Policy Brief

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Gas and electricity in Europe: the elusive common interest

By Guillaume Durand

Background

The last few months have seen a sharp rise in world energy prices. The cost of oil has reached an all-time high, at more than 70 US dollars a barrel, with similar increases in gas prices.

Given the continuing thirst for energy in rich countries, particularly the US, and the strong increase in demand in emerging countries, energy prices may well remain at these high levels for a long time. Recent events in Iran, Iraq, Nigeria and Venezuela have also shown, once again, how dependent world energy markets (and indeed the global economy as a whole) are on deeply-unstable countries for supplies.

In Europe, the issue of security of supply came under the spotlight in January this year with the Ukrainian gas crisis sparked by Russia's decision to cut supplies to Ukraine because of a politically-charged row over prices. This also disrupted supplies to many EU Member States and demonstrated Europe's vulnerability.

In 2004, almost 54% of EU-25's energy consumption was met by imports and this dependency ratio will increase over the coming decades. Denmark is the only Member State which is self-sufficient, and nine countries (including Italy and Spain) have a dependency ratio of more than 80%.

All this has strengthened the case for the EU to act. Energy has jumped to the top of the European agenda, prompting a flurry of reports and papers. The European Commission presented its own contribution – a Green Paper on 'A European strategy for sustainable, competitive and secure energy' – in March, and a good third of the Presidency Conclusions from the Brussels European Council of 23-24 March were devoted to this issue.

A tale of two mergers

Energy cuts across a wide range of both national and European policies, but in the current debate, it is the single market and competition rules which have come to the fore.

Two very large mergers have captured headlines throughout the EU and drawn attention to how energy and, in particular, gas and electricity markets, function across the Union.

The first merger battle began in September 2005 when Gas Natural, Spain's largest gas supplier, launched a formal (hostile) takeover bid for Endesa, Spain's largest electricity producer. Then, in February this year, the German electricity and gas giant E.On launched a 30-billion-euro counter-bid for Endesa – the largest cash offer ever made in Europe. The fate of the Spanish company is still undecided.

The second merger, between Gaz de France (GDF, France's virtual gas monopoly) and Suez, a French company dominant in the Belgian energy market, was announced in February by French Prime Minister Dominique de Villepin. It was clearly a defensive operation, quickly engineered to counter a looming hostile takeover bid for Suez by ENEL, Italy's largest energy operator.

The French government has explicitly defended its right to help create 'national champions'. Similarly, the Spanish government has unambiguously backed the 'national'

Gas Natural/Endesa deal, overruling strong objections from the Spanish competition authority and issuing a tailor-made decree to protect Endesa from E.On.

'National' mergers undeniably have a strong protectionist flavour and comments in the international press have conveyed the impression that these 'political' deals were intrinsically bad and contrary to the spirit of the ongoing liberalisation process in Europe. By contrast, supposedly purely 'market-based' transnational deals are widely held up as essentially positive contributions to a well-functioning pan-European market.

This 'black and white' view may need to be nuanced. With hindsight, the recent deals were indeed politically-charged but were also fully in line with previous mergers.

Not so long ago, in July 2002, the Schröder government authorised a merger between Germany's largest electricity producer, E.On, and its largest gas supplier, Ruhrgas. While E.On is now seen as the 'good guy' in its transnational bid for Endesa, this should not hide the fact that it stems from a political decision to create a German 'national champion' in the face of strong opposition from the highly-respected German Federal Cartel Office.

Most deals in the energy sector are connected to politics in some way. This is neither surprising nor particularly shocking in what is arguably the single most important sector in any economy, and politicians therefore cannot afford to ignore what happens in the industry.

The idea that 'good deals' are market-based and 'bad deals' politically-influenced is also far too simplistic. For instance, ENEL's planned bid for Suez was regarded as market-based, even though the company's main shareholder (with a 30% stake) – the Italian treasury – is a political body.

More importantly, markets make mistakes and many mergers do not live up to shareholders' expectations. And while governments may make policy mistakes, they also sometimes take good decisions – and are held accountable for their actions.

State of play

The Commission's lack of specific competences in energy policy has meant that its natural inclination to date has been to use its internal market powers to open up and 'liberalise' the European gas and electricity sector.

There are, of course, other EU policies which have a significant impact on energy: for example, environmental policy and, in particular, the Union's efforts to counter climate change and the launch of the EU CO_2 emissions trading scheme (ETS) in January 2005. However, the Commission looks at electricity and gas, mainly through internal market lenses.

The priority at European level has been to 'liberalise' and to put a single market in place through two waves of directives: the first for electricity (1996) and gas (1998), and the second for both sectors (2003).

Although the declared objective of these directives was to achieve 'competitive' (i.e. market-driven) prices, the whole liberalisation process was largely 'sold' as a recipe for lower prices.

However, 'low prices' have always been a highly-problematic policy objective – and electricity and gas prices have not, in fact, declined across the board.

The dynamics which drive prices are complex and influenced by factors totally unconnected to the behaviour of players in the market, including the evolution of gas prices (which have increased significantly over the last couple of years), taxation and the cost of environmental protection systems (ETS). However, even taking these elements into account, the liberalisation process has not created a competitive European market and prices vary significantly between Member States.

To a large extent, the rules governing European gas and electricity markets have led to more cartelisation and entrenched existing dominant positions where incumbents are either national/regional monopolists (Belgium, France), or part of a cosy oligopoly (Germany).

As a result, there is no European market in gas and electricity as yet. The Commission has repeatedly referred to this, particularly in its latest report on the functioning of the internal market in electricity and gas, published in November 2005.

Clearly, it does not help that the main regulatory authorities dealing with key issues such as third-party access to networks are national (in Belgium, there are actually three regulators operating on a regional basis) and have varying powers. This leaves the Commission, with significantly less resources and expertise, as a weak 'regulator of the regulators'. As a result, markets are, at best, regional and few are truly competitive.

Competition rules to the rescue?

Since 'liberalisation' has not lived up to its promises, the Commission is now starting to wield its competition powers in the sector.

Amid strong suspicions that market operators were abusing their dominant positions, it launched an energy sector competition inquiry in June 2005. The final results of this inquiry have not yet been published, but a preliminary report, published in February this year, confirmed that markets remain seriously dysfunctional.

At the very least, the existing regulatory framework leaves considerable scope for companies to abuse widespread dominant positions. The largest incumbents, in particular those operating long-established power plants, are making huge profits and creating sizeable imbalances in the sector.

There are, however, strong doubts about how far the Commission will go in using its competition powers. Enormous investments are needed in existing networks to overcome the geographical fragmentation of the gas and electricity markets, making it crucial for individual companies and Member States to cooperate. If the regional or national cartelisation of markets is found to be a problem *per se*, it is also hard to see what resources the Commission could muster to combat this.

The tough measures needed to de-cartelise European markets would be politically very costly, not least because they would hit virtually all the large incumbents hard.

In addition, the blatant loopholes in the Commission's current Merger Regulation weaken its ability to act, as Competition Commissioner Neelie Kroes explicitly recognised in November 2005 when she called for more power for the Commission to rule on mergers between two firms from the same country, after the Commission was forced to refer Gas Natural's bid for Endesa back to the Spanish authorities.

'National mergers' are particularly problematic: whatever the size of the merged entity and its relevance for the European market, if each of the two companies generates more than two-thirds of its turnover in one Member State, it is the national authorities in that Member State which are responsible for deciding whether to authorise the merger.

This explains why the E.On/Ruhrgas merger was eventually dealt with by the German authorities, even though it had significant implications for the European market. Conversely, the Commission did intervene to prevent the Portuguese power-firm EDP from merging with Gas de Portugal in December 2004, even though this deal would have strengthened the merged company's dominant position on the Portuguese gas and electricity market but would have had virtually no impact on the overall European market. However, the Commission ruled on the case because EDP generates one-third of its turnover outside Portugal.

Reaching the limits

More fundamentally, there are increasing misgivings about what market liberalisation can achieve within the current framework. Tensions are rising, even in regional markets which have been reasonably competitive (in the Nordic countries and the UK), and the market may well prove unable to attract the investments needed to keep supply in line with demand.

As long as national or regional markets remain fairly insulated from each other, as they are now, market participants have an overriding common interest in keeping prices high and, if they do not invest, they will make higher profits.

The current regulatory framework conspicuously lacks any incentives for the long-term management of supply, and consistency between different policy areas is needed in relation to the long-term management of demand. For instance, while the need to boost energy efficiency is widely recognised, it has taken a decade from the adoption of the first European electricity liberalisation directive to prepare the forthcoming White Paper on energy efficiency.

This points to a dramatic lack of policy integration and shows that markets *per se* are no panacea and need to be properly designed, framed and regulated to deliver the desired benefits.

Prospects

Developments in European gas and electricity markets over the last decade have highlighted a distinct clash of approaches, resulting in a distinctively suboptimal result and thwarting any serious debate on how to define the 'European' interest.

On the one hand, supporters of tough market-liberalisation measures, spearheaded by the Commission, have consistently put their faith in market forces: Europe should liberalise its energy markets for real and this will produce the desired outcome in terms of prices, security of supply and environmental sustainability. According to this view, it is the lack of liberalisation, rather than liberalisation itself, that is to blame for current problems.

This is a reasonable argument: in the absence of truly competitive European energy markets, it is difficult to conclude that competition is intrinsically bad. However, it would be equally mistaken to idealise the market.

Irrespective of any ideological considerations, the notion that free markets will take care of everything is unrealistic and naïve.

The recent political deals on high-profile energy sector mergers have shown that, in the absence of a consistent European strategy, Member States will continue to seek their own strategic advantage in a non-cooperative fashion. One cannot set up a framework that results in reckless and distorted competition, and then complain that market participants are only pursuing their own interests using all their assets – including political connections.

'National' interest?

On the other hand, any form of 'economic patriotism' of the kind recently displayed by the French government and, in a less arrogant manner, by the Spanish authorities, is equally unhelpful. It is quite legitimate to maintain that energy is too vital a sector for the national economy and the domestic population to be left to the vagaries of markets, and that it should be subject to democratic control. However, economic patriotism is a vague, misguided and flawed concept.

First, it is not always clear that the general interest would be served less well by foreign companies (i.e. respectively, E.On and ENEL), since they would be subject to the same legal obligations as any national operator. Second, it may be too generous to label the French or Spanish governments' recent moves as attempts to defend their citizens' interests.

Given the personal ties between the politicians and the businessmen involved, one could just as well argue that these deals protect vested interests.

Finally, such national posturing makes the whole debate on a European energy policy sound rather hollow. There may not yet be a proper European energy strategy, but those Member States which say they want it most (such as, rather paradoxically, France) need to break the vicious circle and demonstrate their willingness to stand up for a broader vision of the common European interest.

These recent mergers have highlighted Member States' distinct lack of enthusiasm for deep integration of the European energy sector, despite all the talk of developing a common energy policy at the March 2006 European Council.

This is somewhat ironic, given that coal (and later nuclear energy) were originally at the heart of the European integration process. It is also worrying. Although the Union does not have competences in the energy sector, all 25 Member States signed a Constitutional Treaty only two years ago which included an energy chapter and would have made energy a 'shared' competence between the EU and the Member States.

This is in stark contrast to the very cautious reaction from Member State governments to many of the ideas outlined in the Commission's recent energy Green Paper. But it is consistent with the fact that Member States still regard energy primarily as a national concern. For instance, Sweden only recently launched a national plan to become the world's first oil-free economy by 2020, while Germany is posed to define its new energy concept by the end of 2007: both these processes involve exclusively national players.

Moreover, Member States have a dismal record in implementing the EU 'liberalisation directives', with virtually all of them dragging their feet.

To kick-start the process, the Commission launched an unprecedented package of infringement proceedings against them in April this year. No less than 43 letters were sent to 24 Member States (only the Netherlands was spared) mainly concerning the liberalisation directives, but also relating to EU legislation designed to promote the use of 'green' electricity and bio fuels, and the management of emergency oil stocks.

Where next?

All this casts serious doubt on the future for an ambitious European energy strategy.

There is still a strong case for devising such a strategy, but to make it credible, the EU should focus its efforts on defining and delivering the relevant public 'goods': energy security, a well-functioning pan-European network, and a set of genuinely common rules, applied consistently across the Union. There also need to be serious debates on controversial issues such as a single European regulator or the ownership of energy grids (i.e. natural monopolies).

Overall, the EU's energy policy should recognise that the market is only a means to an end, not an objective *per se*, and that it will not meet all policy objectives. It therefore also needs to integrate potentially-conflicting objectives such as competitiveness, security of supply, environmental protection and nuclear safety, and strike a more appropriate and sustainable balance between competition and cooperation.

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