WORKSHOP ON BEST PRACTICES IN THE ENERGY SECTOR: RESTRUCTURING, PRIVATISATION; THE ROAD AHEAD - 12 MAY 2004

BUILDING BETTER GAS MARKETS IN EUROPE AND BEYOND

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The European Union took a gigantic step towards building better gas markets within Europe with predictably far-reaching consequences for countries outside of the EU periphery when adopting the Gas Directive in 1998 and the subsequently broader Gas Directive of 2003. A better gas market presupposes that the status quo is inadequate and certainly in the period leading up to the Directive, the European gas market was dominated by large firms facing little competition and offering little choice. Complicating the picture was a market at different levels of development, with mature downstream infrastructures in the Netherlands, the UK, Germany, Hungary, Italy, France, Poland and the Czech and Slovak Republics, and young markets in Spain, Portugal, Sweden, Ireland, Turkey and Greece. During the intervening seven years and on the eve of meeting the provisions of the Directive (1 July 2004), there has been only modest progress in reforming the market along the lines cast in the Directive.

Central to the Directive is the notion that member countries may choose between negotiated access and regulated access. As the International Energy Agency notes, „the Gas Directive leaves the European countries considerable scope in deciding the exact shape and extent of the reforms they wish to make. This would allow each European country to define a regulatory framework best suited to its specific circumstances, in consideration of the positive experiences with third party access regulation, in, for example, the UK, but also the drawbacks of the approaches taken there. On the other hand, this subsidiary-approach could lead to inconsistencies between national approaches to regulatory reform which could be an obstacle to the rapid development of a fully open and fluid market." Indeed, as we shall see, choosing negotiated access has favoured the traditional market, as it has given existing firms more leeway in regulating themselves. But this has not led to the open and competitive market envisioned in the Directive. On the contrary, it has slowed reform and kept potential new firms wishing to enter the market on the margins.

This poses a significant problem for the regulator, for; on the one hand, he is seeking to promote a more balanced and efficient market through increased competition. But, on the other, if he presses too far into the market, he may undercut the economic incentives that support long-term investment in the gas infrastructure and in the end weaken Europe's security of supply.

Let us look at several key European countries, beginning with the UK and moving on to France, Denmark and Germany, for insight into how they have resolved the fundamental issue of negotiated versus regulated access to the indigenous gas infrastructure.

The UK was, of course, the first European country to liberalise its gas market back in 1982 through the Oil and Gas Enterprise Act. British Gas (BG), a vertically integrated, state controlled firm with near control over the entire gas chain (production, transmission, distribution and retailing), was obliged to allow for others to compete in the sales of gas to end-users. But the new regulation did not provide for access to the BG gas grid. Hence, in 1986, BG was privatised and the government expanded the Gas Act with provisions for gaining access to the transmission lines. There were not many takers. BG was able to frustrate entry by withholding

adequate information on cost of third party transportation. Due to its market dominance, it further discriminated between customers.

This forced the regulator to again intervene in the market and compel BG to provide more information about their charges, how they were calculated, and unbundled the operations of transportation from marketing and purchasing. By 1990, the government initiated a 20 to 40 percent reduction in transportation tariffs.

Its objective of increased gas-to-gas competition by way of eventual, regulated third-party access and unbundling the various downstream functions re-structured the market. BG has been broken up into two companies with separate responsibilities for domestic and foreign markets and transportation and distribution facilities have been spun off and combined into a separate company (Transco, 1998) as well. Into the 1990s short-term agreements between producers and buyers were developed and the spot market that resulted from this began to affect long-term prices. Power companies began to build combined-cycle turbines that used gas that further facilitated market transactions between multiple gas producers and gas consumers. In! 998, all of the British gas industry was opened for competition.

If Great Britain has led the way for deregulation within Europe and has taken great strides forward, France has remained at the back of the confederation and has generally opposed liberalization of the gas market by July, 2004. The French gas market has been characterized by the domination of state-controlled Gaz de France and it has been reluctant, to say the least, of opening the market to competitors. Last year the French parliament approved of the Directive and it has been transposed into French law. But as the July deadline approaches the French have taken modest steps to make up for lost time and in recent months the regulator CRE has ordered Gaz de France and Total owned Gaz de Sud Quest to sell some of their long-term supplies to competitors. New market entrants like Norsk Hydro, BP, Wingas, and ENI have made some progress in securing market share in northern France, but the volumes of gas offered by Gaz de France are low and it appears doubtful that the CRE measures will be sufficient to stimulate real competition in France. Further measures to open the market will be taken before the July deadline, with gas release schemes planned for consumers in the south using a total of 105 billion cubic meters a year. But the success of the French efforts will ultimately depend on the terms and conditions, the price, whether transport capacity is also offered and where exactly the gas will be delivered.

Denmark has also had one player, DONG (the Danish transmission company) dominating the market and competition has been virtually non-existent. Efforts to liberalize its market have been grudging, as DONG has been reluctant to unbundle its activities. Indeed, development of the Danish gas market has led to vertical integration, with DONG taking over two of Denmark‘s five regional distribution companies and reducing the competitive threat from this part of the gas chain. Until the market was opened in 2002 gas prices were characterized by discrimination among consumers. Different tariffs for different consumer groups. Volume discounts and rebates were also present in the market. In the intervening two years the problem of price discrimination has been greatly reduced, with one sales tariff for small consumers and one for the large ones. Volume discounts have also been given up for large consumers.

Turning to Germany, Europe‘s largest and most important gas market, we see similar attempts by the large players dominating the market to resist reform and strengthen market position before the July deadline. While Germany has had a fully liberalized market since 1998, there has been little true change in the status quo. This is because the German Ministry for the Economy and the gas companies agreed initially that a negotiated access to the transmission networks

would be preferable to a regulated one. Supervision of market conditions would be soft rather than hard. Market forces more efficient in satisfying the consumer than government control. The sheer complexity of the German gas market, with over 700 suppliers of gas, lent support to the argument that less regulation was better than more. In other words, industry said, forcing companies to unbundle their services would only complicate the market and not yield the desired results. In keeping with this philosophy, German industry concluded several of the so-called Verbändevereinbarungen that strove to create more transparency and competition, simplified access to the transmission networks, an end to price discrimination and a schedule of costs. Left to their own devices, the proposed measures did not reform the market as intended. The transmission networks became accessible, but the tariffs were left either too opaque or too excessive for the general market to be attractive for competition. Those brave enough to enter complained about high tariffs for transporting gas, and it was contended that the dominating gas companies, especially Ruhrgas with over 60 percent of the market, were charging overly high tariffs to subsidize its losses at the distribution segment of the market. Such concerns prompted the Ministry for the Economy to monitor the development of the market and its subsequent report, issued in 2003, highlighted the obstacles to a fully liberalized market.

The Monitoring Report has become a cornerstone for a new draft Energy Law that should be ratified before the July deadline. The draft law underscores the intention of the German government to regulate competition and force more transparency and access on the gas market. It also suggests that the negotiated market approach has not achieved the degree of openness that the government, as well as the EU, demand.

The preceding examples suggest that without various forms of government intervention in the operation of private, natural transport monopolies, EU member states will unlikely meet the criteria for market liberalization as listed in the Directive. It is certainly the case that the July deadline would not be met if negotiated access were allowed to run its course. In other words doing nothing was no longer a governmental option. By intervening into their functioning, governments have repaired market failures created by dominating enterprises.

At the same time, it may be useful in closing to draw attention to an inherent conflict in EU energy policy: It is in Europe's interest to enhance the security of energy supply and to this end developing upstream gas is vital. But the unbundling imperative in the EU Directive will act to discourage large capital intensive energy projects, as getting an adequate return on investment will be difficult, to say the least, when distribution assets have been separated from wholesale activities. It has been suggested that the EU may waive, in some case, third-party access rules to secure needed supplies.

To put all of this in the context of best practices, I would like to make the following observations:

1) We are very early into the liberalisation process;

2) No two markets are alike;

3) You can avoid the pitfalls by opting for regulated access;

4) The best practice case has yet to be made.