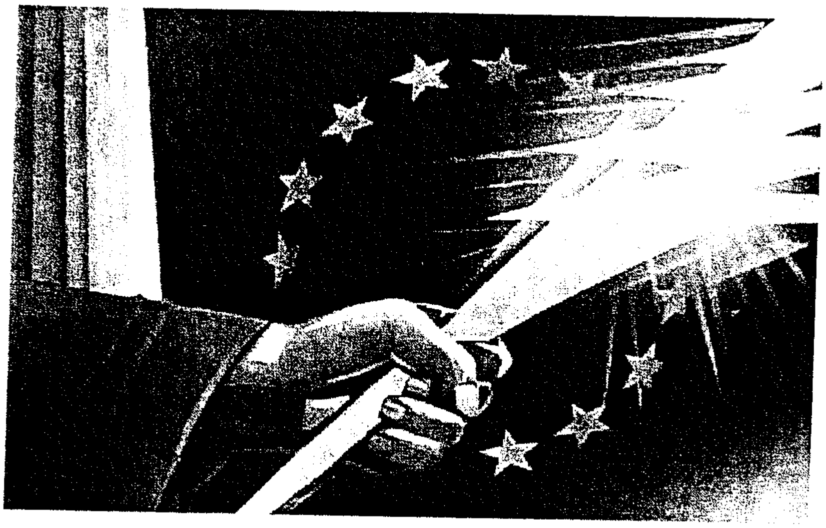
G65

The politics of power

Feb 9th 2006 | BRUSSELS, MADRID AND PARIS
From *The Economist* print edition

Concerns about security have driven the liberalisation of Europe's energy market into reverse



WHEN Russia cut off gas supplies through Ukraine at the start of this year all of Europe took fright. The European Union's long-term energy supply plans, which depended in good part on Russian gas, suddenly seemed naive. Although the gas was quickly turned back on, prices have been rising sharply during what has been a cold winter in many parts of Europe. From Italy to Britain, fears about global warming have put energy policy, including the possible reintroduction of nuclear power, on the agenda.

Meanwhile, European energy companies have continued to consolidate, but, controversially, mostly within countries rather than across borders. In the latest such deal, Gas Natural and Endesa won approval for a €22 billion merger that would combine Spain's biggest gas and electricity companies to create a new national champion.

Behind all of this activity is an intense debate over the future of energy and its impact on Europe's economy. On the one hand is a longstanding project for lower prices led by the European Commission designed to liberalise the market and enable producers and distributors to compete freely within and across national borders. On the other is a camp that argues with growing confidence against further freeing the market. In its view, long-term security and stable prices can best be preserved in managed national markets that are dominated by strong quasi-monopolistic companies which can withstand bullying producers and sudden shifts in demand and supply. It may be no coincidence that many of continental Europe's biggest energy groups peddle this argument—after all, the less competition there is, the higher prices can remain.

This tension has big implications for businesses across Europe. Today business customers in different countries pay prices that vary by as much as 100% across what is supposed to be a single European market. And, playing on fears of insecurity, suppliers try their best to tie customers into long-term contracts—sometimes lasting ten or 15 years. That harms the development of transparent spot prices, further hindering the growth of competition. A freer market in energy promises to reduce prices back to something like a Europe-wide clearing level. Energy is a critical input to businesses, especially manufacturing, and rising prices are putting unwelcome pressure on already tight margins, as companies try to compete with emerging low-wage economies in Asia.

Is it a good idea to push for liberalised markets, or, as many critics claim, would that simply open the way for black-outs, uncontrolled price manipulation and gouging, as America experienced in California's notorious electricity crisis in 2000-01? Is energy provision too important at a strategic level to be left to the market? How much is this a politically and commercially convenient argument deployed by those who doubt the entire single-market project and are seeking to protect national interests?

Some answers lie in the one part of Europe's market that has been liberalised. In contrast with America, Britain is a role model for successful deregulation. After privatisation in 1990, the country's energy sector went through a period of intense restructuring. Today three of the six dominant companies are owned by foreigners: npower and Powergen belong to the Germans and EDF Energy is owned by the French. Scottish Power and Scottish and Southern Energy, and Centrica, a gas retailer, are British.

Competition has been good for consumers. British businesses have paid lower prices for gas and electricity over the past 14 years than most of their European rivals, says Ofgem, Britain's energy regulator. They continue to pay less, even though the past year saw steep price increases and fears over supply. Indeed the British market has so far withstood an unexpectedly rapid fall in North Sea gas supplies and a cold winter. It looks as though the market will remain tight for a while, but higher prices of wholesale gas and electricity, for which gas is a big fuel, have stimulated new investment in liquefied natural gas terminals and helped the prospects of a new generation of nuclear plants.

Continental drift

Britain is not a self-contained market, and companies such as Centrica complain bitterly that its consumers are now suffering because of stalling liberalisation of energy markets on the continent. According to a report commissioned by Centrica from Global Insight, a consultancy, continental Europe's failure to liberalise and its predominance of long-term supply contracts have maintained the link between the price of gas and the (rising) oil price. This means that the gas price is largely isolated from actual supply and demand and is open to manipulation by big suppliers. That could cost British gas users some £10 billion ($18 billion) in extra bills this year.

The stalling of liberalisation has defied a hefty legislative programme designed to ensure that Europe's market would be completely open by the commission's deadline of July

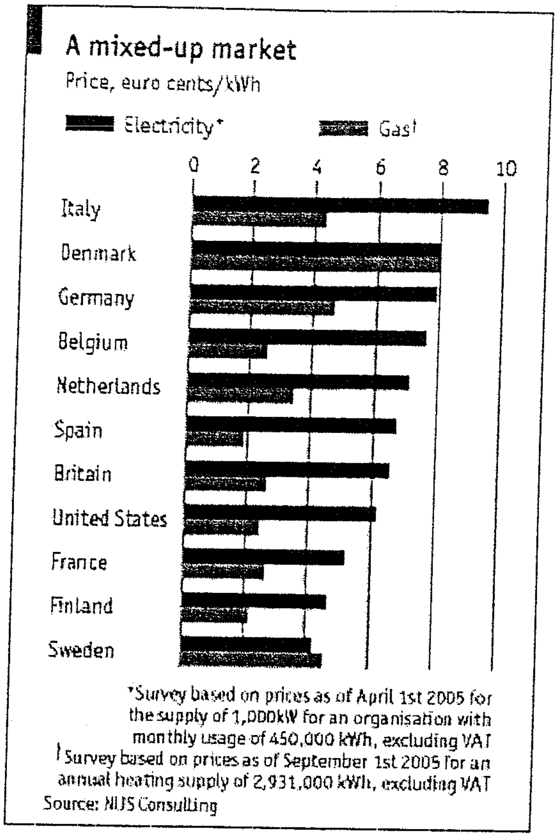
2007. Since 1999 big companies have been able to choose among rival power suppliers and in July 2004 all business users won that right, at least on paper. In December Leon Brittain, a former EU competition commissioner, predicted that by summer 2007 EU members will probably have gone through the formal process of implementing the three energy directives. Despite this, the reality is that the supposedly open market will remain a collection of national markets with relatively few of the interconnections needed for a competitive flow of energy.

The failure to liberalise has several causes. First is deliberate state interference motivated by a desire to build strong national competitors. Second, and directly related, it has not really been in the interests of the big companies to improve the infrastructure in ways that would allow more competition. Third, although enforcers at the commission have some teeth, they cannot counter a lack of effective local regulation. Each of these will have to be overcome if a genuine market in energy is to be possible.

Because energy is so important, it has long been seen as a proper area for government policy. France and Germany have done their best to comply only minimally with the requirements of EU legislation, all the while bolstering their electricity and gas giants—Electricité de France (EDF), Gaz de France (GDF) and E.ON and RWE in Germany. Although Britain and the Scandinavian countries have completely freed their energy industries, consumers in these countries cannot fully benefit from the gains of competition. About 80% of Europe's energy markets are rigid, while the rest suffer all of the price volatility, says William Ramsay, deputy head of the International Energy Agency.

Although entrenched monopolies have lost a little of their strength over the past few years, they remain dominant in France, Italy and Spain. German utilities have reinforced their position since the merger of E.ON and Ruhrgas in 2003; Gasunie dominates the wholesale market for gas in the Netherlands and France's Suez controls the gas and electricity market in Belgium through its local subsidiaries.

No European energy executive is so crass as to campaign openly for turning back the clock on liberalisation. Rather, company bosses say they want to position themselves for the opening of the market while enjoying the bulwark of their privileged position at home. "We want to be ready for competition in Europe," says Rafael Villaseca, of Gas Natural. Pierre Gadonneix, of EDF, says that it is very much in his company's interest to create a single market in energy.



EDF is a powerful European protagonist. It is the second-biggest energy company in Britain, the second-largest electricity firm and the third-biggest gas company in Italy, as well as the overall number three in Germany. But the French market has barely opened to outside competition: EDF still controls 86% of it. Enel, Italy's dominant electricity company, was allowed in last year only after months of horse-trading over EDF's 2003 investment in Edison, an Italian group. In the near future Enel hopes to fortify its position by starting to supply gas to French households.

Italy has gone further than France in opening its market to outsiders. Under pressure from Brussels, the government forced Enel to make divestments that have reduced its share of generating capacity from 80% to 40%. Endesa and Belgium's Electrabel snapped up a big chunk of these assets. "We have an independent highway and policeman," says Simone Mori, who looks after regulatory issues at Enel. The company's Terna subsidiary, which operates the national electricity-transmission grid, has become a separate entity.

Even so, prices remain the highest in Europe (see chart) and the Italian government, owner of 30% of Enel and Eni, still tends to reward its friends when deciding who will run them. Until last year the government cited reciprocity for its decision to limit EDF's voting rights in Italenergia, the holding company of Edison, the country's second-biggest electricity company.

The battle in Spain between Gas Natural and Endesa has been another politicised takeover. But the likely outcome will serve only to entrench established interests. The merged company will be stronger in Spain. But, further raising the barriers to integration, it will be weaker in the rest of Europe because it will have to sell its French and Italian subsidiaries.

It's a gas

A similar row went on for months in Germany three years ago. The government ignored the arguments of both the Cartel Office and the Monopolies Commission by allowing E.ON, an electricity giant, to merge with Ruhrgas, Germany's biggest gas company. Its blatant goal was to oversee the creation of a national champion capable of standing up to EDF and GDF.

The big continental firms are stout defenders of their market position and behaviour. A former senior executive of EDF argues the electricity giant was in fact a virtuous monopoly in the past and that prices rise when markets are liberalised. In his view consumers continue to benefit from EDF's dominance of the French market through lower prices compared with, for instance, Italy (though not, of course, with deregulated Britain). As both producer and retailer of electricity, EDF can arbitrage within its own business.

With its foray into gas, EDF has also embraced the industry's big trend. E.ON and Ruhrgas in Germany, Electrabel and Distrigaz in Belgium, Enel and Camuzzi in Italy and Gas Natural and Endesa in Spain are all examples of marriages between gas and electricity companies. This integrated model and dual-fuel strategy is by far the best for the companies, says one energy banker. But it runs counter to efforts to promote competition for their customers.

As the big get bigger, Mr Gadonneix thinks that mid-size companies will struggle to survive. Armed with rich war chests, Europe's biggest energy companies are all looking at potential takeover targets, especially in Spain, Britain, the Netherlands, Central Europe and the Nordic countries. Nor do they show many signs of wanting to throw off the yoke of government ownership or close affiliation with politicians. The French government sold stakes of 15% in EDF and 22% in GDF last year only after dithering until the last minute about whether to go ahead. Both deals were a great hit with small investors, but big institutions were sceptical about owning shares in companies that are under state control. Their worries have proved well founded: the French government, badly shaken by recent riots in the suburbs, intervened to stop GDF increasing its tariffs at the beginning of the year, fearing that a price rise during cold weather would cause renewed unrest.

From there to here

The second factor hampering integration is practical: how to transport gas and electricity efficiently across Europe's dispersed markets. The engineering challenge is far more tractable than big companies' collective will to undertake it. Interconnections between national electricity grids do not have enough capacity to allow prices to equalise across the continent. The EU has prescribed that interconnections should be able to carry at least 10% of national consumption, but few states have that great a capacity.

Though new links for gas transportation are being built, existing ones are not used to full capacity, says Britain's Centrica. For example, the interconnector pipeline between Zeebrugge, a gas-transportation hub in Belgium, and Britain sometimes runs well below capacity, partly because excess gas is put into storage in the Netherlands and Germany instead of being released on to the market. That is mystifying when this gas could be sold abroad at a handsome profit.

Some say that the uncertainties of a deregulated market will create smaller companies less inclined to make long-term investments such as international links which take 10-15 years to build. Rubbish, says Rafael Miranda, boss of Endesa, who is also head of Eurelectric, a pan-European industry lobby. His company, owner of about 30% of the interconnections between France and Italy, is keen on enhancing the network, but local bureaucracies get in the way.

To many observers it looks as if big energy companies, far from seeing deregulation as the problem, have made so little effort to improve interconnections because energy trading is not in their interests. The weaker the cross-border network, the less price competition they face. Further, it suits them—as a justification for higher prices and national champions—that consumers have the impression that supplies are vulnerable. Whether they are acting as old-fashioned, risk-averse energy companies that have over-engineered their own networks and can store more gas than is strictly necessary (just in case, you understand) or whether they are keeping supplies lower than they would otherwise be, the effect is the same: entrenched companies with protected market positions.

The third problem in European energy markets compounds the first two. Europe remains a patchwork of national energy policies and regulation. The power of authorities in Brussels to intervene is limited. Although the commission can fine individual companies, it depends on national governments to push through liberalisation. According to Enel, of the big European countries only Britain and Italy have strong and independent regulators. Germany did not even have a regulator until the establishment of the *Bundesnetzagentur* last year. Spain's regulator is prone to yield to political pressure.

According to Mr Miranda, the lack of harmonised regulation and local regulators' distrust of the wider market are big obstacles to liberalisation. In addition, he says, energy directives are unwieldy and governments have been unwilling to work together. Loyola de Palacio, a former energy commissioner, campaigned without much success for common stocks of energy, or at least a system to co-ordinate national stocks. Her plan to establish an EU regulator was also shot down.

Nevertheless, the commission is reluctant to give up the fight. Andris Piebalgs, the commissioner for energy, and Neelie Kroes, the competition commissioner, are making an extra effort in the run-up to the final deadline for full liberalisation. But it is hard work.

In July 2005 the commission took Spain, Luxembourg, Greece, Estonia and Ireland to the European Court of Justice for their failure to implement the 2003 directives. Most member states missed the July 2004 deadline for implementing the second liberalisation package, catching up only in the following months.

If the second set of directives does not bear fruit, Mr Piebalgs says there will be a third effort. Last November he presented his department's yearly report on the functioning of the internal market. As well as pointing out stubborn price differentials, it noted that cross-border flows of electricity were 10.7% of total consumption in 2004, an increase of less than three percentage points since 2000.

A waste of energy?

Ms Kroes says that she is determined to use her powers as watchdog of mergers, antitrust and state aid to get the market to work. The commission can fine firms up to 10% of total sales for anti-competitive behaviour. But so far, despite evidence of infringements, the commission has yet to fine an energy company.

Not that the commission has failed entirely to rein in anti-competitive practices. It successfully rapped Norwegian gas producers on the knuckles for collusion. It also obtained the dissolution of a Danish gas consortium. The commission will carry on fighting contracts that contain any clauses barring importers from selling on gas to other countries: until it intervened, for example, E.ON was not able to sell on gas supplied to it by Russia's Gazprom.

The EU liberalisation campaign is starting to energise national regulators. Germany's Cartel Office is arguing with E.ON about its long-term contracts, on the ground that they are unfair to newcomers seeking access to the market. In the past, E.ON struck contracts for 15 years or even longer with regional distributors, in effect locking competitors out of the market. The row continues, though for now E.ON has had to limit to two years any new contracts with companies getting more than 80% of their supply from E.ON and to strike four-year contracts when it provides half of a regional distributor's supply.

Endesa's Mr Miranda says Europe needs some €1 trillion of energy investment over the next 25 years to be able to meet increased demand. And that neatly encapsulates the stakes in the debate between the merits of a functioning free market and the solidity, but higher prices, of an essentially fixed one. At the moment, the current in Europe is flowing in the solid, but expensive, direction.