



The Politics of the Third Energy Package

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The Politics of the Third Energy Package

The Third Energy Package, aiming at completing the liberalization of EU's gas and electricity markets, must deal with the discontent of a powerful coalition of political and economic interests. However, on balance, the internal market in general and Romania in particular stand to gain from its implementation.

The EU has started liberalizing its energy markets in the late 1990s. Against a conservative background of national energy markets dominated by powerful monopolies, typically embedded in long-standing political and social arrangements, the liberalization process has been driven by the vision of a truly competitive, transparent and unified market, extended at continental scale.

The legal backbone of the process was laid down by the European Commission (EC) as a series of so-called *Energy Packages*, in fact sets of European Directives and related Regulations. The First Energy Package (96/92/EC and 98/30/EC) was issued between 1996 and 1998 and cracked a first opening in the internal electricity and gas markets. The Second Energy Package (2003/54/EC and 2003/55/EC) followed in 2003 and advanced the process quite a bit, so that by the late 2000s its positive outcomes were tangible: more options for consumers to choose among retailers, generally affordable prices despite the increasing value of the oil barrel, better services. But it turned out that a major block in the way of more substantive liberalization was the exclusive control that major energy producers exerted upon the transport networks, effectively precluding competitors from market access. The Third Energy Package (henceforth TEP) was therefore issued in 2009, consisting in two Directives on electricity and gas markets (2009/72/EC and 2009/73/EC) and three Regulations regarding the access conditions to the gas transmission networks, the network for cross-border electricity exchanges, and the creation of the Agency for the Cooperation of Energy Regulators (ACER).

TEP's goals are the following:

- Independence of the *transport system operators* (TSOs) from the control of particular energy producers. "Vertical integration" in the energy sector entails TSO's inherent interest to privilege the interests of its own company in terms of network access and market information.
- Non-discriminatory access for "Third Parties" to the retail distributions both in the electricity and gas sectors, and to storage capacities, in the latter's case.
- Autonomous energy regulators, with management and finances outside the reach of political control.
- Adequate social protection without distortions of the market's competitiveness.

TEP's deadline for transposition into the national legislations of the Member States (MSs) was March 1, 2011, but as yet none of them has completed this step; only four MS have filled partial notifications to the EC. Romania is also delinquent. In fact, not only has Bucharest not been able to meet the March 1 deadline, but the last couple of years saw a trend reversal in terms of implementing EU's internal energy market policies.

With regard to the first aspect, TEP gives MSs three policy options, which they ought to translate into reality until March 2012: *ownership unbundling*, entailing that the vertically integrated companies are to sell off their gas and electricity grids; an Independent System Operator (ISO), entailing the *lease* of networks to an independent third party and monitoring by the national regulator; and an Independent Transmission Operator, in which ownership rests with the "mother company", but network control belongs to a subsidiary company, under regulatory supervision.

This piece of regulation had by itself led to uneasiness and dissatisfaction among governments and some major energy companies all over Europe, for several reasons: For one thing, some MSs (such as France) have a tradition of monopoly and vertical integration. Then, in other West European countries, such as Germany and Italy, the large energy companies are bound in time-tested lucrative deals with Gazprom, the largest natural gas exporter to Europe, whose business model runs fundamentally against TEP's grain. Also, in Central and Eastern Europe (CEE), a certain disappointment with an apparent disunity and a perceived "lack of solidarity" EU-wide in matters of energy security has bolstered a breed of self-centered and often erratic energy planning, in which TEP is seen either as a useful or as a detrimental externality, depending on the circumstances of specific deals.

Here are two opposite illustrations. On the one hand, Poland's recent option for increased gas imports from Russia has confronted Warsaw with a problematic side of TEP: the Yamal-Europe gas pipeline, on which the imports depend, is a \$15.6 billion investment that Gazprom operated in Poland through EuRoPol Gaz, which it owns in parity with the Polish Oil and Gas Company (PGNiG) (48% each) and Polish Gas Trading (4%). The deal thus needs an exemption from TEP's unbundling requirements. After EC's warnings about an infringement case against Poland, a compromise seems finally to have been reached, with Polish Gaz-System due to serve as a TSO, but only for the gas volumes available in excess of the contracted quantity (likely to be negligible). On the other hand, Lithuania has used TPE as a legal instrument in its efforts to reduce Gazprom's leverage upon the Lithuanian gas system. Gazprom owns 37.1% of the country's main gas company, Lietuvos Dujos, while E.ON Ruhrgas has 38.9%. Vilnius decided to separate gas supply from transport assets, invoking European legislation. Expectedly, Gazprom has protested vigorously, calling Lithuania's action an "effective nationalization".

It is though important to acknowledge the inherent disincentives that ownership unbundling creates when it comes to large infrastructure investments, such as oil and gas pipelines. The international energy producers have zero interest in spending on projects that end up giving market shares to their competitors. Hence, an argument can be made for *partial* exemptions from the unbundling requirements, on a case-by-case basis, when it comes to major international pipelines. The formula agreed upon for Nabucco, for instance, reserves a 50% quota of pipeline's capacity for the consortium's members, with the rest open to market bids.

On the "foreign policy" dimension of EU's energy business Gazprom is certainly a key player. As the main supplier of natural gas to Europe, the Russian company's downstream interests in Europe have ridden on partnerships with several European energy majors. On June 30, Gazprom announced its intention to acquire power-generating plants in Germany. This will again place Gazprom at odds with TEP, as it would effectively implement a producer-to-consumer supply chain within the EU. The background of such initiatives is Gazprom's regained leverage with the currently high oil prices and especially after Germany's April decision to give up nuclear power, that will likely lead to even more German imports of Russian gas. The coming completion of Nord Stream's first leg should also be factored in. Hence, a picture emerges in which the CEE states find themselves squeezed in terms of energy security between the cash-rich, energy hungry Western Europe and a Gazprom with excess transport capacity and barely able to match production levels to contractual obligations.

What about Romania? Bucharest's energy policies saw a remarkable evolution toward market liberalization from the early 2000s until just after the EU accession. A considerable degree of separation was achieved between production, transport, distribution and retail capacities, on both the electricity and natural gas markets. By 2008, about two thirds of the gas market was open to competition, with the rest being price-regulated by the National Agency of Energy Regulation (ANRE). Also, a significant amount of electricity is traded through the Operator of the Power Market Operator (OPCOM), which works like an electricity exchange.

However, the fundamentals of Romania's energy policies seem to be running against TEP's gist. There has been no real competition in the energy generation sector, as there were no privatizations of the state monopolies. Then, the regulated gas price has been constantly kept way below the European market level – presently less than half of it: \$160/1000m³ as established by ANRE in late 2009 and "frozen" ever since, though meanwhile the imports have increased both in price (currently at over \$400/1000m³) and proportion of the total gas consumption (almost 20% annualized).

Importantly, the inefficiencies thus generated are mainly absorbed by the two main players of the regulated gas market, GDF and EON (each with about 45% of the sector). These companies

must acquire expensive imported gas in order to fulfill their retail obligations at the regulated price level. Their reported losses amount to several hundred million dollars.

Meanwhile, as per law, a few large industrial consumers from the chemical industry and power generation sector benefit from privileged access to the cheap domestically produced gas. Not only does this cause distortions in the free market functionality of the system, but is also engenders moral hazards and obscure complicities between the political power and various interest groups. Indeed, a sizeable amount of electricity is subject to opaque transport contracts, in which well-connected “wise guys” (as notoriously labeled by President Bănescu) buy cheap electricity from Hidroelectrica only to sell at a profit. Undoubtedly, the politicization of ANRE, currently under the prime minister’s direct control, makes TEP’s regulatory autonomy objective all the more germane.

Also, the governmental reluctance to liberalize the energy market for fear of electoral costs before the 2012 general elections is being well served by ANRE’s obedience. Yet TPE addresses the need for social protection in the face of an expected price surge following the prices liberalization. TPE’s demand is that the category of a “vulnerable consumer” be legally defined and protected through pin-pointed state subsidies, as opposed to the current mechanisms of protecting *all* household and *some* large industrial consumers through price caps. Nonetheless, in recent legislative measures, the Ministry of Economy has displayed an inescapable attachment to the latter approach. The most recent example is the Economy Ministry’s Order of June 22, 2011 that freezes the gas price for household consumers until March 31, 2012.

With respect to de-monopolizing the supply chain, the Romanian government actually took an opposite course, deciding in early 2010 the creation of two vertically integrated “national energy champions”, each bunching up profitable and unprofitable power generation assets. The Romanian planners (somewhat inspired by the European majors’ practices, driven by a certain degree of economic nationalism, and worried about Gazprom’s tactics) seem to have embraced the idea that Electra and Hidroenergetica, as they are called, can become international-level competitors. Yet the EC, but also the IMF and the World Bank have each in the recent months emphatically insisted that Bucharest conform to TEP’s requirements.

To conclude, aware of the organizational complexity it demands and the apprehensions it stirs among Romanian decision makers, we believe that TEP does serve Romania’s developmental and strategic interests on several crucial scores: it leads to genuine market liberalization, with the associated longer term benefits that increased competition brings to the consumer, and the needed short-term social protection measures; it stimulates the much needed private investments in all branches of the energy sector; it favors the interconnection of national markets at regional level. In terms of energy security, TEP can efficiently serve as a protective mechanism against potentially aggressive “economic diplomacy”. The Package must though be

consistently pursued and uniformly implemented by all the Member States, with no exemptions allowed for EU's stronger countries and no excessive penalties given to the weaker ones.