an immediate and sustainable reduction in the cost of network access, there was some uncertainty amongst our panellists about whether this would be immediate, but a general consensus that this would eventually lead to a reduction in cost. However, most believed that full ownership unbundling would improve the availability of market information.

The majority of our respondents also agreed that the disclosure of more supply data to all market participants would improve gas and power market liquidity. Most believed that the provision of information is a key issue, and that this should be available to all, not only to the largest energy operators. In addition, if all market participants have access to supply data, this should help to establish a liquid market. There was a general agreement that everyone trading in the market needs access to the same information, otherwise it will continue to be controlled by the larger incumbents.

There was also agreement about the kind of data that is regarded as essential information, with an extensive range of information on gas regarded as particularly desirable. This is largely because gas liberalisation has tended to lag behind that of electricity, and some basic information that is beginning to be available for power is not yet available for gas.

Possibility of a Compromise

In conclusion, much now depends on the detail of the directive that the Commission will present later this year. Opponents of full ownership unbundling hope that the Commission's proposal can be blocked, while supporters are concerned to ensure that there is no weakening of the proposal to achieve a compromise.

However, the possibility of legal challenges to ownership unbundling could yet force the Commission to soften its stance. The final legislation could therefore abandon full ownership unbundling in favour of the adoption of the independent system model, as the Commission tries to ensure that at least some progress is made in its efforts to create a single energy market in Europe.

MOFFATT ASSOCIATES

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