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**THE REGULATION OF EUROPEAN GAS MARKETS:
THE PROMOTION OF COMPETITION***

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Your Excellencies, Ladies and Gentlemen,

It is an honour to be invited to address such a distinguished gathering. Particularly so, in a part of the world known for its remarkable abundance of gas and oil reserves. This abundance is of course in stark contrast to the situation in most of the countries of the European Community, which rely heavily on imports of both of these resources to maintain economic growth.

However, in the northern part of Europe there has been considerable success in discovering and developing gas and oil resources. As many of you will know, the Netherlands has been very fortunate in having large deposits of natural gas onshore as well as some modest quantities of oil offshore. The United Kingdom has also been fortunate in having significant deposits of natural gas offshore, principally in the North Sea. Outside the European Community, there are very large deposits of gas in Norway which are playing a greater and greater role in the European gas market.

What I want to talk to you about today is the growing tension between the framework for the development of gas resources in the countries of Europe which are members of the European Community and the broader framework of increasing economic integration of which these countries are a part. Every industry thinks of itself as different and the gas industry is no exception. However, the development of international trade requires a degree of openness in economic life which cannot pay much respect to the uniqueness of a particular industry. Around the world the major trade blocs are discussing ways of removing barriers to the free movement of goods and services: the North American Free Trade Agreement and the European Community's Single Market Programme are examples, as are the ongoing discussions on the Uruguay Round of the GATT. A striking feature of all the discussions is the extent to which energy and particularly gas and electricity have been successful in resisting the trend towards a growing liberalisation of

international trade.

In this context it might be instructive to look at the efforts to promote competition in a regional bloc which has managed over the past thirty years or more to maintain a very steady pace of economic and political integration. How has energy fared in the process? In particular, how has the gas industry fared?

First of all I shall examine the main features of the European gas market. I shall then outline the so-called Internal Energy Market (IEM) programme of the European Commission as well as the principal features of the Community system into which the programme has been introduced. Finally, I shall provide you with a review of the latest steps taken by the Commission to promote gas-to-gas competition.

1. The European Gas Market

The European gas industry appears to be poised on the brink of major changes. Until the mid 1980s regulation of the gas industry in Europe was a national affair with the single important exception of government intervention in imports and exports. Since the late 1980s the European gas market has become considerably more international in character. In this process there have been three important developments concerning regulation^[1].

(i) a growing awareness by governments of the potential for regulation of utilities supplying essential goods and services to the public. Regulation for competition in sectors of the economy characterised by large-scale monopoly may bring benefits to the many sectors which depend upon them - whether for water, telecommunications or energy. The perception that governments CAN do something to promote competition in these sectors is new.

[1] The subject of regulation is dealt with at some length in my study of the European gas markets: "Gas Regulation in Western Europe", Financial Times Business Information, 1990 (50-64 Broadway, London SW1H 0DB; fax: 44-1-799-2259).

The next stage is to ask: what measures should be taken? The answer to that question may be found by looking at the experience of other countries where attempts have been made to effect change. Governments may take the first step but industry will have to follow fast if it is to respond to the interpretation placed upon the evidence gathered by its government. Since increased regulation may impose large extra costs on industry, it is important to be able to counter arguments for change based on the experience of other countries. Consumers too have an interest in knowing what governments do on the other side of the border or across the Channel.

(ii) the decision of the European Community (EC) Commission to ensure that energy was to be included in the programme to create an internal market in Europe by 1992. For the first time it appears that the energy sector might be significantly affected by the EC's programme of completing a single market by 1992. For the gas sector the influence of the United States' recent deregulation experience was clearly evident in that document. All parties likely to be affected by the Commission's ideas, which were not actual proposals, took a new interest in the practices of their fellow member states.

Since that time, the Commission's interest in the gas market has shifted from cross-border trade issues to ones linked to the promotion of competition in a market already characterised by a high degree of intra-Community trade. Since it possesses the legal power to substantially affect business practice in the Community, its new conversion in this area cannot be ignored.

(iii) the impact of a growing concern over the environment upon the energy sector, particularly in air quality and pollution regulation: natural gas and liquid low-sulphur fuels being preferred in consequence. These trends are not new; for example, since 1973 a law for the preservation of Venice made the use of natural gas compulsory in order to preserve the local monuments.

Each of these developments have generated much interest in the ways in which regulation is carried

out in the various countries of Europe which consume gas.

1.1 Exclusive rights and monopolies

Uninterrupted security of supply has been a central concern of the gas industry from its earliest days. It takes two forms: firstly, there is a need to import much of the gas consumed from abroad and secondly, there is a need for security since the gas supply chain is integrated and supplies have to be produced and sold in advance before the construction of a pipeline is financially viable. This need for security of supply is the political and economic basis for a variety of legal devices designed to limit competition. Governments have encouraged public or private monopolies and legal privileges concerning the import, export and transport of gas in the national gas markets of Europe. Even where there is no monopoly and several companies exist, these are either federated or are under the primary influence of one of them. This situation is currently being questioned, since the limited scope for competition is no longer regarded as the unavoidable outcome of a situation in which there are large elements of natural monopoly, especially in the transmission and distribution sectors. The main question is whether utilities should be obliged to grant competitors access to their pipelines and to transport energy perhaps at the expense of their own gas sales. The problem has so far only emerged in the electricity industry but supporters of this approach seek to extend it to the gas industry. As far as the continental gas market is concerned, the debate is taking place in the context of the EC proposal to establish a single market by the end of 1992.

From a regulatory point of view, the structures in the UK and West Germany stand out. The industry is privately owned and government plays a role as regulator, limiting the abuses of economic power which an open market gives rise to rather than attempting to control economic power. By contrast, the gas industry in many European countries is publicly owned. Vertical integration is also found in some cases such as France. Horizontal monopoly is also common, whereby one company enjoys a monopoly for one stage of the industry, except in West Germany.

The many publicly owned companies can be employed as instruments to impose a national energy policy, frequently to ensure security of supply and to provide a reliable, continuous supply for the public service. This has not been attempted in West Germany but the distribution sector is being reorganised to achieve that aim in the Netherlands.

One might also note that the attitude to the involvement of the state in the economy changes as one moves south in the Community. There is a kind of unofficial border line between the north and the south with France, Italy and Spain preferring a liberal use of state instruments and in the north something like a different industrial culture.

Quite apart from the use of state companies as instruments, there are also a variety of exclusive rights to import, export or transport gas over long distances in both the north and the south as well as monopoly concessions in local areas over gas distribution; restrictions on the export on indigenous output of gas and bilateral contracts which are restrictive in character.

In each of the member states, some form of concession is used to delegate government authority to private or public companies to supply gas. In a decentralised structure - Spain for example - this authority may be shared between the central and the local authority (Autonomous Community).

1.2 Competition

Pressure to liberalise the European gas market has come from three sources:

- 1) a new emphasis upon competition in the national regulatory policies for the gas and also the electricity sectors. Privatisation measures have shifted commercial risk from the public to the private sector. The anti-monopoly measures being taken in the United Kingdom against British Gas have played a role, especially the introduction of common carriage. Domestic developments of a different kind have also had an impact: the excess generating capacity in the French electricity industry raises the possibility of power exports to other Member States;

- 2) the EC Commission's 1992 programme. Member States have agreed to remove barriers to the creation of a single European market by 1992
- 3) the US experience of deregulation of the gas sector using above all the legal instruments to ensure open access to pipelines.

1.3 The US Experience

The influence of the American model of gas market liberalisation in Europe is inevitable, since restructuring of the industry to permit greater competition has gone much farther there. Its influence on the EC Commission's thinking is readily apparent, especially in the field of common carriage. However, it is questionable how appropriate the comparisons are since the market structures show significant differences.

(i) By European standards, the American gas trade is highly regulated, despite the existence of a spot market. In contrast, European governments have rather chosen to intervene directly in the establishment and operation of their gas industries, especially the transmission and distribution components. Each European country has its own national transmission company, which also controls, either directly or indirectly, the end-user market, to the exclusion of producer-consumer contacts. Usually, consumers have only a single source of supply, with prices and contracts controlled by publicly appointed boards or other public authorities. The issue is therefore not one of deregulating markets which have been inhibited or distorted by heavy-handed regulation but is rather one of liberalising a market which already has a large element of direct public sector control. As the Chairman of the US Federal Energy Regulatory Commission (FERC) has put it, 'it does not appear that the European gas structure is currently conducive to the level of open access that exists in the US'^[2].

(ii) The US market is driven by gas-to-gas competition and there is no security of supply since

[2] Remarks, p.5.

producers and distributors and pipelines are not integrated. By contrast, in Western Europe security of supply is guaranteed by two mechanisms:

- (a) a diversity of sources and
- (b) long-term contracts.

This is how an apparently over-supplied Europe can start negotiating for the purchase of LNG from Nigeria.

Compare the situation in the USA where the gradual elimination of the pipeline company merchant function and the transformation into transporters, the guarantees which went along with long-term contracts are under threat. This threatens cogeneration business and residential business: inability to think long-term. How short is 'long-term'? Twelve months. (California recently ran out of gas with a spot market also weak.

(iii) While liberalisation of the American gas market benefited specifically American companies, the dependence of Europe upon gas imports creates the possibility that liberalisation measures, taken by the EC Member States would principally be of benefit to non-EC companies. The bulk of Europe's gas supply comes from a few large suppliers in the North Sea, the USSR and Algeria, plus indigenous sources such as the Netherlands.

(iv) The structure of demand in the two regions is different. The European gas industry is concentrated, with nearly 90% of gas demand found in five countries. Two thirds of demand is met by four suppliers alone: Algeria, the Netherlands, Norway and the USSR. This is in contrast to the USA, where thousands of small and medium-sized producers use pipelines owned by others to take their gas to their customers.

(v) There is no body in Europe comparable to the FERC. At the European Community level, the EC Commission has no comparable authority. Moreover, the rapid growth experienced by FERC, particularly in its legal department, since it began its deregulation programme may cause many to

hesitate before seeking to introduce such a bureaucracy into Europe. Currently, the Commission simply lacks the staff for such a role.

Nevertheless, it may be argued that a gas structure similar to the US is not a prerequisite for open access. In Canada, for example, there is only one major inter-provincial pipeline, precluding competition among long-distance pipelines, but a form of open access has developed nonetheless.

By contrast, the 'European way' has been to place the emphasis on structure. Historically, when the large-scale development of the European gas business was being considered, the American experience was viewed and rejected as a model including the open-ended take-or-pay field depletion (producers have not been able to unilaterally increase the reserves sold; the production profile is negotiated) and the disintegration of the gas chain in the US, imposed by regulation rather than commercial choice^[3].

Take-or-pay clauses were developed over a period of years to make it possible for gas buyers and sellers to adapt to changes in the economic situation: including flexibility of take and price variation formulae. To execute these contracts, the European transmission grid was gradually built. Firm take commitments were made, making it possible for extremely large investments to be made (for example, Troll but also Nigerian resources). This required the creation of purchasing consortia to pool the strengths of the major European companies. Hence, co-operation.

1.4 Open Access

An important instrument for the promotion of competition is the open access system of transportation to permit transport through existing systems and break the de facto or de iure monopoly of the large gas companies.

[3] See for example the remarks by the heads of Ruhrgas and Gaz de France at the 17th International Gas Union in Washington in June 1988: 'A Changing Gas World?' by K.Liesen and 'France and the European Gas Structure' by Jacques Fournier.

The argument in favour of open access goes like this. Open access creates choices for buyers and marketing opportunities for sellers. It provides the physical means for a spot market to develop. In turn, price signals are transmitted to the wellhead, increasing the likelihood that the gas reflects its market value vis-a-vis alternative fuels. This will result in the availability of sufficient supplies at competitive prices - to the mutual benefit of both industry and the consumer^[4].

Such a system might well be suitable in the developing market. The European end-user markets (industrial, electricity generation and cogeneration markets) appear to have the potential to expand. Producer access to the major end-user markets, combined with gas-responsive prices, might help to realise the potential for market expansion and supply-demand balance. Gas could then be sold at market-clearing prices. If producers were able to negotiate with end-users through a form of open access transmission, economic benefits similar to those felt by the US gas industry and gas consumers might be possible.

However, open access is recognised as practical in the U.S. because 'the structure is conducive to a more competitive environment'^[5]. To illustrate, almost all the major supply areas and market areas are served by more than one pipeline. Moreover, about 84 percent of interstate gas sales for resale volumes are vulnerable to competition from other pipelines.

In contrast to the situation in the United States, a liberalisation of the gas market might benefit 'non-subscribers' to the regional network: non-Member States might reap the benefits of greater freedom required by the Commission. In contrast, it was American companies who benefited from deregulation in the U.S. with its ample domestic gas supply. In Europe, with its dependence upon non-European sources of supply, it will be the Algerians and the Norwegians who will benefit. Why should the Commission act to promote their interests, while waving the flag of market freedom?

[4] Martha Hesse, Remarks made at the Gas Daily International Conference, Amsterdam, 22 September 1988, p.5.

[5] *ibid.*

1.5 The Major Markets

(i) The United Kingdom

The United Kingdom is one of the European Community's two major gas producing states, the other one being the Netherlands. Consumption of gas is also high. The domestic gas market accounts for about 25% of the total gas market in the Community. Any far-reaching decisions which the British authorities make about the organisation of their gas supply are therefore of great interest to their continental neighbours, despite the lack of any physical link between the British and continental European gas grids.

The regulatory environment in the UK has been in a state of considerable flux since the privatisation of the domestic monopoly British Gas (BG) in 1986. As European gas companies discuss the implications of EC Commission proposals to introduce competition into the gas markets of member states, the British market is already wrestling with the consequences of regulation for competition. For the British gas market, 1992 began in 1986 and nothing that the Commission in Brussels is likely to do in the coming years is likely to be as far-reaching in its effects.

(ii) West Germany: The Strategic Market

West Germany is unique in the European gas market because of its high consumption of gas and its central location with respect to sources of supply, whether originating from the USSR and destined for markets in the west or from the Netherlands or Norway in the north for markets in the south.

The country's decentralised political structure is also unique in OECD Europe and makes the interaction between the Federal government and the eleven States (Länder) of great importance to energy regulation in the country. Consensus between the Federal Government and the opposition

parties and some of the States on the combined development of coal and nuclear broke down after the Chernobyl nuclear accident in 1986. The Federal Government maintains that the use of nuclear power under existing safety standards is justified and economically necessary. Taxes on natural gas and heating oil have been introduced and are likely to reduce consumption, which is already declining. In 1988 it fell to 62.5 m.tonnes from the previous year's 64.4 m.tonnes, a fall of 4%¹. Its share of the energy market declined from 16.6% to 16.0%. Nearly 70% of the gas consumed was imported: principally from the Netherlands, Norway and the USSR. Overall, however, gas has increased its market share since the oil shock of 1973 by 6% while the share of oil has declined by 13%. The EC Commission estimated that nearly 30% of all German dwellings were heated by natural gas and about 10% of all inland deliveries go to the electricity sector².

The strategic role of the West Germany at the crossroads of the continental gas market has ensured that the industry has taken a very critical view of the EC Commission's proposals to promote competition in cross-border trade by 1992. Not only are German transmission companies likely to be most affected by the introduction of a common carriage obligation, but the largest transmission company, Ruhrgas, has made it plain on many occasions that its policy is not to transport gas for others but to buy and resell gas³.

(iii) France

Declining production, import dependence and strong inter-fuel competition are the main characteristics of the French gas market. In contrast to West Germany and the UK the role of government, both directly and indirectly, has been an extensive one. Its interference with GdF's contracting for international gas supplies has proved expensive for GdF but has been justified on strategic grounds. France is the only member state in the European Community which receives large-scale supplies of gas from outside its frontiers: almost 90%. This import dependence is likely to increase since domestic production from the Lacq area, where most French gas is found, is expected to cease altogether by the year 2000.

Over the last 20 years natural gas has become a primary fuel for the industrial sector, especially in steam generation, where the advantage of gas is decisive. It gives maximum heat recovery from flue gases and environmental protection. The share of total energy use held by natural gas increased from 3% in 1965 to 12.3% in 1988¹. Other indicators of the industry's rapid growth are that between 1947 and 1987:

- the length of the urban distribution network tripled;
- the national transmission network grew tenfold;
- total sales grew by a factor of 30;
- sales to industrial consumers increased by a factor of 100.².

Despite these indicators of growth, its share of the domestic energy market is smaller than the average of 18-30% found among other consuming countries of the EC. Gas has no share of the domestic power plant market and its opportunities for expansion in a more or less stagnant market are only at the expense of electricity or fuel oil.

2. The Role of the European Community in Promoting Competition

Some preliminary acquaintance with the workings of the Community institutions may be useful, particularly since the modifications introduced by the Single European Act. In the context of this paper the most important are the Commission and the Council. Others, such as the European Parliament and the Court of Justice, are at the present time playing a much less important role and will not therefore be covered in this paper. The full legislative process is summarised in the chart attached to this paper.

(i) The functions of the Commission are threefold. It is the main initiator of Community policy; it has a wide range of executive and regulatory functions and a limited law-making role; also it acts as the guardian of the Treaties and in that role is required to ensure that Treaty obligations are observed (fn. to the three Treaties).

The Commission is composed of 17 members known as Commissioners. Each Member State must have at least one commissioner but may have not more than two. France, Germany, Italy, Spain and the United Kingdom have two Commissioners and Belgium, Luxembourg, the Netherlands, Denmark, Greece, Ireland and Portugal have one. The Commission bears collective responsibility for its acts. It acts by majority vote.

The role of the Commission as an initiator of Community policy is important since the Council of Ministers in exercising its legislative powers under the EEC Treaty can, in most cases, only act upon proposals submitted to it by the Commission. Basing itself on the EEC Treaty the Commission may formulate proposals on any matter provided for in the EEC Treaty, either where the power is specifically granted as in Article 100 A, discussed below, or under the more general power in Article 235 covering matters not specifically identified in the EEC Treaty. In addition, under Article 213 of the Treaty, the basis for the price transparency and energy investment proposals, the Commission is required to collect any information and carry out any checks required for the performance of its tasks.

Before a proposal is submitted to the Council, the Commission consults with interested parties and then, with the assistance of its specialist Directorates and advised by its Legal Service, it considers the policy proposal before reaching its final position. In drawing up the proposal for the Gas Transit Directive several of the 22 Directorate-Generals (DGs) were involved: in particular, DG XVII (Energy), DG IV (Competition) and DG III (Internal Market and Industrial Affairs). Once the final proposal is formulated, the document is sent to the Council where it is discussed by the Energy Experts' Group, composed of experts from the Member States and by the High-Level National Governments' Group. The document is simultaneously under consideration by the European Parliament (see the diagram) and the appropriate Parliamentary Committee. In energy matters, the appropriate Parliamentary Committee is the Energy, Research and Technology Committee (CERT).

A major change in the exercise of the Council's powers was introduced by the SEA, which enhanced the role of the European Parliament in the decision-making process. This change, introduced through the amendment of Article 149 of the EEC Treaty, created a new co-operation procedure involving the Parliament, which is used primarily in cases where Council legislation concerning harmonisation measures for the establishment and functioning of the internal market is proposed. An unintended consequence of the introduction of the co-operation procedure may be a slowing down of the decision-making process. Under the procedure, the Council is required to submit proposed legislation to the Parliament for its opinion. Once the Parliament has submitted its opinion and the various interested groups have produced a report on their discussions, this is presented to the Council of (Energy) Ministers, which meets twice a year. The Council's task is to consider both the opinion of the Parliament and the report and to take a decision whether to approve, reject or amend the Commission's proposal.

It should come as no surprise that the involvement of particular DGs in energy policy making should vary over time. According to some accounts, DG III seems to have played an important role in ensuring that energy be included among the areas for reform in the drive to establish a single market. The Competition Directorate can afford to adopt what may appear a rather passive stance on energy issues since it relies heavily on receiving a complaint before it may use the considerable legal powers at its disposal. Its limited resources mean that it must also choose carefully the sector in which it should act (between say telecommunications, civil aviation or energy). The role of DG XVII has clearly been fundamental, but it is surely no accident that its role only became more forceful after the advent of a new commissioner, Sr. Antonio Cardozo e Cunha.

In its role as the executive of the Communities, the Commission has a duty to ensure that the rules of the Treaties are applied to the conduct of Member States and also to the conduct of undertakings and individuals. Under Article 155 (first paragraph) of the EEC Treaty the Commission has a duty to ensure the application of that Treaty. The EEC Treaty also contains specific expressions of this

duty, including those contained in Article 89 (duty to ensure the application of Articles 85 and 86) and in Article 90 paragraph 3 the Commission has a duty to ensure the application of the provisions of Article 90. Also Article 93 imposes a duty on the Commission to keep under strict review the application of the provisions of Article 90. Moreover, Article 93 imposes a duty on the Commission to keep under strict review the application of the provisions relating to state aids. The regulatory functions relate to the making of secondary legislation, particularly in relation to competition matters. The law-making powers are limited but, in the context of the IEM, they are important.

The role of the Commission as guardian of the EEC Treaty is, in respect of Member States, derived primarily from the duty imposed on it by Article 169 to initiate a proceeding against a Member State which it considers to be in breach of an obligation under the EEC Treaty. The Commission is required to draw the attention of the Member State to the alleged breach and if the matter is not satisfactorily resolved to deliver a reasoned opinion on the matter to the Member State. If the State concerned does not comply with the Opinion within the period specified by the Commission, the Commission may bring the matter before the Court of Justice. The Commission also has powers to ensure the compliance of undertakings and individually with their EEC Treaty obligation. These powers are particularly important in the context of the application of the Articles of the EEC Treaty relating to competition particularly Articles 85 and 86.

(ii) The Council of Ministers

The Council of Ministers, usually referred to as the Council, is, subject to certain specific exceptions contained in the EEC Treaty, including, importantly for the legal measures connected with the IEM, that contained in Article 90 (supra), the law-making body of the Communities.

All Member States, at present 12, are represented at meetings of the Council. Article 148, paragraph 1 of the EEC Treaty provides for simple majority voting in the Council except for those cases specifically provided for elsewhere in the EEC Treaty. The exceptions to this rule are

requirements for unanimity or a qualified majority. The SEA contained provisions which amended the EEC Treaty by replacing in a number of Articles a requirement for a unanimous vote or a simple majority with a requirement for a qualified majority. The purpose of the amendment was to facilitate the creation of the internal market. Amongst the Articles which were amended was Article 100 which required unanimity in relation to proposals relating to the approximation of legislation. The SEA, added to the EEC Treaty a new Article 100A. As much as two thirds of the legislation required to complete the internal market may be made by a qualified majority under this Article. Article 100A states that the Council of Ministers shall, acting by a qualified majority on a proposal from the Commission in co-operation with the European Parliament, and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market. Fiscal provisions, measures relating to the free movement of persons or the rights or interests of employed persons are excluded from the scope of Article 100A and require approval by unanimous vote under Article 100.

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Voting by qualified majority is a system of weighted voting, in which the big four States (France, Italy, the UK and Germany) have 10 votes each, Spain has 8, the medium size states (Belgium, Greece, the Netherlands and Portugal) have 5 votes each and Denmark and Ireland each have 3. Luxembourg, the least populous Member State, has 2. The allocation of votes is shown in the table below.

Country	Votes
France	10
Germany	10
Italy	10
United Kingdom	10

Spain	8
Belgium	5
Greece	5
Netherlands	5
Portugal	5
Denmark	3
Ireland	3
Luxembourg	2

The total number of votes is 76. The required minimum vote for a qualified majority is 54. In this way, two of the large States or six of the small States may be outvoted.

Quite clearly, the system of qualified majority voting makes for a more rapid and effective system of decision-making than a system based upon unanimity. The application of the qualified majority system to the internal market measures has emboldened the Commission to perform its role as policy initiator in the context of the internal market with remarkable zeal, not only in the energy sector. It has also led to considerable bargaining between Member States to pass measures through the Council.

The Gas Transit Directive and also the Electricity Transit Directive were made under the Article 100A procedure.

3. The Commission's Proposed Directive on Natural Gas

The proposals in the European Commission's Internal Energy Market (IEM) Programme are designed to lead inter alia to an increase in gas-to-gas competition. The measures are a response to

the accelerated pace of integration brought about by the Single European Act and the Commission's wish to have the energy sector included in the process of integration as soon as possible and to the greatest extent possible.

In this section I shall first of all outline the proposals which have special relevance to the European gas pipeline industry. Secondly, I shall note some of the ways in which the developments at the Community level may impact upon the structure of gas industries in the Member States. Finally, the potential impact of the measures in the light of recent British experience will be mentioned.

(i) The Commission Programme

Why does the Commission want to make changes in the European gas market?

In the Explanatory Memorandum to its recent proposals, the Commission sets out three principal characteristics of the gas market which give rise to concern about the level of competition. They concern disparities in the market structures and development; patterns of market growth and the dependence of the Community on third countries for supplies of gas^[6]. Noting that as much as 95% of the natural gas in the European Community is consumed in only five Member States, the increase in gas use will be located primarily in the newly established or developing gas markets. Demand will grow as will dependence upon third countries for supplies of gas. Are the existing structures sufficient to provide the competition which will lead to efficiency in gas supply? It concludes that they are not sufficient.

How does it propose to amend them?

The main elements of the programme are contained in the draft directive on natural gas which the Commission approved on 21 January 1992. The fact that the draft is approved does not mean that it is yet law however; only that it has now commenced the long march through the Community institutions to be voted on by the Council of Ministers according to the procedure of qualified

[6] Completion of the Internal Market in Electricity and Gas, 21 January, 1992, pp. 22-23.

majority voting set out in the Treaty of Rome, Article 100 A.

Entitled "Completion of the Internal Market in Electricity and Gas", the Explanatory Memorandum sets out the Commission's thinking on the subject of the Community natural gas industry. As it notes, the draft directive provides for a three stage approach to the achievement of the internal market in gas and electricity. As far as gas is concerned, the three stages take the following form:

- 1) 1991-92. Implementation of the directives on gas transit and price transparency^[7].
- 2) 1993-95. Introduction of new measures of liberalisation which respect to the existing structures and introduction of third party access to large industrial users.
- 3) 1996-98. Completion of the internal market for gas and electricity and extension of open access to small industrial users of gas.

The scheme is based on four general principles:

- 1) A gradual approach to liberalisation is required to maintain stability in the market and to avoid deterring future investors. The Commission recognises that the gas industry needs a period of time sufficiently long to adjust in a flexible and orderly manner to the new market environment. However, by dividing the liberalisation programme into distinct stages, the Commission can set a minimum of change to be achieved at each stage, allowing some states to proceed at a faster pace in their domestic market than others. A step-by-step approach is also dictated by the need to avoid uncertainties on the part of investors in future pipeline construction;

[7] Council Directive 91/296/EEC of 31 May 1991 on the transit of natural gas through grids, O.J. No L 147/37, 12.6.91; Council Directive of 29 June 1990 concerning a Community procedure to improve the transparency of gas and electricity prices charged to industrial end-users, O.J. 90/377/EEC.

- 2) rigid mechanisms are to be avoided and instead a framework should be defined enabling Member States to adopt a system best suited to their energy resources, the state of their industry and their energy policies. This is an expression of the principle of subsidiarity;
- 3) excessive regulation is to be avoided. In a spirit of great candour, the Commissioner admitted that "moves towards greater liberalisation will undoubtedly make it necessary to introduce new regulations". The assumption is however that such new regulation will replace rather than supplement existing regulation but in his view these monopoly situations call for "a substantial degree of regulation", notably in the form of price controls". However, the Commission only envisages such regulation as is strictly necessary to achieve the aims of liberalisation, leaving room for commercial negotiations between the companies involved in gas transit, for example;
- 4) the Commission's approach should be based upon Article 100A, permitting a maximum of consultation with the Council and the Parliament under the co-operation procedure and with other interested parties. This is accompanied by the caveat that the Commission may use its other powers conferred by the Treaty of Rome as and when appropriate. These include its buyers under Article 86 (abuse of dominant position) and also under Article 90 mentioned below.

Returning to the three Stages and the timetable, the first stage has already begun. It concerns the implementation of the gas transit and price transparency directives. Under the transit directive designated gas companies have the right to negotiate the transit of gas through neighbouring transmission grids provided that at least one border is crossed and that the move has no adverse effects on the quality or reliability of supplies. Under the price transparency directive, information on the prices paid by industrial end-users must be forwarded to the Commission for publication in a manner which safeguards the confidentiality of commercial data.

Stage 2 is of very great interest. It contains what the Commissioner describes as "new agents for change" and is based on three elements:

Firstly, it requires the abrogation of exclusive rights to construct gas pipelines. Proposals to increase competition in the production of gas are also likely to be included but not in the proposals expected in the next few weeks. The aim is to increase the potential for investment in pipeline capacity by independent operators, while permitting national authorities to reject proposals which essentially duplicate existing pipeline networks.

Secondly, the idea of unbundling services is to be introduced. This means that vertically integrated companies will have to separate management and accounting functions in production, transport and distribution operations. The aim of this is to promote price transparency, not to affect ownership structures. In this context, one might note the recent undertakings given by British Gas to the Director General of Fair Trading in Britain. Under these, British Gas has undertaken to unbundle its transportation service into a "transportation unit" which will remain a part of British Gas. This is discussed in some detail below.

Thirdly, there is to be a scheme of Third Party Access (TPA) to the European Community gas network. Transmission and distribution companies will be placed under a legal obligation to offer access to their network to companies which are designated as eligible. Access is to be offered against reasonable remuneration and to be granted subject to capacity being available.

The criteria for eligibility to the scheme are, in the first instance, extended to the large industrial consumers with a consumption exceeding a certain threshold, such as fertiliser companies and power plants, as well as the distribution companies. For the latter, however, there are two possible methods of implementing a gradual approach: either the threshold mechanism may be used to determine the eligibility of distributors or they could be eligible up to a certain percentage of their

total sales. The aim of involving the distributors is to ensure that other industrial users and domestic users benefit indirectly from TPA. Companies eligible will be able to negotiate contracts with suppliers of gas anywhere in the Community. However, they may be required to enter into contracts for a minimum period covering at least a part of the gas supplied on a TPA basis, in the interests of market stability.

This seems to embrace a number of large consumers and distribution companies in the European gas market such as Dow Chemical, Akzo, the Dutch VEGIN and ENEL in Italy, all noted for their dissatisfaction with the current arrangements for gas supply.

Finally, implementation of the second phase will be guided by the principle of subsidiarity, about which more will be said below.

The aim of the Stage 2 proposals is to strike a balance between an extension of the possibilities of investment in production and transport to independent operators, in particular large gas consumers and a respect for the national requirements on energy policy, environmental protection and town and country planning.

The link between the second and third Stages is a particularly important one. The choice of specific measures to be adopted in Stage 3 is not to be determined in advance and will depend on the progress (or lack of it) achieved in Stage 2. This means that the legal instruments which it has recently tried and then withdrawn might well reappear. These include the draft Article 90 Directive. Another point worth noting for a British audience is that the threshold for eligibility to the open access system will almost certainly be lowered in Stage 3. TPA will be extended to small industrial consumers rather as is now being proposed in Britain. This is likely to be resisted by France, the Netherlands and Germany as well as by many other Member States.

(ii) The Impact of the Developments at the Community Level on the Structure of Gas Industries in the Member States

The key to understanding the likely impacts at the national level is the notion of subsidiarity contained in the directive. This means that Member State governments will be free to choose their own measures to implement the directive; whether they propose to set up a special regulatory agency or rely on competition rules or both as in Great Britain. Member States will also retain their flexibility in the following areas:

- setting tariffs for gas for all final consumers not eligible for TPA;
- the determination of the size and nature of the rights of distribution companies and their public service obligations (this means that they will be able to grant exclusive distribution rights vis-a-vis all the users below the eligibility threshold, subject to the transparency requirements contained in a separate measure);
- the establishment of detailed criteria for granting authorisation for the laying of gas transmission and distribution lines.

The principal features of national gas regimes which are likely to be affected by the Commission's directive are those concerning the exclusive rights in transportation and distribution and the organisation of the domestic gas companies. It might be helpful to look at the main features of the national regimes. Since there is some variation from one Member State to another, I have attempted to illustrate the principal national features in the form of tables^[8].

Some comments on salient features of the national regimes are perhaps in order here:

[8] This material is based upon a study which the Institute has recently completed for the Commission on the legal dimension of gas and electricity distribution networks in the Community.

Germany: The important role of pipeline authorisations in the implementation of Wintershall's plans to lay new gas pipelines has probably brought this item to the attention of the Commission. Even if the procedure was lengthy and time-consuming however, the pipeline authorisations were obtained from the various Laender, demonstrating that there is a fair degree of freedom to construct new pipelines, at least relative to many other Member States in the Community.

Italy: There is no legal monopoly of gas imports but the SNAM has the exclusive right to install and operate pipelines for the transport of hydrocarbons produced in Italy. As far as access is concerned, some limited steps towards introducing wider access to existing networks have been introduced. In January 1991 Law No. 9 (Article 12) permitted producers of Italian gas to seek carriage or vettoriamento from transporters if the gas is to be used in their own plants, or in plants owned by the parent company or affiliated company by the producers or to be delivered to the state electricity utility, ENEL, or to companies falling within the scope of the existing legislation^[9]. Conditions and fees are to be agreed by the parties, taking into account remuneration of investments, operating costs, the criteria followed in the European gas market in determining gas carriage fees for third parties and the evolution of the energy market. If the parties fail to reach agreement, the conditions and fees will be established by the Comitato Interministeriale Prezzi (CIP), after it has heard the parties. The gas to be carried has to be interchangeable and be acceptable in terms of transportability and content of noxious substances. Carriage proposals will be evaluated in terms of transportation capacity, development programmes and the utilisation ratio of the network.

All companies owning gas pipelines in Italy are subject to this carriage obligation. In practice, those means SNAM (the state gas company) and local distribution companies. However, we understand that neither ENEL nor SNAM consider there is much scope for TPA to be developed on a

[9] G. Zavattoni, A Limited Form of Gas Carriage for Third Parties in Italy, 9 Journal of Energy and Natural Resources Law, 1991, 207-210; Gas Matters, April 29, 1991, p.5-6.

continuing basis under the existing pipeline network. The system was designed for use by SNAM. Obviously there is room for disagreement on technical capacity but it appears that the major purchaser takes a similar view to SNAM on this issue. Of course, there has been a recent example of ENEL's independent purchases of gas from abroad. It appears that this will be transported by SNAM but not on the basis of a common carriage style contract. New market entrants will have to build new pipelines.

However, the new Commission proposals are also relevant for Italy because of their structural implications: in particular, unbundling. The issue of privatisation, for example, has raised much interest. This concerns not only the privatisation of state-owned companies such as SNAM but of entities such as the ENI. An enabling law on privatisation was issued in Italy this year but was repealed soon afterwards. The law took the form of a Decree. This means that the law was made as a matter of urgency. It enters into force immediately but the approval of Parliament is required within 60 days. In this case the issue was the subject of heated debate and the Decree was eventually not approved. It may be re-issued however and so it is worth noting what it meant by privatisation. The Decree envisaged a partial sale of shares in the public enterprises. This would be made possible by the law but not mandatory and no deadline for privatisation was included. It would nonetheless be possible in theory to float all the shares. The Commission's proposals on unbundling are interesting however because they may well revive interest in the privatisation of energy companies, leading in this case to the establishment of, say, a SNAM holding company, with separate SNAM companies dealing with transportation and with purchase and sales.

The situation in a number of other countries is illustrated in the tables attached. It will be seen that the introduction of TPA rights will require partial waivers of the import monopolies. Special transportation and distribution rights will also have to be modified in a number of Member States.

(iii) The Potential for Change

From a legal point of view, the Internal Energy Market paper of 1988 made it clear what the Commission's resources were: the various Treaty articles designed to permit the establishment of an Internal Market via legislation (Article 100A) and the application of the competition rules in the Treaty of Rome, such as Article 90. The Internal Market procedure has been used to introduce a directive (a transit directive) aimed at bringing about free circulation of gas within the Community^[10] and a directive aimed at improving the transparency of prices for industrial consumers^[11].

The Energy Commissioner has now made it clear that Article 100A of the Treaty introduced by the Single European Act is to be the legal basis of the plans now being considered. However, one might note that the Commission's other powers under the Treaty are referred to as a source of powers of last resort. In the short term, this strategy represents a retreat from the use of Article 90 and the Commission's Treaty powers. Given the large degree of controversy which has arisen recently over the scope of the Commission's powers to act independently of Council consent, particularly in the De Havilland take-over case, this strategy avoids and postpones the debate on specific measures such as the use of directives under Articles 100A and 90.3. Quite apart from disagreements among legal experts, there are political reasons why the strategy is being adopted. Firstly, there has been recent controversy over the Commission's veto of the De Havilland take-over bid by Aerospatiale and Alenia. Secondly, the divisions among Member States were already considerable prior to the Maastricht conference on a new Treaty and would only be exacerbated by measures such as those proposed in the draft directives of mid 1991 based upon Article 90. The form of the current proposals is almost certainly the result of a compromise involving a number of issues outside the energy sector.

The track record of using Article 100A in the gas sector has so far not been very impressive. On

[10] O.J.No.L 147/37, 12.6.91

[11] O.J. No.L 185/16, 17.7.90.

a strict legal view, the Commission has not achieved very much. It has introduced a directive on price transparency and a directive on gas transit. Other proposals have been stalled or abandoned. In terms of the Grand Plan to establish an Internal Energy Market there is still much that needs to be done. However, the impact of the Commission's statements about TPA on competition should not be underestimated. The threat of using a legal measure can sometimes be sufficient to produce results. Hence, the repeated references by Commission officials to Articles 85-92 EEC, both explicitly and implicitly.

However, the momentum for change in the direction of gas-to-gas competition seems likely to continue from sources other than Brussels. In the discussion about what the Commission can and cannot do, it is sometimes forgotten that the Commission is used quite properly by consumers - albeit not all consumers - to promote their ends. The initiative lies with them - at the national level too, although it is clear that some Member States are not likely to be sympathetic to their complaints. The Netherlands is only one example of this.

A further source of momentum to the Commission's proposals is the experience of Britain as the laboratory of gas-to-gas competition in Europe, even if recent developments suggest that such an influence will not be uniformly favourable. From the Continent the model of competition emerging in Britain seems to be largely about the promotion of competition among the producers on the UK Continental Shelf. At the Government's initiative, the large oil companies are being encouraged to set up arms to distribute and sell gas discovered on the UK Shelf. All this is occurring against a background of change in government attitude towards the privatised utilities in general.

These specific features aside however, the recent agreement between the competition authorities and British Gas to take steps to promote competition in Britain is a most telling development. Inter alia British Gas undertakes to release gas to distribution companies with the intention of bringing about genuine self sustaining competition in the contract market. Since this seems to suggest that gas-to-

gas competition was not emerging (at least not to the extent that the Government considered satisfactory in terms of its objectives).

The sweeping character of the measures is illustrated by the provisions of the undertakings on unbundling. The new Transportation Unit "will be responsible for all the assets used in the conveyance of gas from the reception terminals at the beach to the meters at the final customers' premises, and also the assets used in the storage of gas". British Gas is to publish a transparent pricing system for transportation on a firm and interruptible basis for shippers other than British Gas and for British Gas Trading. Gas is not to be purchased by British Gas Trading for re-sale to final consumers. The result is the most advanced form of unbundling in the European gas industry.

In addition, in the context of the rather narrow focus on competition in recent years, one might also note the recent amendment in the threshold below that which grants British Gas a monopoly^[12] is an interesting development since it is an area which the Commission has specifically targeted as requiring investigation in the recent statement. It relates to a kind of protected area found in other Member States in which specific public service obligations apply. Below that level, it seems that Governments regard security and reliability of supply as more important than competition. For example, the Gas Act in Britain contains provisions which pay special regard to people who are handicapped, elderly and so on, who might have difficulty in paying their bills. Attempts to lower the threshold will encounter this element of public service which will always figure in designing a regime for gas supply, with no origins in competition but inevitably figuring largely in the minds of politicians. Indeed, the political factor will play a crucial role: the amount of gas consumed by each individual may be very small but each adult consumer holds one vote and the total is not likely to be overlooked. The Commission seems to be taking the view that these limits do not really concern them and that Member States can do pretty much as they like in setting them. Even if the thresholds vary throughout the Community, the level is an important matter since below it there is

[12] The Competition and Service (Utilities) Act 1992, section 37.

no gas-to-gas competition. It also indicates that the economists' view of the market and the place of natural monopoly in it is in practice distorted by a political factor^[13].

In conclusion, for many of the consumers, producers, transporters and governments with an interest in the gas industry, the recent proposals by the Commission represent either a panacea or the beginning of an apocalypse. At the moment the situation is in flux and it is too early to say whether Article 100 A will yield the middle ground which the Commissioner is now seeking with increasing haste. Even if the measures were to be passed as they are, and frankly that looks increasingly unlikely, much of their success will depend on the availability of supplies of gas. Perhaps the Commission's gas experts are already looking eastwards to the former Soviet Union. In this context the European Energy Charter has a role to play - but that seems like a cue for another, longer paper than I have time for today.

[13] This point is further developed in the forthcoming book by Peter Cameron and Michael Brothwood, *Competition in Gas: the European Community and Regulation*, Oxford University Press, to be published in Autumn 1992.

1. International Gas Report, 6 January 1989, p. 6. Also the source of the following statistics.
2. EC Commission Energy Review, February 1988, p. 56.
3. For example, the paper delivered by Dr. B. Bergmann of Ruhrgas at the Offshore Northern Seas Conference and Exhibition in Stavanger on 24 August 1988, 'Gas Market Structures in Western Europe'.

EUROPEAN COMMUNITY LEGISLATIVE PROCESSES

