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

$\Rightarrow$ 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

$\Rightarrow$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

$\Rightarrow$contracts to hedge risk

- also against regulatory opportunism
- liberalisation shortens contract length
- will these contracts sustain investment?

Sustaining efficient competition

- acceptable to voting consumers

$\Rightarrow$ 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

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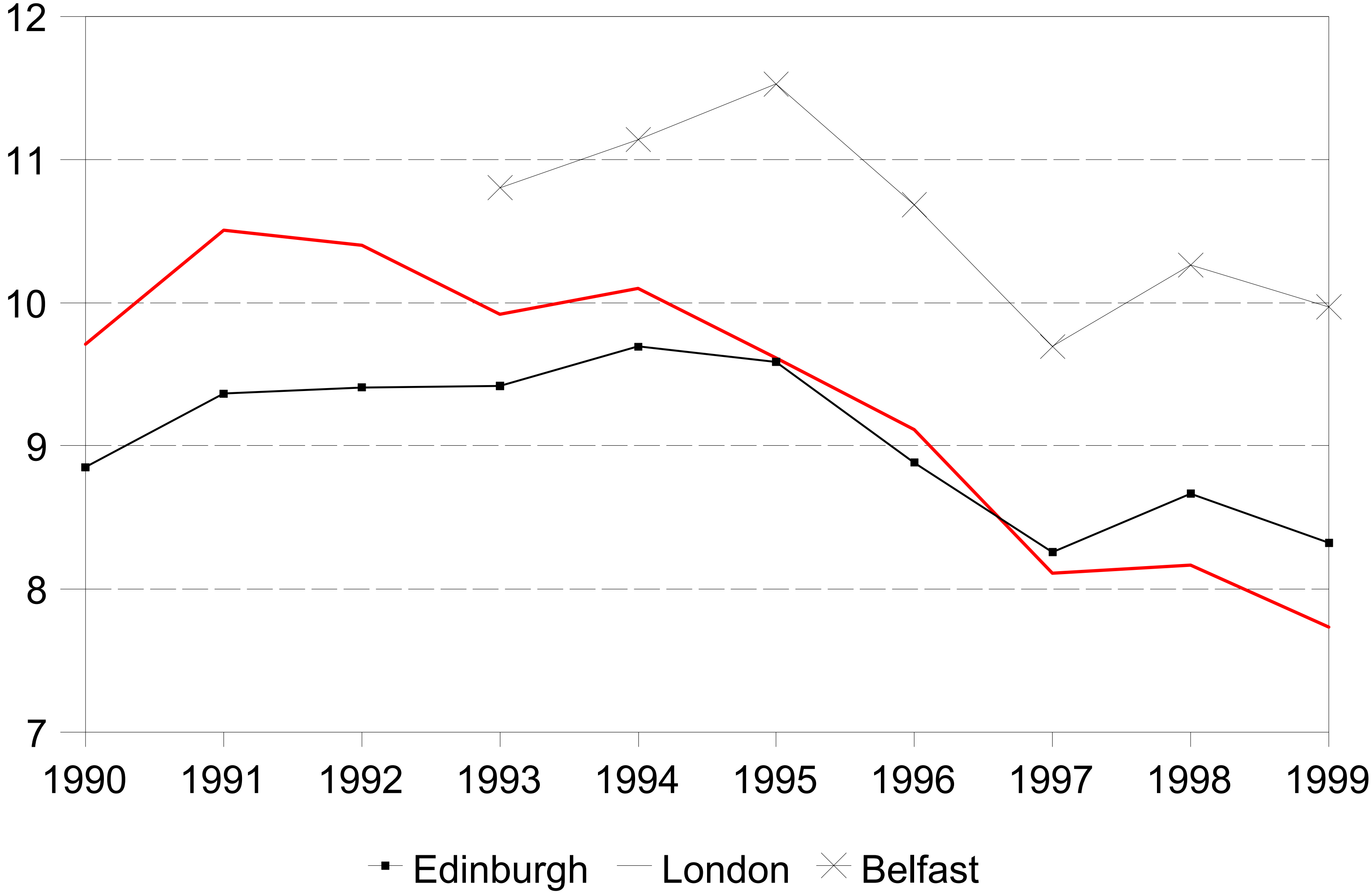
A Single European Electricity Market?

- 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

Electricity prices by town
3,300 kWh at 2000 prices excl VAT



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

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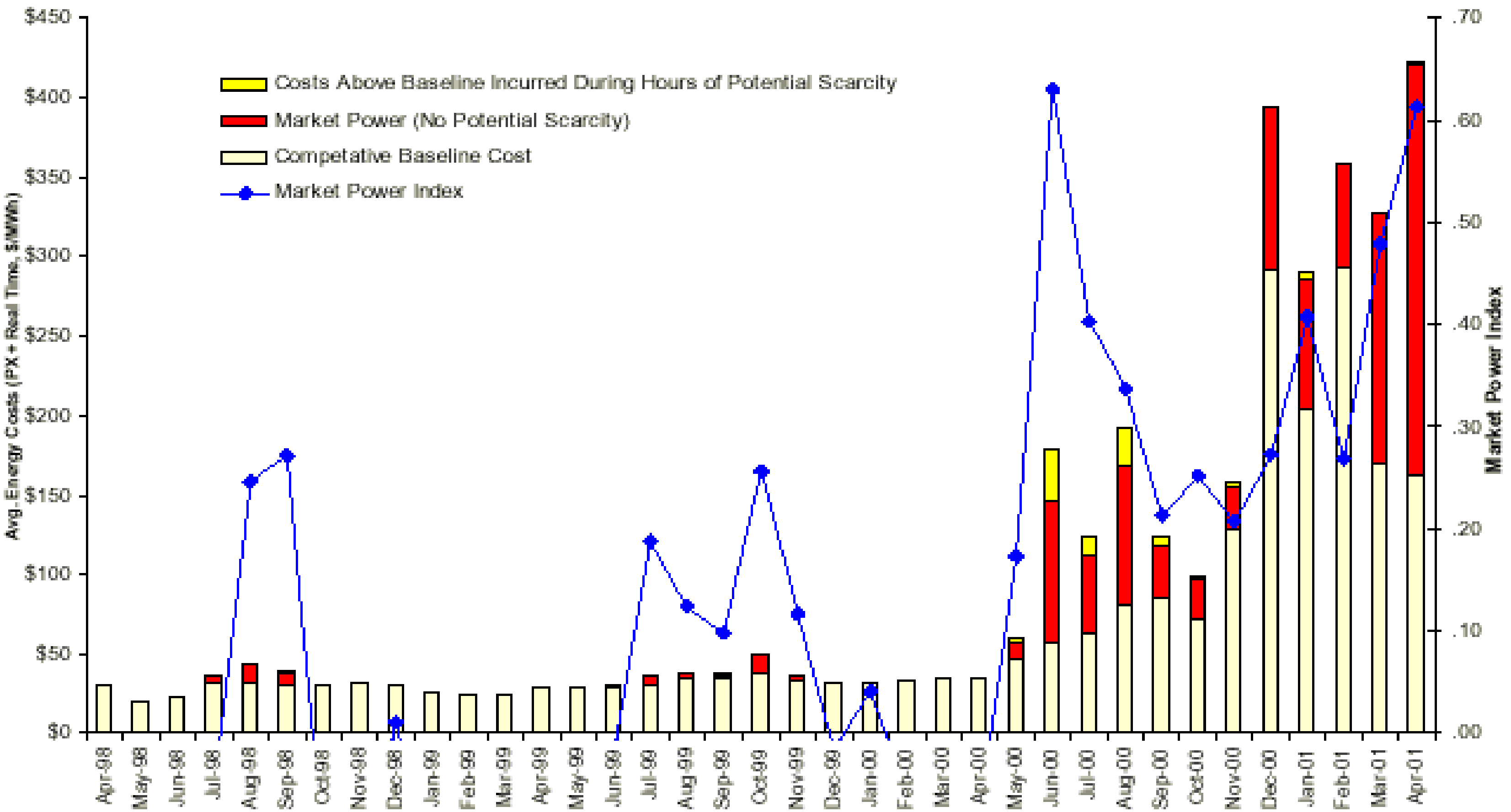
What Explains the High Prices?

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

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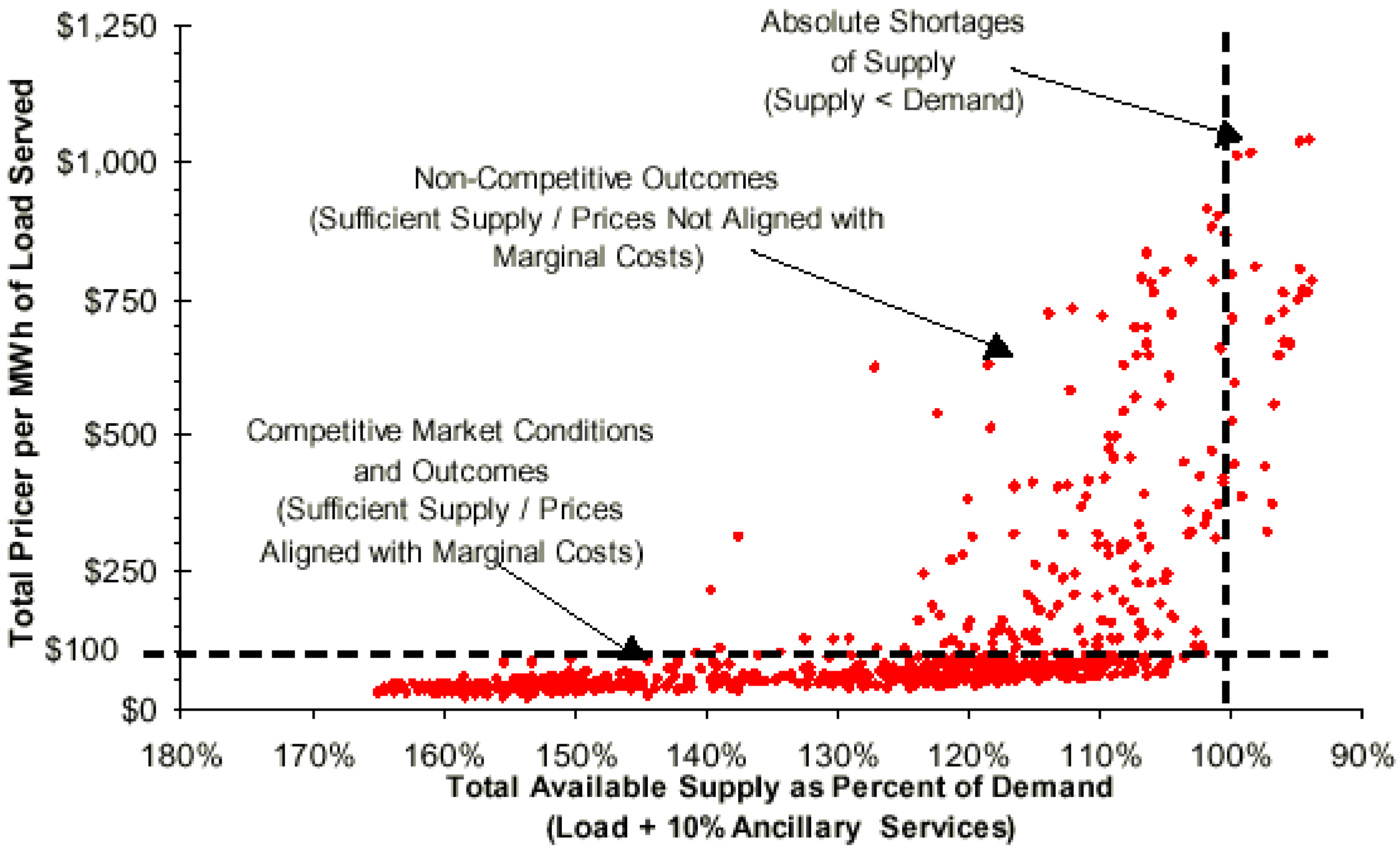
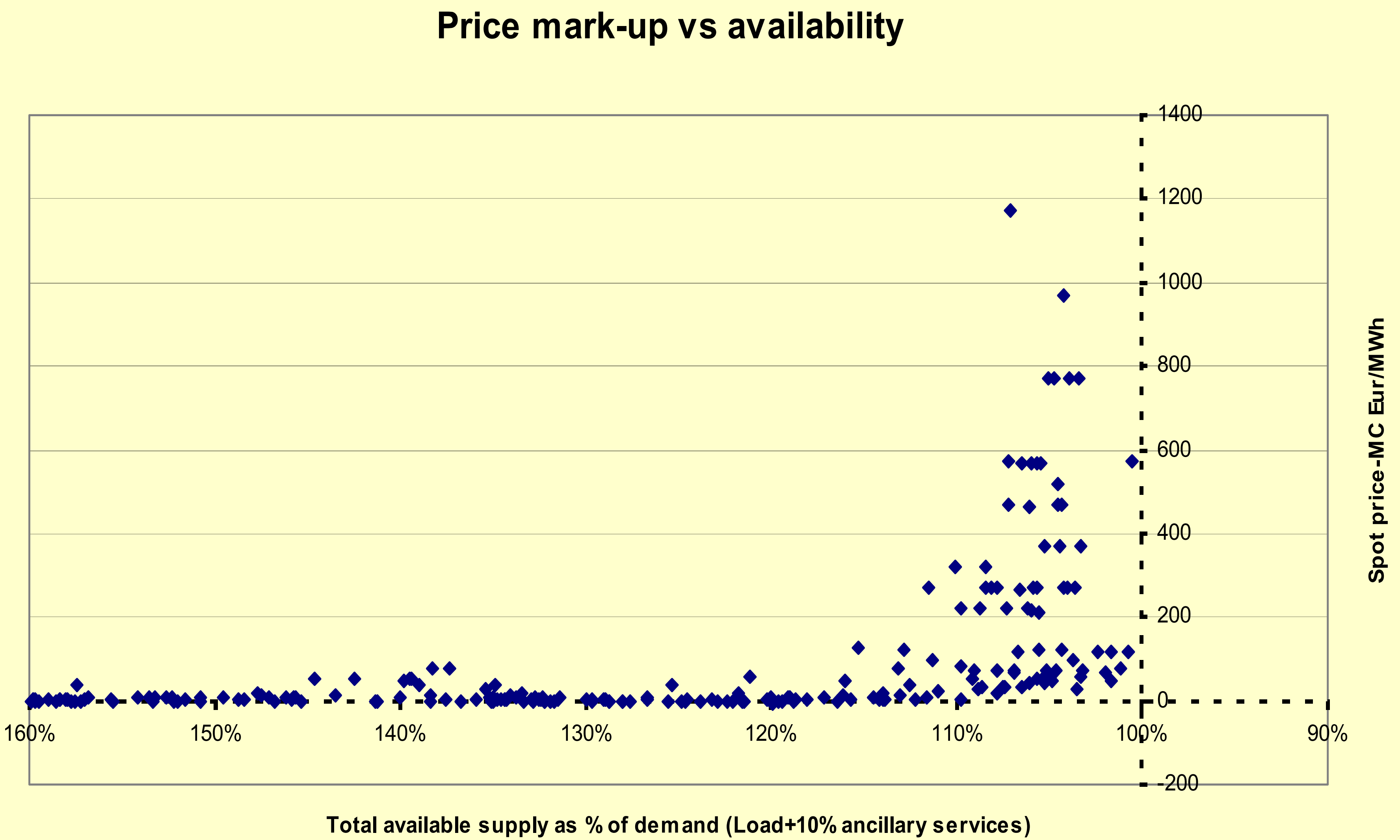
Scarcity or Market Power?



* Source: *Report on California Energy Market Issues and Performance: May-June, 2000*,
Prepared by the Department of Market Analysis, August 10, 2000

Electricity prices in Europe



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

$\Rightarrow$ generators integrate into supply

- remove counterparties to entry contracts

$\Rightarrow$ reduce spare capacity

- limited interconnection $\Rightarrow$ 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

$\Rightarrow$ long run EU-wide shortages?

- Need credible counter-party for investment
  - Generation capacity is public good

$\Rightarrow$ keep domestic franchise?

Conclusions

- Challenge: create effective competition
- Market structure changes hard to reverse

$\Rightarrow$ Be cautious of mergers

- Need pro-competitive regulators
- CEC should help, not hinder

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