The Third Package: A Structural Diversion?

The European Commission argues that unbundling will remove incentives for vertically integrated transporters to protect or favour related businesses. However Robin Cohen of Deloitte concludes that while a single and effective European electricity market requires enhanced physical integration and the associated investments, regulatory risk is the main impediment. The proposed Agency for the Co-operation of Energy Regulators may prove to be the institution for tackling this problem but as yet no solutions are proposed.

A Setting the scene

The EU Commission's approach to effective unbundling carries with it numerous risks.

- Ownership unbundling reduces incentives for discrimination, but also risks compromising economies of scale and substituting unclear investment incentives.
- ISOs – the permitted alternative to ownership unbundling – are complex and so may result in worse investment incentives and more regulation than before.
- More regulation is envisaged by the Commission, but, regulatory risk is already the main impediment to investment into electricity networks in the EU.

Some incumbents in response to the Commission's proposals are already preparing to sell their networks, but regulatory risk acts as a deterrent to some buyers and the 'Gazprom' clause may further depress the value to be realised from sales.

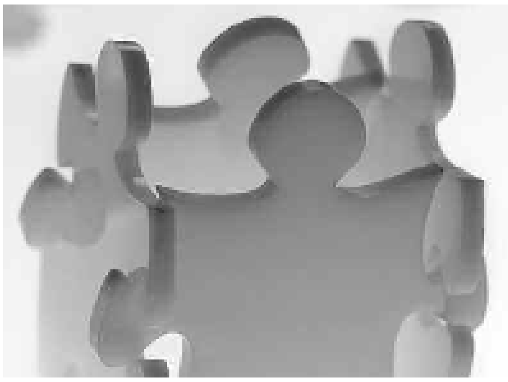
Ownership unbundling

Ownership unbundling directly removes any potential conflicts of interest which might arise from the same company owning and operating networks on the one hand and having upstream or downstream interests on the other. As a consequence it reduces the need to "police" a company's behaviour through regulatory oversight.

However, there is evidence[1] of significant cost savings from vertical integration, which must be weighed against the potential detriments arising from discrimination against independent suppliers.

Furthermore, the practical effect that ownership unbundling will have on investment is unclear. Investment in any sector primarily depends on the likely rate of return to be earned from the asset, albeit that this may include external – or vertically related – benefits. The main risk faced by network assets in Europe – and accordingly the main investment driver – is regulatory and political risk, something regulators rarely admit.

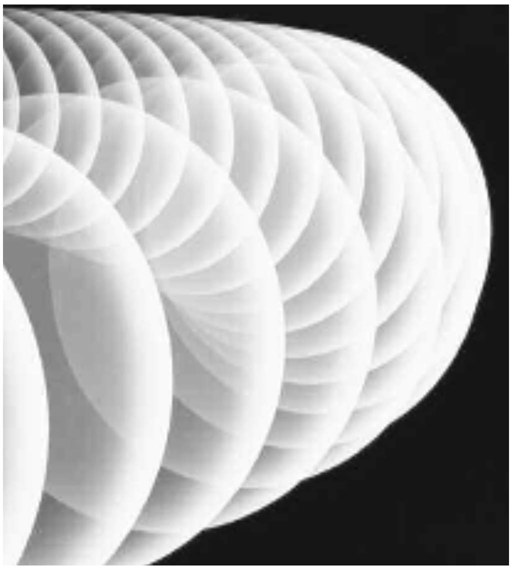
(1) Evidence of the extent of these cost savings in the electricity industry is provided in Kaserman, D.L. and Mayo, J.W (1991) "The Measurement of Vertical Economies and the Efficient Structure of the Electricity Utility Industry," Journal of Industrial Economics 39(5): 483-502, 1991.



ISOs: new investment incentive problems

As an alternative to ownership unbundling the Commission's proposals provide Member States with the option of allowing vertically integrated gas or electricity incumbents to retain ownership of their networks in exchange for handing over their operation to an independent systems operator (ISO).[2] In principle this should remove the opportunity for the owner of the transmission network to discriminate against third party suppliers. It also facilitates the integration of operation of transmission networks in separate regions and under separate ownership.

However, separating network operations from network ownership leads to several potential incentive, regulatory and organisational problems, especially with respect to the interface between the ISO and the network owner. Difficulties arise especially with respect to developing a contractual structure which provides the transmission owner (TO) and the ISO with appropriate incentives to minimise costs and expand the network in an efficient way when there are not such close connections between the two. Instead of reducing the need for regulatory oversight in the sector through the creation of an ISO, regulatory focus will simply shift from policing third party access to scrutinising the interface between the ISO and the transmission owners.



Initial reactions have revealed that both ownership unbundling, as well as a deep ISO model, is unpopular with a number of incumbent vertically integrated companies. Indeed the Commission is arguably already anticipating attempts to water down the unbundling implications of its Directive through forming voluntary regional co-operation agreements by incorporating the proposal for formal EU networks of transmission system operators in electricity and gas in its legislative package.

Regulation is the main driver of network investment

Currently there is a clear regulatory gap in Europe with respect to cross-border network investments. Inconsistent regulatory rules across the EU pertaining to revenue caps, regulated rates of return and investment incentives mean that investors face varying regulatory and commercial risks. The 3rd legislative package proposes the establishment of a new Agency for the Co-operation of Energy Regulators (ACER) which is a first step towards creating a clear and stable regulatory framework for cross-border investment. However, the powers and remit of ACER are as yet unclear. Most importantly, the degree of independence of ACER from the Commission is itself also unclear but regulatory independence is a key concern for potential investors.

(2) Independence in this context relates to independence from upstream and downstream interests in the sector. Variants of the ISO model have been implemented in Alberta, Canada; Australia; Britain; California; Chile; the PJM regions (Pennsylvania-New Jersey-Maryland); New York; and New England. There is much variety in the details of ISO structure in different locations.

The 'Gazprom' clause

Given the uncertainties surrounding future unbundling requirements, a number of the large integrated European utility companies are potentially considering the sale of transmission assets. Infrastructure funds are certainly interested in regulated businesses with relatively stable cash flows. However regulatory risk is not the only factor determining value realisation from network sales.

The draft Directive contains a clause, commonly referred to as the 'reciprocity' clause, which may have significant implications for the permitted identity of investors into TSOs. This clause provides that transmission systems or transmission system operators shall not be controlled by a person or persons from third countries, unless there is an agreement between the EU and this third country. This 'Gazprom' clause introduces potentially increased state intervention by requiring international government-level negotiations. It may also act to deter or bar some investors with a consequent impact on network values.

Conclusions

The EU's unbundling proposals are ambitious and controversial. The 3rd legislative package has now passed to the European Parliament and Council (Member States) for full legislative scrutiny. This "co-decision" process is open-ended, but usually lasts 2-3 years.

There is significant resistance to the unbundling provisions especially from France and Germany who will argue that ownership unbundling is an unnecessary change that will reduce investment and that the alternative ISO model is overly complicated and bureaucratic. Concerns are also likely to focus on whether the value potentially released from asset sales is less than the value lost from the 'benefits' of integration. The European electricity market requires enhanced physical integration and the associated investments. Regulatory risk is the main problem in this context and the Commission's proposals have not articulated a clear way forward on this issue.

From the UK perspective, if the EU's proposals are implemented as envisaged, then BETTA would need changing at a minimum to give NG investment decisions, something the Scottish network owners are likely to be opposed to.

However in many ways the Commission has already advanced further with its proposed reforms than some critics might have expected. German and French resistance is nothing new. The Commission is to a significant extent staking its reputation on energy sector reform, not just through the publication of the 3rd legislative package but also in the competition enquiries running parallel. It will not easily give up on the core proposals in the 3rd package, including the unbundling provisions, however protracted and fraught the "co-decision" process preceding the final version of the new Directive will be.