Integrating and liberalizing the market for services

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Building a more dynamic Europe
IESE Conference, Barcelona 27/11/01

www.econ.cam.ac.uk/dae/research/regulate.htm
Create a single market in services

- in financial services, energy, telecoms, transport
- liberalise network utilities
  - competition to increase efficiency
  - to grant access across borders
  - to admit private finance for investment
- while ensuring efficient network regulation
Reforming network utilities

• Regulation
• Restructuring
• Risk management
• Ensuring effective sustainable competition
Main regulatory problems

• no national regulatory authority (NRA)
  – Germany for gas, electricity
• NRA not sufficiently independent
  – problematic where state is also owner (France)
• powers may be inadequate
  – licence conditions useful but often lacking
Other regulatory concerns

• credibility
  – Railtrack example salutory

• predictability
  – about future environmental policies

⇒ agree sensible environmental policy
  – energy diversity hinders progress (nuclear in FR, gas in NL, hydro in SW, coal in UK, DE)
Restructuring

- logically unbundle with separate owners
- lose synergies of vertical integration
- gain bias against entry
- gain efficiency of competitive pressure

⇒ what is the optimal structure?
Desirable network structures

- electricity: legal separation
- gas: separate on-shore transmission
- telecoms: is it a natural monopoly?
  - Facilities-based competition or LLU?
  - Does call termination require regulation?
- Rail: separate trains from infrastructure?
- Water: retain vertical structure?
Unbundling, risk and contracts

- unbundling creates intermediate markets
- price risks here can be large
- deregulation permits price volatility
  ⇒ contracts to hedge risk
- also against regulatory opportunism
- liberalisation shortens contract length
- will these contracts sustain investment?
Sustaining efficient competition

- acceptable to voting consumers
  ⇒ avoid sudden large price rises
- avoid market dominance
- regulate for efficient free entry and investment
- adequate *ex ante* competition powers

*These challenges remain in EU*
Reforming Gas

• Opportunity cost of gas in situ unclear
• Long-term contracts obscure values
  – pipeline access limits competition
  – results in discriminatory prices
  – gas prices in UK halved with competition

*Large gains from competition*

⇒ liberalise to create gas-on-gas competition
A Single European Electricity Market?

• authorisation preferable to tendering
• access is key to creating single market
  – press for rTPA
• require ownership separation of G & T/D
• strong sector-specific regulation needed
Proposed New Directive

• for electricity and gas
• only rTPA, tariffs published *ex ante*
• sector-specific regulator
• legal (but not ownership) unbundling G&T
• no SBM, no tendering (except reserve)
• 1.1.2005 all gas + elec markets fully open
Stockholm, March 2001

• CEC claims reforms will avoid California problems caused by “inadequate legal framework and .. capacity”

• France opposes new Directive: not convinced of liberalisation

• Germany opposes need for regulator
  – also has nTPA and vertical integration
What Explains the High Prices?
Prices above competitive levels were due to both higher production cost and higher mark-up from market power.
Causes of the Californian debacle

• Under-investment + cheap hydro from NW
• high demand growth in WSCC
• Huge swing in hydro supply (=12 nukes)
• Regulatory disapproval of contracts
• Price caps imposed with perverse effects
  – High Western prices $\Rightarrow$ bankruptcy
Preconditions for ESI liberalisation

• rTPA + ownership unbundling: CEC ✔
• adequate and secure supply: CEC ✔
  – network adequate and reliable
  – production capacity adequate
  – security of supply of primary fuel
• power to regulate competition: CEC ✗
Competition policy for utilities

“competition where possible, regulate where not”

• Leave markets to competition legislation?
  – *Ex post*, penalties ⇒ legalistic, slow
  – dominance ~ 40+% of market
  – information collected only for case

⇒ need *ex ante* regulatory powers

• UK licences as useful model
Mitigating market power in US

• Federal Power Act 1935 requires prices that are ‘just and reasonable’
• Selling at market-related prices requires:
  – utility and affiliates do not have market power
  – competitive prices are just and reasonable
  – can withdraw right if there is market power
  – can re-impose cost-based prices caps
Contrast with Europe

- no prior legislated cost-based regulation
- no concept of ‘just and reasonable’ prices
- little power to control wholesale prices
- often limited power to get information
  ⇒ weak market surveillance
  – competitive tests derive from other markets
Competition problems in EU ESI

- dominant incumbents (Fr, Be, It)
- merger wave (EdF, E-on, RWE)
- inadequate interconnect transmission
- illiquid or absent wholesale markets
- under-staffed or no regulator
- access to information patchy
- lack of regulatory enforcement power
Scarcity or Market Power?


July 17, 2001
Anjali Sheffrin, California ISO
Electricity prices in Europe

Price mark-up vs availability

Total available supply as % of demand (Load+10% ancillary services)
Possible scenarios - 1

• lack of markets + domestic franchise ⇒ contracts necessary
  – reduces short-run market power, hedges spikes
  – yardstick regulation of PPAs countervails
• incumbents + opaque markets deter entry ⇒ horizontal, vertical integration ⇒ old German-style equilibrium: safe but costly?
Possible scenarios - 2

- new Directive ends franchise
  ⇒ generators integrate into supply
- remove counterparties to entry contracts
  ⇒ reduce spare capacity
- limited interconnection ⇒ market power in national markets
- ESI now 400 bn euros, high prices costly
Solutions

- increase interconnect capacity rapidly
  - ‘excess’ T is public good
  - dilutes market power in short run
  ⇒ long run EU-wide shortages?
- Need credible counter-party for investment
  - Generation capacity is public good
  ⇒ keep domestic franchise?
Conclusions

• Challenge: create effective competition
• Market structure changes hard to reverse
  ⇒ Be cautious of mergers
• Need pro-competitive regulators
• CEC should help, not hinder
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