

# Agenda

Advancing economics in business

## The new European energy framework: a plan for the future

**The role of energy regulation in Europe is undergoing radical change—not least as a result of the Third Energy Package, which aims to fill the holes in cross-border regulation. Lord Mogg, Chairman of the European Regulators' Group for Electricity and Gas, explains how regulators will be facing up to the challenge of tackling the divergent objectives of climate change, consumer protection, and security of supply**

Energy regulation is something of a new kid on the block in Europe, and yet is maturing after an adolescence of regulatory change. Concerns about climate change, carbon emissions reduction and security of supply are moving the focus from price as the drivers of regulatory change—with substantial implications for regulation and for regulators.

New legislation—environmental and to accelerate the achievement of the single European energy market—will literally change the boundaries and bring wider responsibilities to national energy regulators and to Member States' energy policies.

We are seeing more and more political activism in energy markets to achieve demanding public policy goals, notably those relating to climate change, consumer protection and security of supply. How these goals can be achieved while retaining a foundation firmly based on competitive markets is one of the most significant questions we face.

The role of regulators will be central to the achievement of these divergent objectives, and in the EU the Third Energy Package changes fundamentally the role of national regulators in ways that will influence the shape of the future. That change is not only at national level but at the EU level itself, notably with the creation of a new European energy agency (Agency for the Cooperation of Energy Regulators, ACER). For the challenges increasingly go beyond national or even international boundaries—indeed, even an EU perspective may be too limiting and limited.

As European energy regulators, we recognise that our role must expand if we are to play our proper part in addressing problems—in helping to create and monitor the development of a single European energy market

and at the same time tackling climate change. We need to find new ways to cooperate practically across the EU, and more widely. ACER will undoubtedly play a key role in facilitating cooperation between European regulators, taking over and developing that role from the existing ERGEG organisation (European Regulators' Group for Electricity and Gas). Yet it is already clear that the global challenges we face will mean that regional solutions alone are inadequate. The new global association, the International Confederation of Energy Regulators (ICER), launched at the Athens World Forum on Energy Regulation in 2009, is one major attempt to forge new alliances to deliver analysis and research at a global level. While institutions are not solutions, effective cooperation is an essential means for identifying them: ICER is a means to enhance cooperation with minimal organisational structure.

### Third Energy Package: key changes

Solutions often begin at home. Europe has launched three attempts to create a competitive single European energy market. The Third Energy Package has, far more than its predecessors, been based on much detailed analysis and hard work of both regulators and the Commission during the months leading to publication of the Commission proposals.

That analysis was certainly needed. The Third Package is the most ambitious, comprehensive and far-reaching attempt to implement an effective regulatory regime across the EU's national boundaries to deliver change. And I believe it promises to be by far the most effective. Of course there are political compromises forged in the heat of the political

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negotiating process—this is Europe after all. But the central elements—the ‘teeth’ of the legislation—aim at addressing the fundamental problems which have for years stymied progress towards a single market and have entrenched national positions. The ‘regulatory gap’ in cross-border regulation will be filled with a network of potentially binding new rules. New European bodies have been created to develop those rules and to oversee them. This is of real importance, and regulators are central players in delivering key changes, which include the following:

- creation of a new European regulatory agency, ACER. ACER can propose that legally binding guidelines are created to ensure cooperation between national regulatory authorities (NRAs) across Europe;
- NRAs will have their powers enhanced—substantially for many of them;
- NRAs will now be independent of direct government influence—but only if Member States properly, and in a timely way, implement the legislation. The days when regulators can be dismissed from their post because of policy disagreements (more common than you might think) should soon be over;
- critically, individual NRAs’ duties will be extended so that they are required to promote the achievement of a single European energy market when undertaking their functions;
- 12 electricity and 12 gas policy areas are identified where potentially legally binding network codes can be drafted. Together they comprehensively cover the issues that will create a complete and legally binding cross-border regulatory framework;
- stronger business separation for transmission companies—and Europeanisation here too as their own European coordination bodies will play a major role;
- the development, every two years, of a ten-year network development plan in electricity and gas to help drive the investment needed to join up Europe’s markets, as well as to meet the objectives of climate change and security of supply;
- the establishment of formal bodies, the European Network of Transmission System Operators (the ENTSOs—one for gas and one for electricity), to coordinate the work that transmission network companies must undertake to fulfil their new European responsibilities relating to the network codes and ten-year network development plans.

This should (eventually) lead to a more effective set of national regulatory regimes, and a significant set of powers that will rest with ACER and the Commission. How the new balance will come to rest we have yet to see. The prospect, however, is of a legal framework which can drive change at the European level, with regulators playing a central role. It will be of critical significance how Member States react to these changes—where they embrace them and, more worryingly, where they resist them, will be a vital question, the answer to which will undeniably rest on considerations of power. For my own part, I am absolutely clear: it is for democratically elected governments to set the parameters of policy and for regulators to deliver within those parameters. But this will always be a difficult area.

## The reinvention of NRAs and the role of ACER

Economic energy regulation in the EU is relatively new—Ofgas in Great Britain was the first economic energy regulator (in 1986), and Bundesnetzagentur in the Federal Republic of Germany the last (in 2005). It is no surprise, therefore, that the business of energy regulation is still developing in all European countries. It is thus understandable that the changes in the Third Package are a major challenge for regulators—new powers, greater independence from government, and broader duties. There will not be an instant transition, but confidence, expertise and ambition should grow over time. And that process will be faster and more profound if all the parties—especially the Member States—are committed to delivery.

The biggest change, and perhaps the biggest challenge at EU level, is the requirement and the ability of NRAs to cooperate effectively on regional and European issues with the objective of promoting European, rather than national, objectives. The legal obligation for many to consider only national benefits will be influenced by an obligation to consider European benefits. How regulators will cooperate will be one of the main factors which determines the pace and extent of European integration in the years ahead. Whatever the outcome, I am sure we are about to see a step change—I hope it will be a sizeable one.

ACER, as a new body—a new EU institution—is being born in challenging times. Its formal start is in Ljubljana, Slovenia, in March 2011, and its first task—providing the requirements for the new European regulatory framework—is so important to the success of European liberalisation and to sustainability and the security of supply goals that we cannot contemplate failure. In our present structures, the Council of European Energy Regulators (CEER) and ERGEG,

European regulators have been working for many months to ensure that the Agency is built on firm foundations. We are already well advanced in preparing the processes and procedures it will need to ensure that the decisions of the Agency's Board of Regulators are firmly based on proper engagement with stakeholders. We are providing technical preparation through the development of draft Framework Guidelines (the basis for potentially legally binding cross-border rules) in priority areas. When ACER becomes operational on March 3rd 2011, it will almost certainly be fully geared up to operate. In parallel, the structures that will give ACER life are in the process of being put in place. The Board of Regulators—where ACER will make regulatory decisions—met for the first time on April 19th–20th 2010, and its Administrative Board for the second time on April 21st. ACER's Director was appointed at these initial meetings of the Board of Regulators and the Administrative Board.

## The present and future challenges in European energy regulation

While a competitive single energy market in Europe remains an unfulfilled ambition, energy policy must respond to changing needs and energy regulators must adapt to new imperatives.

Climate change is, understandably, among the greatest challenges the industry and we, as regulators, face. The regulators must ensure that the regulatory framework operates in a way that encourages companies to cost-effectively play their full part in addressing this problem, and at the very least certainly does not impede them from doing so. There are critical issues related to the climate for capital investment, information for consumers, and the design of support schemes to deliver. The incentivisation of network companies—making the commercial drivers of companies align with public policy objectives—is a major tool that regulators can deploy, but as yet is underutilised in many countries. The mix of technologies used for electricity generation will also need to adapt to a low-carbon economy, so market rules may well need to adapt, and networks must also adapt to what may be a more uncertain world for network companies. How these risks are managed will be a major concern for regulators who seek outcomes which deliver value for money—especially so in these difficult economic and financial times.

Security of supply clearly remains another central issue for governments. While a single European energy market may be in the making, the political reality is that security of supply is likely to remain the policy responsibility that citizens hold national governments accountable for. Europe has recent experience of blackouts, brownouts and gas shortages.<sup>1</sup> Network

regulation remains in the spotlight for regulators—particularly in relation to electricity—but now the interaction between the networks of Member States is critical. System emergencies must be managed effectively by transmission system operators across the continent acting in a coordinated way. In gas we face different problems, the solution to some of which depends on greater reliance on the developing world market for gas. It is already apparent that Europe's growing reliance on the world liquefied natural gas market depends on it having a fully functioning gas market itself. But the move towards low-carbon generation also poses a question on the future size of the gas market in Europe, and as a consequence, on the future investment requirements of Europe's gas networks.

Despite recent falls in wholesale prices of both gas and electricity, over the medium and longer term, prices look set to increase in the face of the massive levels of investment that will be needed. A formidable challenge for regulators will be to maintain confidence in competitive markets as an optimal way to ensure the most efficient outcome, against a background of potentially rising prices which particularly impacts on the socially disadvantaged and possibly on the international competitiveness of European industry if, as is likely, price changes are not uniform globally.

## What the future might hold

Forecasting is never easy and certainly no easier in relation to energy. I feel, therefore, that I have to caveat my vision of European energy policy for the future. I am an optimist—or, more precisely, an optimistic realist.

In part, our future is in our own hands—as ACER develops the European regulatory framework with the active support of NRAs, the NRAs could at the same time increasingly cooperate regionally, but not inconsistently with EU legislation and the single energy market, using their new powers to implement this European regulatory framework. Thus I expect more active coordination between regulators and network bodies at both European and regional levels—testing new ideas to find out what works and what does not, harmonising approaches where necessary, and implementing them across Europe through regional cooperation. But ACER itself will deliver coordination of national regulators with their own objectives. EU experience suggests that ACER may provide the nucleus of an important agent to deliver future policy changes at EU level. And if this management of change is to work, Member States themselves must be actively engaged at the regional and EU level without damaging the independence of

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regulators. The temptation to undermine the independence of regulators, especially at national level, will always be present but will, I hope, be overcome. Certainly, if it is not, the inevitable tensions inherent between national interests and European goals will be exacerbated.

European energy regulators are already cooperating to prepare ACER for its work: preparatory work on key framework guidelines is under way, some to be introduced very quickly. This is an early indicator of the change which is coming to Europe's energy markets. We are about to see the development of the first ten-year network development plan which, following assessment by ACER, and the Commission decision, will guide investments in the new infrastructure needed to join up Europe's energy markets. The ten-year plan is most definitely not central planning—but clearly there is the potential for it to be converted into that if confidence in markets were to wane.

The joining-up of markets—to the point where we have truly regional, and ultimately European, energy markets will equally change the way we see the major energy companies. This, coupled with proper unbundling (another Third Package requirement to be overseen by regulators), could transform vertically integrated regional monopolies and oligopolies into competitive European (or even global) companies anxious to maintain and enhance their share of Europe's energy market, giving competitive prices and real choice to Europe's energy consumers. I see signs that companies are already embracing the future: restructuring is beginning and I expect it to continue.

There are risks. The drive towards low-carbon—or even carbon-free—energy supplies means that there must be intervention in energy markets on a scale never seen. The technology changes we are already experiencing will bring further challenges (witness the consequences of intermittency from the development of large amounts of wind generation). These developments must be foreseen through rigorous analysis and overcome in ways which work with the grain of the market. If we fail we invite further intervention in energy markets, which will have the effect of undermining the very markets we are trying to create. We must therefore be vigilant about the effects of unnecessary intervention in markets, and here I see

a further important role for regulators in providing policy-makers with high-quality and impartial technical advice to help ensure that policy decisions are properly informed.

## Regulation: solution and challenge

Many of these issues are not unique to the EU. Across the world regulators are faced with similar challenges and all develop their own response according to the local conditions. There are real benefits in sharing experience. ICER has jumped to its feet within the first months of its life and should increasingly contribute to this process by operating across the world with truly international virtual working groups. Among the main areas of its work will be to:

- promote the exchange of information on best practices to augment regulatory capabilities, including new partnerships, between regulators from developed, transitioning, and developing countries;
- strengthen efforts at regional coordination through associations of energy regulators and other key sector stakeholders;
- increase professional training programmes to enhance institutional regulatory frameworks;
- explore opportunities for cooperation between international development agencies and associations of energy regulators.

I have been frankly amazed at the level of support that has been forthcoming for ICER from regional regulatory associations and regional and world bodies interested in public policy. I hope this is a true indication of the growing role that regulators can play in contributing to the solutions needed for some of the world's main challenges.

The future is not yet written—if anyone thinks it is please let me know. But we, as regulators, recognise that we are one of the central players that will help influence that future in relation to energy markets. 'Exciting' is a rare adjective to be used in our regulatory world—yet I can with some astonishment recognise that being a regulator is truly exciting!

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<sup>1</sup> 'Brownout' refers to the dimming of lighting that results when voltage levels in the power supply are reduced.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email [g\\_niels@oxera.com](mailto:g_niels@oxera.com)

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