

# **Electricity and Natural Gas Marketization in the EU**

## **Current Studies on Business/Public Policy Issues in Energy**

*An Energy Institute White Paper*

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*Prepared by:*

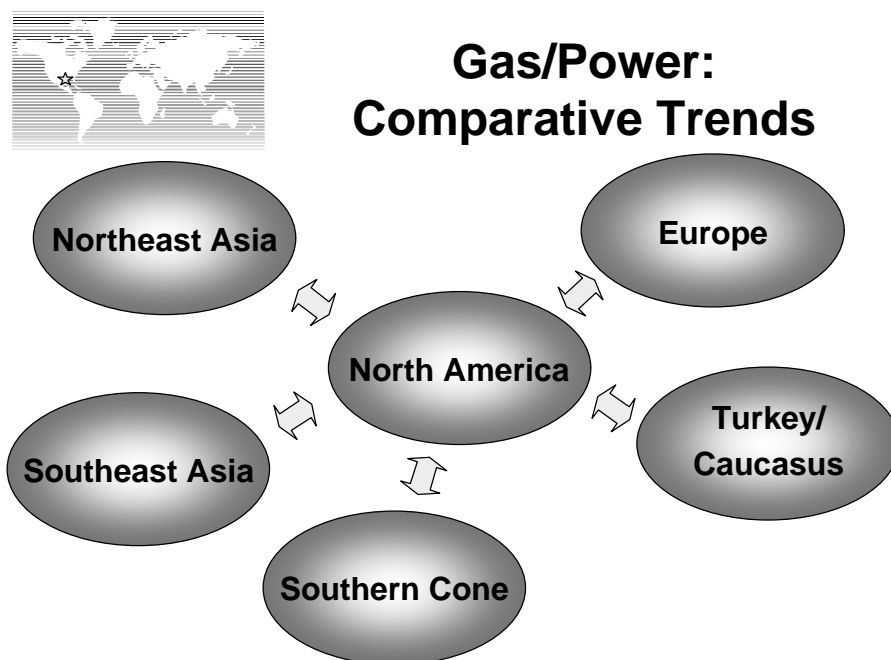
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## Preface

This white paper is an integral part of an overall goal at the Institute to build a profile of comparative studies on natural gas and electric power marketization\* trends in key world energy regions, as the diagram below illustrates.



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The Institute and UH are strongly positioned in North America. Our most recently completed report, *North American Energy Integration*, funded through the Shell Interdisciplinary Scholars Program at UH, is a survey of the regulatory and policy environment and energy trade in light of the North American Free Trade Agreement (NAFTA). Similar conditions exist of course in Europe, where the EU, common market regime and Energy Charter Treaty overlay a set of trade conditions upon energy markets that adds an additional dimension to decision making within member countries. The current white paper studies the European experience in detail. The paper will serve as background for the roundtable on the *North American and European Natural Gas Policy*, organized by the Energy Institute and the Royal Institute of International Affairs, in London, in September 1998. A related study by the RIIA is also provided as an attachment.

Our other research targets are the Mercosur trade region in South America (commonly referred to as the Southern Cone); the potential for trade-influenced cooperative regimes that facilitate gas and power infrastructure networks in Northeast and Southeast Asia; and the emerging markets in the Black Sea/Caucasus region and their linkages to the potential natural gas production in and around the Caspian Sea. Our report, *Power Marketization in Turkey* starts our research effort in this final region. We plan to release a complimentary report on Ukraine in early 1999.

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\* The concept of "marketization" was developed by Michelle Michot Foss and first presented by the Institute in our report *Asian Oil & Gas: Megatrends, Balance and Geopolitics*. We know of one other notable use of the term marketization in *The New Geopolitics of Energy* by John V. Mitchell, Peter Beck and Michael Grubb, 1996, Royal Institute of International Affairs. The theoretical basis and implementation process for marketization is defined in a forthcoming white paper by Michot Foss and Roland Priddle, *Getting from Here to There – Introducing and Implementing Energy Market Reforms* (expected publication date Fall 1998).

In all of these target regions, our interest is in understanding common factors, problems and approaches. Already, we can state the following from the work we have produced thus far.

- Pressure from trade flows can change internal conditions within domestic markets, making market-based approaches more acceptable. Countering these forces, however, is the strength of government control.
- Open trade cannot adequately compensate for inadequate institutional development within countries to support the gas/power value chain.
- Economic development is both a constraint and imperative for open energy trade and market-based institutional development. Many of the reasons governments cite for retaining control of their energy sectors are *precisely* the reasons why government control should dissipate – price disparities across customer groups, inefficiencies in energy production and delivery, and lack of modern infrastructure.

Our work will add to the body of research on regional gas/power networks and the role that regional trade regimes play in fostering infrastructure development. Some of these inquiries are taking place elsewhere within the Institute network as well as by outside organizations. We invite the reader to join us in these efforts by providing comment and input on our efforts.

— Michelle Michot Foss, Ph.D.  
Director, Energy Institute

## Introduction – The Central Question

The process of the liberalization of natural gas and electricity sectors in Europe has been arduous. However, Europe has undergone a unique energy liberalization process because European institutions are always in flux. It is unknown just how much power the European Union (EU) will yield in relation to member states. Also unknown are the future relationships among the EU institutions themselves: the Council, the Commission, the Parliament and the European Court of Justice (ECJ). One can observe what the relationships among institutions were in a particular policy area in the past. But since relationships change so often and vary so dramatically across policies, it is difficult to predict how the balance of power will affect the policy making process.

Furthermore, the roles of the EU institutions are confusing. The European Parliament does not have as much power as national parliaments. On the other hand, the Commission, a bureaucratic agency, has enormous legislative power compared to average national bureaucratic forums. The ECJ has more power than most member states' high courts at the national level, and enormous power considering that it is a transnational ECJ. Each institution in the EU has legislative, executive and judicial powers. Thus, understanding the role of any institution requires analysis that transcends the formally designated branch of the institution.

In EU countries, the energy industries are not regulated by independent agencies as in the United States. In other words, there is no parallel to the U.S. Federal Energy Regulatory Commission (FERC) or State public utility commissions, either on the member state level or at the level of the EU. Instead, state monopolies have completely controlled (and in most cases, owned) production, transportation and distribution facilities of natural gas and electricity. There is no regulatory infrastructure in place outside of the European Commission to ensure compliance once the utilities are privatized. The exception is Great Britain, which privatized both its natural gas and power industries and where the Office of Gas (Ofgas) functions much like the FERC.

There are fewer industrial actors in Europe. Because of that, some people believe that the market cannot guarantee fair consumer prices through effective competition. However, Britain and the United States experiences show that the number of suppliers grows as the incentive structure allows and that effective regulation is necessary to ensure fair competition practices after privatization.

Understanding the history of electricity and natural gas industries, and all interests involved, including consumers, producers, and distributors provides a useful foundation for analyzing the politics of energy liberalization in Europe. The primary objective of studying the legislative history of electricity and natural gas is to demonstrate which issues cause controversy and explain how institutions deal with these controversies. It is also necessary to explain the constraints and incentives structured by the institutional setting. Such an explanation is important for two reasons: 1) to explain the outcome of the legislation that has already passed, and 2) to help predict future trends.

There are three objectives of this white paper. *The first* is to offer a brief history of the EU and introduce its basic institutions and processes. *The second* is to outline a history of the development of natural gas and electricity policies to show which institutions and interests were instrumental in the formulation of these policies.

*The third* is a deeper theoretical objective. The development of European energy policy is used as a case study to develop a theory that predicts how energy policy will develop in the future. Such predictions are based on the reality of the energy situation in Europe, which is the interplay of stakes, interests, and the role of institutions in the political economy of energy.

The central question is to explain the institutional interchange of issue agendas. Issues are distributed among several institutions. This process, however, can be explained by the strategies of both public and private actors. The hypothesis is that when institutions are unable to deal with a particular controversy effectively, then other institutions will address that issue. This happens because actors outside the governmental process strategically allocate their resources to push their policy agenda in the institution that is most likely to address their concerns. This process transfers jurisdictional power from legislative and bureaucratic institutions to courts. When this occurs, judicial institutions become more powerful.

In the long term, this baseline draft is a springboard for further research funded through the *Energy Institute*, which will address the complex issues of energy deregulation in Europe. It analyzes the institutional and cultural constraints on effective energy deregulation. In the short term, the research serves as the foundation for the roundtable on the *North American and European Natural Gas Policy*, organized by the *Energy Institute* and the *Royal Institute of International Affairs*, in London, in September 1998. One aspect of further research will be to assess the extent to which Europeans and NAFTA member countries can learn from one another's mistakes and successes, both in transforming and integrating the energy industry and its policies.

## Executive Summary

### ➤ New Liberalization Proposals

The late 1980's witnessed an increase in liberalization efforts, not only in the EU, but also around the world, in broadcasting, telecommunications, and energy sectors. Britain transformed its natural gas and electricity monopolies, after successful liberalization in the telecommunications industry. The EU proposed changing its energy regulatory policy, just after proposing to break up monopolies in telecommunications.

➤ Maastricht Treaty. The Maastricht Treaty (the Treaty from hereon), signed in 1993, created the EU out of the European Community. New treaties in Europe generally mean that the old treaty simply has been revised. Therefore, the Maastricht Treaty is a revision of the Single European Market Treaty of 1986, which was itself a revision of the original treaty of 1957, the Treaty of Rome.

➤ Trans-European Networks. The Maastricht Treaty established that there should be Trans-European networks that connect energy, telecommunications and broadcasting infrastructure. However, this provision is an intention to establish the physical networks, not a provision that establishes regulatory frameworks that will guarantee access to these networks.

➤ New Legislative Process. The major revisions included new legislative procedures that put more power into the hands of the Parliament, and set aside more policy areas that could be decided by simple majorities in the Council. The intentions of the process is to make the decision making process more efficient and more democratic. Unfortunately, the intended consequence and the actual results are not well matched in this case.

➤ Timeline: **Figure 1.**

**Figure 1. Timeline of EU Liberalization Policy**

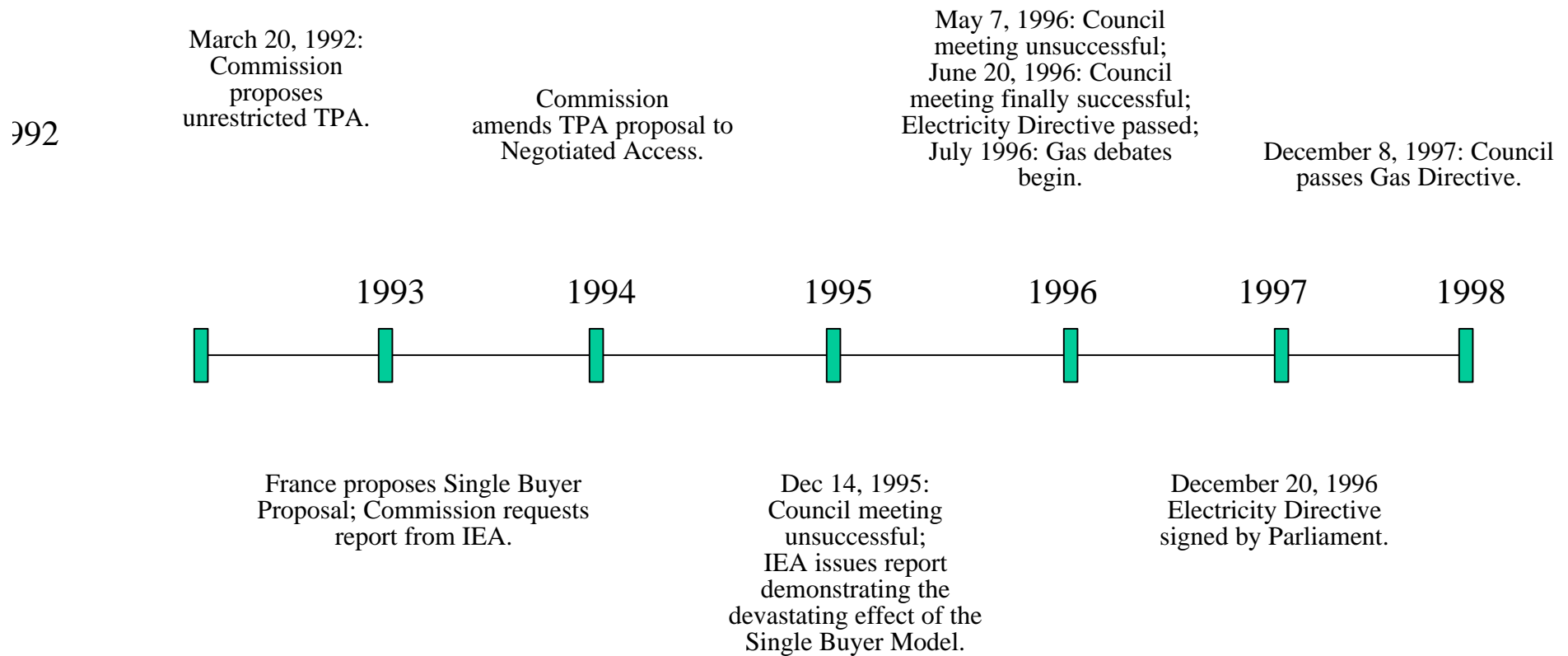


Figure 1 shows the timeline of Energy Policy Proposals and Final Legislation. Proposals for unrestricted Third Party Access (TPA) began in 1992 for electricity and gas. However, when the issue seemed to provoke extreme levels of controversy in member states and the Parliament, the Commission decided to focus on only electricity with a new proposal in 1994. The new proposal, Negotiated Access allowed for greater restrictions than the original TPA proposal in that the state could require licensing restrictions on those who would provide access. France proposed the Single Buyer Model, which revised the Negotiated Access proposal in that only one buyer would be licensed by the state. The International Energy Agency issued a report during the negotiations claiming how harmful the Single Buyer model would be in the market if passed as a parallel policy with the Negotiated Access proposal. Nevertheless, the Single Buyer option was granted in the final legislation. Immediately following the electricity deliberations the debates for liberalizing the gas market began.

➤ Price Transparency and Public Procurement Directives. The first regulatory changes that have to be made in a liberalization process are to make accounts transparent, and to make procurements public. This legislation was accomplished fairly early in the process; however, it is unclear how effective this transparency is likely to be. For example, countries that may get away without complying with mandatory access may also get away with less than full transparency.

➤ Electricity Directive. The Electricity Directive was passed by the Council during the summer of 1996, and was finally signed by the Parliament in December 20, 1996. The directive provides for a gradual opening of the market. The directive also allows the member states to establish their own licensing procedure for those that will be allowed to negotiate access. The directive also allows a member state to establish a monopoly to a Single Buyer. The government can readily regulate that access.

➤ Gas Directive. The Gas Directive was signed by the Council in December 8, 1997, and was finally approved by the Parliament in the summer of 1998. Some major issues, such as how to deal with take or pay (TOP) contract terms, stranded assets and reciprocity were, for the most part, left without clarification. Therefore, the power of the Directive is likely to be very weak.

➤ European Energy Charter Treaty. The European Energy Charter Treaty is based on the promise to the post-communist countries that the European market will be open to their gas and other energy resources. There were many signatories -- all of Europe, including Eastern Europe and the former Soviet Union, and most other industrialized nations with the notable exceptions of the U.S. and Canada. Though it is not an aid program, it is related to the issue of foreign aid, since these countries will have the opportunity to develop their economies quickly through quick payoffs in the energy sector. However, the Commission has argued that the Treaty in no way guarantees access to countries outside of the EU. It is yet unclear how the Charter Treaty will impact the openness and competitiveness of gas markets in Europe. It is clear, however, from recent controversies dealing with access to Siberian gas undertakings, that the matter will have to be resolved. Because legislation has already done what it can do, parties are looking to litigation to solve their conflicts.

### ***Findings of the Report***

The future of natural gas and electricity policy in Europe seems to hinge on the question of which institutions hold the keys to direct and implement policy. What is the relationship between member states and EU institutions? How much power does one individual member state have in vetoing legislation? How will the relationships among EU institutions affect future policy? Both natural Gas and Electricity Directives have passed, but does this mean that the policy making process is over? Beyond legislation, there is the problem with regulation. The directives simply set a course; they must be implemented in each of the member states to be effective. Thereafter, it is unclear who will provide oversight -- the EU or member states? If every member state allows competition with incompatible approaches, are producers



and consumers better off? Will the legislative bodies be willing to "cede" power to the regulatory commissions? Will states choose simply to regulate through their ministries? This report highlights the constraints that act against an efficient and effective energy legislative and regulatory liberalization. It further identifies which institutions are equipped with overcoming particular barriers.

There are informal constraints and catalysts to the energy policymaking process. When private and public interests are compatible, the process seems to move more expeditiously. Electricity liberalization seems to be dominated by groups that favor liberalization, a feature that helped expedite the process. On the other hand, many actors involved in the gas liberalization benefit from the status quo. For example, chemical companies that consume but also produce gas are less likely to fight for quick moves toward greater competition, primarily because they enjoy subsidies and state aid. It is therefore instructive that while initial proposals to liberalize included both electricity and gas, policy makers finally had to drop gas liberalization from the agenda to focus only on electricity. The Gas Directive was eventually ratified in December 1997, a year after the Electricity Directive was passed. It is also noteworthy that when the citizens discern potential benefits in liberalization they are motivated to support the reform process. On the other hand, when the ideological conflicts (e.g., worker-owner opposition in France) characterizes the conflict the process seems to move much slower.

Institutions can work as both catalysts and constraints in the policymaking process. The greatest institutional constraint that threatens efficient policymaking is that the EU balance of power is characterized by an excessive number of "veto players." Veto players are institutional actors in government that have the power to work as "checks and balances" in the policymaking process. For example, in the United States, the President acts as a veto player because he/she has the power to veto any congressional legislation. A large number of veto players is an indicator that many institutions can interfere with efficient progress toward further competition.

An example of the excessive number of "veto players" is the Council of Ministers. Each member state minister has *de facto* veto on all legislation, a property that renders the Council an inefficient venue to make decisions. France has been the staunchest opponent of both gas and electricity liberalization and has succeeded in stalling reform progress on several occasions. On the other hand, creative ideas, such as reciprocity, were instituted to counter France's derogation. Reciprocity provisions in the Electricity and Gas Directives were enacted to ensure that no member state would benefit disproportionately from liberalization. Under the provisions, states not willing to open their markets to regional competition are in turn denied access to foreign markets. However, it is not yet clear how effective the provisions will be.

The European Parliament has had a great deal of power since the implementation of the Treaty and therefore, has the opportunity to revise policies according to its own wishes. Because the Parliamentary elections are invariably held separately from general elections, political parties that dominate are likely to be different from the parties that dominate the Council of Ministers (an assembly of government ministers). For this reason, increased power for the European Parliament will always result in a slower policy making process and in the process, bolster the status quo.

The catalysts of energy liberalization have been, and are likely to continue to be the ECJ and the Commission. The Commission's bias is notably pro-EU, and its policy proposals invariably lay the ground for greater integration and open competition. The Commission first proposed unrestricted TPA. Notably the Commission had to revise its plan strategically after realizing that the Parliament and the member states would not so easily accept open competition.

The ECJ has powers to choose whether to bolster the power of the Commission, or to protect the member state's sovereignty. Generally, the ECJ has actively supported pro-integration and pro-liberalization policies, almost relentlessly (despite some recent exceptions). Legal analysis shows that Treaty law is

stronger in its pro-integration and pro-liberalization stance than the Gas and Electricity Directives that have been implemented. Furthermore, the European Energy Charter Treaty will bolster the ECJ's position, especially if it hears cases that challenge some protective provisions of the Directives. Predicting from past experiences, the ECJ will likely amend both the Gas and Electricity Directives. In fact, some conflicts have arisen and appear to be opportune premises for the ECJ to commence its review.