

ENERGY REGULATION BRIEF

June 2000

"THE EUROPEAN GAS DIRECTIVE: WILL IT LEAD TO AN OPEN AND COMPETITIVE MARKET IN GAS?"**David Hough**
Former Associate
Director**Rocío Concha**
Former Senior
Consultant

In recent years, the European gas market has seen many new entrants seeking to sell gas to new consumers, to consumers of existing (incumbent) gas suppliers and to the incumbents themselves. Much of this activity has been driven by the prospect of competition following implementation of the European Union's Gas Directive.¹

One of the Directive's main aims is to "...take measures to establish the internal market in natural gas"² among the 15 Member States. See Box 1 below for a summary of the key features of the Directive. To achieve the Directive's aim, it is vital that the legal and regulatory framework allows consumers to buy natural gas from any supplier within the EU. In this *Energy Regulation Brief* we look critically at the Gas Directive, argue that it falls short of its stated aim in a number of crucial areas, and suggest what needs to be done.

Box 1: Key features of the European Gas Directive

- Licensing of gas industry operations
- Public service obligations as determined by Member States
- Non-discriminatory open-access to the transmission and distribution networks for eligible customers
- Choice of "negotiated" or "regulated" access charges
- Access to upstream pipelines
- Unbundling, through separation of accounts
- Minimum levels of market opening for eligible customers
- Facilitating direct pipelines (physical by-pass)
- Means for settling disputes between industry participants

New Gas Laws: A Very Mixed Bag?

Despite its ambition to establish a European market in gas, the Gas Directive adheres to the "*principle of subsidiarity and sets down rules that are no more than general principles providing for a framework, the detailed implementation of which should be left to Member States*".³ The subsidiarity principle allows individual Member States to tailor laws and regulations to their particular circumstances. However in the gas industry it has resulted in a very mixed bag, both in the terms of access and the speed with which the Directive is to be implemented in each national gas market.

Member States are obliged to implement the Directive through national legislation by 10 August 2000. With about one month to go, progress towards this deadline is still at varying stages of completion. A minority of Member States have already passed the necessary legislation (Belgium,⁴ Finland, Germany, Ireland, Italy, Spain and UK). Others are discussing draft laws (Austria, Denmark, France, Netherlands and Sweden). While one is in the earlier stages of discussing possible new laws (Luxembourg). Finally, two are seeking derogation from the provisions of the Directive for the time being (Greece and Portugal).

¹ Directive 98/30/EC of the European Parliament and of The Council concerning common rules for the internal market in natural gas; 22 June 1998.

² Op. cit. Clause (5) of the Preamble.

³ Op. cit. Clause (9) of the Preamble and Article 3 (1).

⁴ In Belgium, the new Gas Law has still to be enacted by the necessary Royal Decrees.

Some governments have chosen to go well beyond the minimum requirements of the Directive on the degree and speed of market opening (such as Germany, the Netherlands, Spain, and the UK). Others are only planning to meet the minimum necessary (such as France and Denmark).

Even if all Member States successfully put their legislation in place before the Directive's deadline, there will remain many differences and inconsistencies between them. These include very different regimes for access to and charges for gas carriage, different technical specifications, different policies on the separation of trading from transportation, and different speeds at which the market is expected to open to consumers. As a result, traders will find it difficult to transport gas to, from and between European Markets in an efficient and economic manner.

Is Negotiated Access “Reasonable and Transparent”?

To ensure that the benefits of competition are realised, traders must have the right of access to the gas pipeline network and know that they can require network operators to transport their gas at charges that are reasonable and transparent. The Gas Directive allows Member States to opt for one of two systems for access charges.

On one hand, Regulated Access “...gives gas undertakings and eligible customers a right of access to the system on the basis of published tariffs and other terms and obligations for the use of that system.”⁵

The alternative is a system of Negotiated Access. This system is based on individual negotiations for access, subject only to a requirement that “natural gas undertakings publish their main commercial conditions for the use of the system within the first year following implementation... and on an annual basis... thereafter.”⁶

As with other optional elements of the Directive, Member States have opted for different systems and this has created inevitable difficulties, particularly in those states that have opted for Negotiated Access (Germany, Belgium, and the Netherlands). In Germany, for example, the government has decided to ask the main consumer organisation (VIK) and the main gas industry association (BGW) to negotiate access terms and tariffs between themselves. There have clearly been difficulties in reaching agreement.⁷

Many of the new-entry gas companies are voicing concerns about the lack of transparency and fairness, not just in Germany but in several countries. They claim that incumbent gas suppliers and gas transporters are discriminating against new players.⁸ Such claims are difficult to prove in a negotiated system.

The main lesson learned so far from the implementation of Negotiated Access in some Member States is that this system cannot entail a process of individual negotiation of even basic (or standard) services. Case-by-case negotiation would not only allow discrimination between users, but would mean also delays for third parties in getting transportation quotes. As a result, the “transactions” costs of switching supplier would increase, which discourages consumers changing supplier, and traders from competing for new customers. Standardised terms of basic services would allow third parties to buy these services within a reasonable timeframe.

Economic Principles of Regulation for Gas Pipelines

Given the little guidance given in the Directive, it is important that national legislation and governments clearly state the key economic principles that need to be settled before the detail of precise access terms and tariffs. For the proper economic regulation of gas transportation, which is likely to remain a monopoly activity, governments and regulators need to set down the following:

- *The main objectives of regulation*; the objective of regulation is to correct the

⁵ Op. cit. Article 16.

⁶ Op. cit. Article 15.

⁷ “Germany to miss TPA deal target” Financial Times International gas report 10 December 1999. See also “Further Comment on the Development of the VV gas”, EFET position paper, 10th April 2000.

⁸ “Opportunities emerge in the Dutch gas market” Financial Times UK Gas Report; 17 December 1999.

distortions that are caused by a monopolist's market power (in this case in gas transportation), by reducing prices and increasing output towards efficient levels while maintaining an appropriate quality of service.

- *Investment incentives*; in order to achieve a sustained increase in output, a monopoly must be given incentives for efficient investment. This requires that investors have a "reasonable prospect of cost recovery" including recovery of the opportunity cost of capital.⁹
- *How costs may be allocated to (and within) the regulated business*; cost definitions need to be very detailed and not subject to the risk of later, and potentially arbitrary, amendment.¹⁰
- *Incentives for regulated firms to act efficiently*. Good regulatory design ensures that the combination of lower costs and higher profits will result in lower prices overall.¹¹

Only when these issues have been decided can governments and regulators address the commercial arrangements that are central to a competitive gas market, including:

- "Cost-reflective" access charges that allow for the impact of any bottlenecks (or constraints) in the gas transmission system;
- A system to govern the commercial relationships between gas suppliers and gas transporters including balancing. In the UK, this relationship is defined through the Network Code. The US uses contractual methods; and
- Appropriate metering to ensure proper billing and settlements for different consumers.

Must the Gas Industry be Restructured?

NERA's experience in different countries demonstrates to us that competition in utility markets requires a restructuring of the industry to make clear the distinction between the *wholesale trading* of gas as a commodity and the *carriage* of gas through the pipeline network. Yet the Directive fails to recognise the fundamental need for separation of functions as part of its overall aim of achieving a competitive market in gas.¹² Indeed the Directive merely requires separate internal accounts and only then for gas transmission, distribution, and storage.¹³ By contrast the earlier Electricity Directive at least specified the need for a designated Transmission System Operator ("TSO").

One of the many (harsh) lessons from the experience of gas market liberalisation in Great Britain and the USA was the need to settle on an appropriate industry structure *before* implementing a new regulatory framework designed to encourage greater competition. Such separation of functions does not necessarily mean the break up of established players. However there are inevitable regulatory tensions within a single company between (1) the management of a competitive gas trading business and (2) the management of a gas transmission business that is obliged to offer open access on non-discretionary terms to all users, including users inside that same company. In 1997, the same tensions led British Gas plc to de-merge its gas trading business from its pipeline operations to form two legally separate enterprises.¹⁴ In the US, restructuring has been forced one decision at a time.

A similar logic has led the regulatory authorities in Italy to call for the break up of SNAM, the dominant gas transporter and gas trader.¹⁵ Similar debates continue in Spain, Germany and the Netherlands, and will follow elsewhere.

Treatment of Cross-Border Flows

The preamble to the Gas Directive states that "...the internal market in the natural gas sector should favour the interconnection and interoperability of

⁹ Two important regulatory decisions in the US Supreme Court helped to establish that regulators must offer investors "a reasonable rate of return" (Bluefield decision 1923). This decision was further refined to establish that the return on capital must be achievable *after* recovery of all other costs (Hope Gas decision 1944).

¹⁰ US regulators agreed a common set of standard accounting rules in 1943 through the National Association of Regulatory Utility Commissioners (NARUC). The main UK, regulators set up a joint working party charged with devising common accounting standards in November 1999.

¹¹ For an exposition of incentive mechanisms see, for example, Armstrong, M, Cowan, S and Vickers, J (1995) *Regulatory Reform: Economic Analysis and British Experience* Cambridge, Mass. MIT Press

¹² Article 3 of the Gas Directive.

¹³ Article 13 says "integrated gas undertakings shall, in their internal accounting, keep separate accounts for gas transmission, gas distribution, and storage... as they would be required to do if these were separate activities."

¹⁴ British Gas plc completed the de-merger of Centrica plc from BG plc on 17 February 1997. The latter has since restructured the company on 13 December 1999 into two distinct parts – BG Transco and BG International - with BG Group plc as the overall holding company. On 22 March 2000, BG announced that Transco would be de-merged from BG Group plc in the autumn 2000.

¹⁵ Opinion of the ACMG on receipt of the EU Gas Directive; November 1999.

systems..."¹⁶, yet there is no reference in any other part of the Directive to the need for rules for gas trading *between* Member States. Nor is there any mechanism whereby those rules might be discussed and agreed. The Commission is now correcting this omission through a series of consultation meetings at the EU-level with gas transmission operators, regulators, and governments. The EU is helping to establish a more formal grouping of system operators (as it has done for electricity).¹⁷

Devising an appropriate framework to govern cross-border trade is particularly important as a much greater proportion of gas consumption is traded internationally than is the case for electricity. The absence of a clear framework has already given rise to many problems. These difficulties include "pancaking" of transmission tariffs, inadequate separation of trading from transport functions, delays in transportation offers, and lack of information (e.g. about gas quality and pipeline capacity). Any framework for cross-border trade will need to cover:

- Transmission charges for carrying gas between Member States;
- Incentives to invest in new pipeline connections to remove constraints;
- Policies to allocate international capacity rights, such as auctions;
- Balancing rules and imbalance charges;
- Measures to ensure interoperability of networks (e.g. regulation of gas quality);
- Charging principles for services such as gas storage and interruptibility; and
- Means for settling jurisdiction over cross-border trade.

The Commission is now starting to address these issues and circulated a series of papers for discussion at the recent Gas Regulatory Forum in Madrid.¹⁸

Conclusions

Implementation of the EU Gas Directive, due on 10 August 2000, is a major step forward in the introduction of competition into gas markets in most Member States. However, there is a long way to go before we see open and competitive gas markets *within* all Member States, let alone *between* all Member States. The vision of a gas consumer in Southern Spain or Northern Scotland being free to buy the cheapest supply of gas whatever its source is still a long way from being realised. However, liberalisation is no longer a 'leap in the dark'. Experience tells us both what the problems are, and what the solutions will be.

n/e/r/a

NATIONAL ECONOMIC RESEARCH ASSOCIATES

NEW YORK

LONDON

*National Economic Research Associates
50 Main Street
White Plains, New York 10606
Telephone: (+1) 914 448 4000
Fax: (+1) 914 448 4040*

*National Economic Research Associates
15 Stratford Place
London W1N 9AF
Telephone: (+44) 20 7659 8500
Fax: (+44) 20 7659 8501*

OFFICES ALSO AT:

*Washington, DC • Los Angeles • Cambridge, MA • Philadelphia • San Francisco • Chicago
• New York, NY • Ithaca, NY • Sydney • Madrid*

© National Economic Research Associates, 2000
An MMC Company

¹⁶ Clause (8) of the preamble to Directive 98/30/EC.

¹⁷ Meeting of European Gas Regulatory Forum, Madrid, 11-12 May 2000.

¹⁸ Op. cit.