

## Ownership Unbundling A Logic Outage for the Anti-Energy Liberalisers?

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The received view of many commentators is that vertically integrated energy incumbents such as E.ON and EDF are in a very strong position to resist the Commission's energy liberalisation proposals and ownership unbundling in particular. However, the recent announcement by E.ON that it is willing to settle with the European Commission in respect of its energy assets and to unbundle its electricity network suggests that the energy incumbents may not be in such a strong position after all. There are two significant reasons why the incumbents are in trouble over liberalisation. The first is that the quality of the argument that they have been able to put up against the pro-liberalisation camp has been very weak, illustrated by the recent French-led counter proposals to energy liberalisation. Second, the potentially devastating impact of the Commission's antitrust prosecutions in the energy sector both in terms of political and reputational damage and financial consequences is forcing incumbents to seriously consider settling with the Commission.

The weakness of the anti-liberalisers position can clearly be seen in the proposals put forward by eight EU member states, led by France and Germany, opposing the Commission's draft plans for energy-market liberalisation. At first glance, this looks like a powerful, even decisive response to the Commission's liberalisation agenda – especially since it's being led by the EU's two most influential member states. But the principal arguments used to support these proposals are insubstantial and cast doubt on the ability of the incumbents' lobby to sustain their case against energy liberalisation.

The Commission's energy-market liberalisation proposals, revealed last September, focus on 'ownership unbundling'. Under such a regime, the business of operating gas pipelines or an electricity network is separated from the business of providing gas or generating power. So *Électricité de France*, for example, would not be able to generate power and own the grid.

The new alternative proposals take an entirely different approach. Businesses, whether state-owned or not, would continue to be allowed to own distribution networks and to supply power. However, a series of obligations would be placed on these firms, including holding the network and supply/generation assets in separate companies. The network company would have to offer equal access to other gas or electricity providers, and a regulator could intervene if the network company discriminated in favour of its own supply company. The plan also allows the state to intervene to force a network company to build new infrastructure.

But these alternative proposals, which were made public in late January, are very weak. The four principal justifications deployed by the eight member states – which also include Austria, Bulgaria, Greece, Latvia, Luxembourg and Slovakia – to attack ownership unbundling do not stand up to any close examination. The states argue that ownership unbundling is

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unconstitutional. They further claim that there is no correlation between unbundling and investment or prices and unbundling, that unbundling has negative social consequences, and that unbundling is a disproportionate measure.

Let's take these objections in turn. The only possible constitutional argument against unbundling is that it violates the right to property. However, that would only be the case if owners were forced to sell at less than the full market value. Under the Commission's draft legislation, sales of network or generation assets would be at full value on the open market.

Yes, there is a chance that values could be depressed since so many assets would be hitting the market in such a relatively short period of time, even if the sales are staggered over a few years' time. But energy investors say there will be fierce competition for such quality assets, which makes below-market prices unlikely.

Member states can hardly argue that the requirement to unbundle itself is unconstitutional. The notion of compulsory sales at full market value in the interests of a public objective, including market liberalisation, is a recognised legal mechanism that exists in all national legal systems across the EU.

What's more, the legal concept of compulsory sell-off at full market value is well-established in European case law. The European Court of Human Rights in Strasbourg has declared this concept compatible with the right to property contained in the European Convention on Human Rights. It is improbable that the European Court of Justice – faced with a legitimate EU objective such as market liberalisation, and the permissive case law of the Strasbourg court – would rule differently.

Equally, the argument that there is no correlation between unbundling and investment and prices is weak. In the first place, the Commission has never argued that there is a direct correlation between price levels and liberalisation. Other significant market factors can affect price. Yet over time, a liberalised market is likely to have lower prices than a closed protectionist market. For example, Eurostat figures show that since 1998 power prices in liberalised markets – including the UK, the Netherlands, Spain and Sweden – prices have increased by only 6%, whereas in other markets they have soared by 30%.

For a more specific comparison, take the German and British electricity markets. From 2004 to 2006, the wholesale price for electricity in Germany was 10% below the UK price, but the price paid by industrial and domestic customers was more than 25% higher than the UK retail price.

There is, however, a direct correlation between ownership unbundling and investment. The Commission has direct evidence that ownership unbundling encouraged new investment in the UK. Four new liquid natural gas (LNG) terminals are operational in the UK, along with the new Norwegian pipeline which has a capacity of 23 billion cubic meters. All of this infrastructure has been built since unbundling took place. Meanwhile, in protectionist Germany there is still no operational LNG terminal, even though the debate over whether to have LNG terminals there started back in 1982.

The eight member states' third argument is that ownership unbundling would bring about "negative social consequences". Yet these supposed dangers of liberalisation are unspecified, and are difficult to imagine in light of the obvious benefits we've already covered.

Finally, the protectionists claim that ownership unbundling is a disproportionate measure – i.e. that it is too extreme and irreversible given the circumstances. But this, too, is difficult to accept. The Commission has already tried imposing all manner of Chinese walls and rules about non-discrimination and third-party access. Yet in the course of an antitrust investigation it has collected overwhelming evidence that the existing legislation has been flouted and undermined by the incumbents, regulators and the member states themselves. In such a context, ownership unbundling is an entirely proportionate remedy to deliver genuine market liberalisation.

In fact, one could easily argue that ownership unbundling is a *more* proportionate solution than creating a permanent and extensive regulatory control over a transmission system operator. Unbundling, by contrast, is a single, clean act splitting networks from supply and generation.

Secondly, in addition to the weakness of the arguments put forward by the incumbents and their member state supporters, there is the threat posed by DG Competition's antitrust prosecutions. Since the launch in summer 2005 of the sectoral review in the energy sector, the Commission has gathered a huge amount of evidence of anti-competitive behaviour which resulted in dawn raids on the premises of energy incumbents in the summer and autumn of 2006. DG Competition is now in the process of launching a series of prosecutions based on the evidence gathered against incumbents on a wide range of issues from price-fixing and market sharing, through to abuse of dominance by denial of third party access.

The key issue to understand here is that these prosecutions are likely to have a major impact on the liberalisation debate. Frankly, the prospect of a fine is a secondary concern for most incumbents. The first major problem is that a Commission prosecution inevitably will mean, unless settled, a 100-page plus prohibition decision resulting in the full details of an incumbent's alleged anti-competitive practices appearing in the public domain. The prospect of significant reputational damage from the revelation of anti-competitive practices that have cost domestic and industrial customers dearly is one that most incumbents would go to great lengths to avoid. Furthermore, the entry of such information into the public domain would place a heavy strain on the relationship between the incumbents and member state governments, which, when faced with complaints from the energy-consuming and voting public, would find it much more difficult to support the incumbents.

The second major problem is that unlike the inherent instability of a price-fixing cartel, which while damaging is likely to only last a few years, the market power of energy incumbents is so great that many of the practices that the Commission would deem to be anti-competitive will have existed for many years, in some cases, decades. Consequently, as across the European Union, interest on damages is usually from date of damage, and not as in the US, from date of judgment, the level of damages to be paid out by any incumbent found to have been in breach of the competition rules by the Commission could be enormous. Worse still, the Commission and the member states are in the process of liberalising national damages rules to make it easier for plaintiffs to sue defendants in antitrust cases in national courts. For instance the latest reform of German competition law focused specifically on making civil actions in competition cases easier in national courts. The prospect of significant numbers of industrial consumers as well as collective actions by domestic consumers for large amounts of money at compound interest will add to the reputational damage and seriously damage the balance sheets of the incumbents.

There is also further internal pressure for incumbents to consider unbundling: it could make economic sense. The experience of ownership unbundling in the UK was that unbundling was not only good for consumers, it was also extremely good for shareholders. In 1997 the privatised British gas company was split into Centrica, a retail and industrial consumers supply company and BG, which owned the transmission network and was subsequently bought by National Grid. The consequences for shareholders have been very good. National Grid's share price has doubled in a decade and Centrica's has tripled.

If E.ON's decision to settle with the Commission over its electricity network results in higher share prices and a favourable re-rating, the pressure on other incumbents to follow will become extremely intense. Settlement offers the prospect of no damaging Commission prohibition decision ever entering the public domain, no damages claims and the prospect of a major advantage for shareholders. Notwithstanding therefore, the resources and political connections of the energy incumbents, a substantial degree of energy market liberalisation might just well be achieved by DG Competition before long.