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**INTRODUCING ENERGY SECTOR REGULATION IN GERMANY: A
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INTRODUCING ENERGY SECTOR REGULATION IN GERMANY:

*A Significant Step Forward or the Death Knell for Competition?*¹

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1.1. Summary and Conclusions

As of July 2004 the new EU Directive on energy sector liberalisation⁴ requires all member states to designate one or more competent bodies with the function of regulatory authorities. These authorities must be wholly independent of the electricity and gas industries respectively in each member state.

In face of the failure to reach a new Association Agreement (AA) in Gas, German policy makers and industry have now accepted that this specific EU requirement will effectively end the unique German arrangements which have prevailed in the energy sector so far. The Minister of Economics, Wolfgang Clement, announced accordingly in March 2003 that a regulator will be introduced to meet the deadline of July 2004. On August 31, 2003 Clement published a Monitoring Report to the German Parliament outlining the experiences with the German 'special' model of network access. The report terminates all speculations and proposes that the Regulatory Authority for Telecommunications and Post (RegTP) takes the role as future energy markets regulator. However, is the introduction of an energy sector regulator likely to significantly change the competitive dynamics of the German electricity and gas industries?

The German energy sector offers an example of a liberalization process where market concentration has increased significantly and hardly any new market participants have successfully entered into electricity retail or generation let alone any wholesale or retail gas activities. This can be explained on the basis of the main structural features of the German electricity market, including a high degree of vertical integration, the absence of a sector regulator, as well as a reliance on voluntary self-regulation through Association Agreements

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⁴ Article 25 of the *Directives 2003/54/EC (for electricity) and 2003/55/EC (for natural gas) of the European Parliament and of the council concerning common rules for the internal market in electricity and natural gas and repealing Directive 96/92/EC for electricity and Directive 98/30/EC for natural gas*

(Verbändevereinbarungen) and on regulation by case law established by the Federal Cartel Office (Bundeskartellamt). At the same time there have been (acknowledged) mistakes in the application of competition policy, allowing mergers between the largest electricity companies to go ahead without demanding significant changes to the structure of the industry, e.g. the legal unbundling of network operations from trading of gas and electricity as has been required in other member states.

Self-regulation suffers from a fundamental contradiction: The entry into the market of efficient suppliers is in the interests of present and future customers within the energy sector, but not necessarily if ever in the interests of the majority of the parties who negotiate the industry agreements. Correspondingly there has been a recent court decision suggesting that the AA process is a cartel negotiation and hence violates both German and European competition law. Self-regulation inherently leads to tensions because it offers inadequate representation and protection for the interests of energy customers (small customers in particular) and leads to numerous disputes, which can only be resolved on an ex-post and case-by-case basis.

The failures of the self-regulation model and the requirements of the new EU Directive have created a situation where the introduction of a German regulatory authority with ex-ante decision-making powers has become inevitable.

We plot below possible regulatory scenarios, not with any claim to predicting realities, but rather with the aim of mapping out the boundaries within which future developments might lie:

- The “toothless tiger” suffers from regulatory capture or inadequate authority and competencies and hence fails to give customers sufficient protection against the exercise of monopoly power or abuse of a dominant position. Crucial in gauging whether a German regulatory authority is likely to turn out to be a “toothless tiger” are the ex-ante powers it will have, especially with regard to the licensing regime, the setting of regulated tariffs, the setting of network access terms and conditions, and the initiation of market abuse proceedings. One example of the toothless tiger scenario might be a situation in which the process of association agreements continues and the regulator merely rubber-stamps the agreements reached.

In any case the cultural legacy of self-regulation is likely to remain and to develop into an extensive consultation process as part of regulatory decision making. It remains to be seen whether the representatives of small customers, new entrant energy suppliers and energy traders, will be not only be permitted to participate in a new consultation process, but will also be given as much weight as representatives of more established interests. In other jurisdictions it is these new entrants who have often argued successfully for change particularly where the regulator has suitable statutory duties and functions allowing the regulator to promote competition in the interests of all customers.

- The “elephant-in-the-china shop” takes the interests of current customers very seriously, but does so at the cost of no longer providing companies with a reasonable prospect of cost recovery or the opportunity to earn a reasonable return on its investments, thus endangering investment levels in the industry and the interests of future customers. An “elephant in the china shop” scenario could develop in Germany, if the new regulatory authority is perhaps less experienced but determined to be an activist and wants to see quick results (e.g. in the form of radical reductions in regulated tariffs) and/ or a regulatory perception develops that ‘companies lie about costs anyway’ and/ or the new regulatory authority might resort to regulatory benchmarking for tariff setting purposes.

Indeed, regulatory benchmarking is likely to develop into a major topic for incumbent German energy companies. The organisational fragmentation of the sector (resulting in a relatively large number of companies) as well as international regulatory precedent from e.g. the UK, Norway, the Netherlands and Austria would all point in this way. However, international experiences suggest that benchmarking for tariff setting purposes has several fundamental flaws and can in the medium term endanger cost recovery and investment levels in the sector.

- The “economically efficient” regulator effectively represents the interests of both current and future customers and in the course of doing so provides companies with an acceptable prospect of cost recovery and an opportunity to earn a reasonable return on their investments. This presupposes a regulatory system which uses *transparent, robust and objective* approaches and which has clear rules as to how to deal with eventualities some of which maybe unforeseen.

The future shape of energy sector regulation is currently being determined. In doing so, the German government has a chance to lay the foundations for economically efficient behavioural regulation in Germany. This is all the more of an imperative in the face of the high degree of concentration and vertical integration characterising the German energy sector at present. Structural remedies addressing the conflicts of interest arising from the integration of natural monopoly elements with potentially competitive market segments have failed to materialise in Germany so far, hence the introduction of behavioural regulation is in many ways a last chance. However, once regulation is introduced, it has to be independent and economically efficient and be seen to be so. Otherwise it is likely to harm customer interests more than it benefits them, be it by legitimising monopolistic pricing approaches through ineffectiveness or by endangering the future security of supply through over-zealousness.

1.2. Competition and Merger Control in the German Energy Sector So Far⁵

The German energy market has been legally 100% open to wholesale and retail competition since 1998. Nevertheless the German energy sector offers an example of a liberalization process where market concentration has increased significantly and hardly any new market participants have successfully entered into electricity retail or generation let alone any gas activities. Most of the new entrants who did brave the liberalized German energy market have exited by 2003 and bankrupt electricity suppliers are increasingly finding it hard to find buyers.⁶ This can be explained on the basis of the main structural features of the German energy market, including a high degree of vertical integration, the absence of a sector regulator, as well as a reliance on voluntary self-regulation through Association Agreements (Verbändevereinbarungen) and on regulation by case law established by the Federal Cartel Office (Bundeskartellamt).

At the same time there have been (acknowledged) mistakes in the application of competition policy, for example by allowing mergers between some of the largest energy companies in Germany let alone Europe, to go ahead without demanding significant changes to the structure of the industry, e.g. the legal unbundling of (monopoly) network operations from competitive trading operations .

The mergers between VEW and RWE in the year 2000 on the one hand and Veba and Viag (to form E.ON) on the other led to a sharp increase in concentration in the German electricity sector. Due to their numerous ownership stakes in regional and municipal companies, mergers between supra-regional companies also led to consolidation of the industry structure at all other levels. According to the Annual Report 2001/2002 of the Federal Cartel Office (Bundeskartellamt),⁷ E.ON and RWE jointly have ownership interests in 210 regional or municipal companies.

In the gas sector competition issues are even more pertinent. Ruhrgas controls almost all gas deliveries to regional and municipal companies in its control area, which translates into a market share of at least 58% on the national level.⁸ Ruhrgas also controls almost all gas imports into Germany and storage facilities. According to a recent statement by EU Commissioner Mario Monti, liberalisation in the German gas sector has so far not resulted in competition, mainly due to highly complicated network access conditions.⁹ Negotiations for

⁵ See also: *Competition versus National Champions: The German Case*, Enese Lieb-Doczy, *Platts' Power in Europe, European Electricity Review 2003*, April 2003 and *Competition in the German electricity sector: giants grow bigger*, Enese Lieb-Doczy, *Platts' Power in Europe, West European Electricity Review 2002*, June 2002

⁶ See also: *Bericht des Bundesministeriums für Wirtschaft und Arbeit an den Deutschen Bundestag über die energiewirtschaftlichen und wettbewerblichen Wirkungen der Verbändevereinbarung*, Berlin 31. 08.03, page 13

⁷ *Bericht des Bundeskartellamtes über seine Tätigkeit in den Jahren 2001/2002*, BT-Drucks. 15/1226 v. 27.06.2003, page 163

⁸ Source: Bundeskartellamt, 8.Beschlussabteilung, B8 – 4000-U- 109/01, 21.01.2002, Paragraph 24

⁹ *Energie- Deutschland erhält Regulierungsbehörde*, VDI Nachrichten, 08.08.03

concluding an improved Association Agreement on network access in the gas sector completely broke down in April 2004.

In 2002 the Bundeskartellamt rejected the merger between E.ON and the dominant gas importer and distributor, Ruhrgas. In this decision the Bundeskartellamt effectively declared the strategy it pursued in passing the year 2000 mergers (of ensuring strong competition in the German electricity sector through the creation of a third force in the east, referred to as “new force”) to be a failure.¹⁰ The Bundeskartellamt argued in this context that RWE and E.ON now jointly control about 65% of German generation capacity, 70% of net electricity generation, 70% of the national high voltage network, 50% of the medium and low voltage network.¹¹ In the opinion of the Bundeskartellamt *a situation of collective market control can be assumed. RWE and EON form an overall symmetrical Duopoly in the electricity market.*¹²

In the opinion of the Bundeskartellamt the E.ON-Ruhrgas merger can be expected to have major implications due to vertical integration: Ruhrgas’s gas import contracts and high-pressure pipelines will be merging with the E.ON’s sizable interests in regional and municipal gas distribution. The German competition authority fears significant market foreclosure effects in as much as 20% of annual gas sales in Germany.¹³ It is also concerned about cross-sectorial effects: A dominant company in the electricity sector is acquiring a company with a dominant position in the gas sector. The new company will have an incentive to discriminate against prospective competitors in the electricity generation and retail sectors by offering disadvantageous terms for gas transportation terms and gas supply.¹⁴

After much legal and political wrangling a ministerial permission allowing the merger became effective in 2003, thus overriding the competition concerns of the Federal Cartel Office (Bundeskartellamt) and of the Monopolies Commission (Monopol Kommission) with public interest arguments based on ‘national champion’ and Security of Supply considerations.

The structural merger conditions imposed by the Ministry of Economics were rather weak. They contain no binding requirements in the following areas:

- Unbundling of network activities,

¹⁰ Bundeskartellamt, 8.Beschlussabteilung, B8 – 4000-U- 109/01, 21.01.2002

¹¹ Bundeskartellamt, 8.Beschlussabteilung, B8 – 4000-U- 109/01, 21.01.2002, Paragraph 50

¹² *ibid*, Paragraph 54

¹³ Bundeskartellamt, paragraph 30

¹⁴ Bundeskartellamt, paragraph 67

- Improvement of network and storage access through the introduction of transparent and standardized access terms,
- Unbundling of contracts to create an effective secondary market for trading of transport capacity.

The conditions which were imposed, significantly fell short of the structural measures which would have been needed to alleviate competition concerns, namely the introduction of a non-discriminatory and efficient network access regime and the sale of (ideally all) EON-Ruhrgas interests in regional gas distribution companies. The gas-release programme imposed by the ministerial approval only obliges Ruhrgas to auction 200 bn kWh during a period of eight years which is likely to be much less than is needed to establish sufficient liquidity in the market.

Thus the merger conditions of the E.ON-Ruhrgas merger did little to promote effective competition in the German energy sector and the public interest arguments remain weak. This negative assessment of the E.ON-Ruhrgas merger presupposes, however, that a concern for competition and consumer welfare was indeed at the heart of the Ministry's decision. It is revealing that consumer interests are not given particular attention in the Ministry's justification for the permit. Consumer interest groups did not even gain admission to the merger hearings, as the Ministry did not view them as sufficiently affected parties. All claimants in the administrative court case against the Ministerial permission were willing to drop their case after protracted negotiations with E.ON-Ruhrgas, although the substance of the case (i.e the competition and administrative concerns) had not changed in any way. This shows again that in the energy sector the protection of consumer interests requires a system of ex-ante regulation and cannot exclusively rely on ex-post intervention by competition authorities.

Less voluntarily than forced by the European Commission, the German Ministry of Economics acknowledges in its Monitoring Report the need to establish a regulator. However, the Ministry differentiates strongly between the achievements in the electricity and the gas sector. Whereas in the opinion of the Ministry the Associations Agreement together with the ex-post control of the Bundeskartellamt has led to a functioning electricity market at least on the wholesale level the Ministry acknowledges the complete failure of self-regulation in the gas sector.

But even in the electricity market high network usage fees at the low-voltage grids, non-transparent balancing costs and difficult procedures have led to a situation where less than 5 % of the retail customers have changed their supplier. Acknowledging that network access is a key impediment to effective competition developing in gas retail and wholesale the

Ministry proposes a new entry/exit-model.¹⁵ On the basis of experiences in the UK, the Netherlands and Italy the model requires the establishment of a virtual market place across multiple gas pipeline systems of different ownership. This raises a number of difficult legal, economic and technical questions, which need to be resolved in the next weeks and months. The Federal Association of Gas and Water Companies (BGW) has announced it will present a detailed proposal for a new network access model by the end of October 2003. It remains to be seen whether this proposal will fulfil the requests of the competitors for non-discrimination, easy procedures with not more than 5 trading zones and low tariffs. Only if these requirements are satisfied would the Ministry be able to transform the proposal into a new network access ordinance.

1.3. The Need for Regulation in the Energy Sector and the Failure of Self-Regulation¹⁶

There are particular circumstances under which the creation of an authority, which can exercise an ex-ante influence on sector-specific regulations, is economically efficient.¹⁷ This is, in particular, the case if:

- an industry is characterised by long-life assets,
- customers are not in a position to participate in the advantages which arise from economies of scale and group benefits, through long-term contracts for example¹⁸ and therefore
- disputes and high transaction costs frequently result.¹⁹

These conditions can be illustrated by the example of the gas distribution network: The gas distribution network is characterised by high sunk costs, long-life assets and large scalar

¹⁵ *Bericht des Bundesministeriums für Wirtschaft und Arbeit an den Deutschen Bundestag über die energiewirtschaftlichen und wettbewerblichen Wirkungen der Verbändevereinbarung*, Berlin 31. 08.03 – Monitoring-Bericht, Page 51 et. seq.

¹⁶ See also: *Grundprinzipien eines wirtschaftlich effizienten regulatorischen Prozesses*, Enese Lieb-Doczy & Graham Shuttleworth, *Energiewirtschaftliche Tagesfragen*, Dezember 2002

¹⁷ Some German language authors have recently been using the term ex-ante regulation as synonymous with incentive regulation and ex post regulation as synonymous with rate of return regulation. (See, e.g. *Vorstudie Marktmodelle, Schlussbericht*, Plaut (Schweiz) Consulting AG, Bern, report for the Swiss federal Ministry of Energy) This is not entirely correct, since with both incentive regulation and rate of return regulation the regulator establishes the appropriateness of network access tariffs before they become effective, rather than industry participants having to resort to remedies under competition law after tariffs have been introduced.

¹⁸ For example, high-pressure pipelines in the USA do not fulfill these conditions, as they are frequently built by consortiums of customers and a well-developed secondary market exists for transmission capacity. No such exception exists in the case of high-voltage lines due to the underlying physical characteristics of an electricity network.

¹⁹ See also: *Opening European electricity and gas markets*, Graham Shuttleworth, chapter 7 in: *Utility regulation and competition policy*, Colin Robinson (ed.), Edward Elgar, 2002

earnings, especially in comparison with the size of the typical (household) customer. Disputes concerning the conditions of access by third parties to the gas distribution network can be expected because the long-life assets co-exist with tariffs and network access agreements of short duration, which involve frequent renegotiations. It is therefore economically efficient to avoid transaction costs in that binding sector-specific rules are defined, ex-ante, which allow discrimination-free use of the network and allow gas customers to participate in the scalar earnings and group benefits within the gas network. The same arguments apply to the whole electricity network.

In this context self-regulation suffers from a fundamental contradiction: The entry into the market of efficient suppliers is in the interests of present and future customers within the energy sector, but not in the interests of the majority of the parties who negotiate the industry agreement. This has led to numerous disputes concerning access to the electricity network and to stagnation of the liberalisation process within the gas sector. Furthermore, self-regulation means that, for lack of a regulatory authority with ex-ante powers, disputes can only be resolved ex-post and case by case. At the same time, an approach based on ex post conflict resolution through competition policy measures rather than an ex ante, regulatory approach is not suitable as a means of consistently restricting the monopolistic profits of companies (and redistributing these to customers), a fact which raises questions not only of economic efficiency, but also of energy policy.

Even in a completely liberalised energy market, there will be monopolistic market segments, especially with regard to the gas transmission and distribution network and the electricity network.²⁰

The German model of self-regulation leads to tensions because it offers inadequate representation for the interests of energy customers (small customers in particular) and leads to numerous disputes, which can only be resolved on an ex-post and case-by-case basis.²¹

The German legislator himself revealed the ultimate failure of the German model of self-regulation, when in July 2003 he introduced a new provision in the Energy Industry Act giving the Associations Agreements a formal legal basis by stating that non-discriminatory network access shall be assumed if it is granted according to the Associations Agreement.

²⁰ If there is no possibility of building high-pressure pipelines which are independent of incumbents or of acquiring transport capacities on a secondary market, the high-pressure network also falls into this category.

²¹ The grounds for the recommendation by the economic commission of the Federal Council (Bundesrat) that the legalisation (Verrechtlichung) of the calculation guideline for electricity and the VV Gas be opposed made references to these fundamental arguments: The ex-post control by the Federal Cartel Office, the inadequate representation of electricity traders and consumers' representatives in the negotiations, the inadequate separation in organisational and accounting terms of network operation and supply operation and the relevance of the "corresponding regulations in telecommunications and railway law" are all mentioned. See: *Proceedings*, 700. Wi, 06.06.02, publication 460/02

This provision not only raised serious concerns as to its compliance with constitutional and European law.²² It also illustrates the failure of self-regulation, which is dependent on the support by the legislator for its inability to establish generally accepted rules for third party access. In August 2003 three milestone market abuse decisions of the Bundeskartellamt, which criticised the provisions of the current association agreement for electricity (VV II Plus) have been overturned by the Upper Court (Oberlandesgericht - OLG) of Düsseldorf on the grounds that the statutory assumption is restricting the pro-competitive powers of the Cartel Authority. This argument was, for example, strongly criticised by the Association of Industrial Customers, VIK.²³

The Federal Association of New Energy Companies (Bundesverband Neuer Energieanbieter - BNE) initiated legal proceedings against the Industry Associations, which have started negotiations on a new Gas Agreement. The BNE argued that the Agreement is null and void because the Associations are forming a cartel, which could only gain legitimacy by the participation of consumer interest groups and the associations of the free energy-traders like the BNE. The court rejected the claim to participate in the negotiations but confirmed the fact that the Agreement violates German and European competition law.²⁴ Only a few weeks later the Associations announced the definite termination of their negotiations on gas. At the same time the Electricity Associations invited the BNE and the German section of the European Federation of Energy Traders (EFET D) to participate in the further negotiations regarding a new agreement on access to the power grids.

These important examples illustrate the factors, which have exerted growing pressure on the model of self-regulation and make it economically efficient that binding sector-specific rules are defined ex-ante going forward. These rules require definition and implementation through an authority with an appropriate statutory basis that clearly defines its duties and functions and gives it the necessary powers to carry out these duties and functions. Whether this is a regulatory authority with a regulator or a department of the Federal Cartel Office, which acquires the ex-ante decision-making authority is an important but at this stage secondary question.²⁵

²² Säcker/Boesche, Der Gesetzesbeschluss des Deutschen Bundestages zum Energiewirtschaftsgesetz vom 28. Juni 2002 – ein Beitrag zur “Verhexung des Denkens durch die Mittel unserer Sprache”?, ZNER 2003, 183; von Hammerstein/Hertel, Die gesetzliche Veredelung der Verbändevereinbarung Gas II – verfassungs- und europarechtliche Bewertung, ZNER 2003, 193; von Hammerstein, Händleralptraum wird Realität, ME 3/2002, 8;

²³ *Verrechtlichung der Verbändevereinbarung Strom und Gas darf nicht verlängert werden*, www.vik-online.de)

²⁴ Landgericht Berlin, Urteil vom 06.03.2003 – 16 U 78/03 -, ZNER 2003, 137; von Hammerstein, ZNER 2003, 139.

²⁵ In this article we use the word “regulator” accordingly in the general sense of an authority which has ex-ante decision-making powers regarding the disputes which arise from the access by third parties to the monopoly elements within the gas sector. Our usage therefore refers to a function, not to a particular authority .

1.4. The Role of the Regulator in Theory

Even in a completely liberalised electricity and gas market, there will be elements that will retain (some) monopoly characteristics especially with regard to gas and electricity distribution networks. Regulation of these monopolistic elements is therefore also required in a liberalised market in order to ensure that *present and future* customers receive the services which they need at prices which reflect costs and are delivered in accordance with suitable standards of service.

The framework of regulation will influence long-term investment incentives and the conditions for participants in a competitive gas market. From an economic viewpoint, an efficient regulatory system operates rather like a long-term contract, which offers two things:

- for the supplier: *an appropriate probability of recovering costs* in order to encourage investment; and
- for the buyer: *protection against the actual or potential power of a monopoly.*

The role of the regulator in a sense takes the place of present and future consumers in negotiations on long-term investments and thereby reduces the transaction costs for energy customers (especially small ones).²⁶

The sluggish competition in the German gas and electricity markets suggests that the interests of small consumers in particular are not that adequately represented if at all. It is, however, so far unclear to what extent the customers' interests will be at the forefront of the new German approach to *ex ante* regulation. It is, for example, so far undecided whether the new regulatory authority will be under the supervision (*Fachaufsicht*) of the Ministry of Economics only or also under that of the Ministry of Consumer Protection and the Ministry of the Environment.²⁷

In pursuing their role, regulatory agencies are usually given a mixture of *ex ante* and *ex post* powers. Important *ex ante* powers of the British regulator Ofgem, for example, include a determining role in the granting, alteration and revocation of licences as well as the initiation of market abuse investigations, the setting of regulated tariffs and taking initiatives in customer protection matters. *Ex post* Ofgem can impose penalties including financial on license holders²⁸ amounting to up to 10% of a company's turnover. It can issue enforcement

²⁶ In Great Britain, for example, the Utilities Act 2000 defines consumer interests as being the primary aim of regulation.

²⁷ The Association of Consumers (Verbraucherzentrale Bundesverband) is strongly arguing for the latter arrangement. See, for example, <http://www.vzbz.de/go/print/presse/264/9/40/>

²⁸ Utilities Act 2000, Art. 59 and 95

orders directing licence holders to alter previous behaviours that are deemed to be outside the obligations imposed on holders through their licences.

1.5. The Minimal Functions of EU Regulators as Described in the New Directive

The new EU Directive sets out the minimum set of competences which the regulatory authorities in all Member States should share, but leaves it however to Member States to specify the functions, competences and administrative powers of the regulatory authorities.²⁹

Regulatory authorities are required to be entirely independent from the interests of the electricity and gas industry. Their minimum responsibilities include ensuring non-discrimination, effective competition and the efficient functioning of the market.³⁰ In this context regulation is to contribute to guaranteeing non-discriminatory access to networks. *National regulatory authorities should be able to fix or approve tariffs, or the methodologies underlying the calculation of the tariffs, on the basis of a proposal by the transmission system operator or distribution system operator(s), or on the basis of a proposal agreed between these operator(s) and the users of the network.*³¹ In order to avoid uncertainty and costly and time-consuming disputes, these tariffs should be published prior to their entry into force.³² Transmission and distribution tariffs are to be non-discriminatory and cost-reflective.³³ In the absence of a liquid market for balancing power, national regulatory authorities should also play an active role to ensure that balancing tariffs are non-discriminatory and cost-reflective.³⁴

The regulatory authorities are also given numerous monitoring functions relating to interconnector capacity allocation, congestion management, connection tariffs and *the effective unbundling of accounts to ensure that there are no cross-subsidies between generation, transmission, distribution and supply activities* and the level of transparency and competition in the energy

²⁹ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC , Point 15 of the Preamble

³⁰ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, Article 23.1

³¹ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC , Point 18 of the Preamble

³² Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC , Point 15 of the Preamble

³³ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC , Point 18 of the Preamble

³⁴ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC , Point 17 of the Preamble

sector.³⁵ Regulators are to have to authority to require changes to the calculation methods or tariffs *to ensure that they are proportionate and applied in a non-discriminatory manner.*³⁶

However, the regulatory authority can be required to submit its tariffs or calculation methods to a *relevant body in the Member State*, of the country concerned such as the Economics Ministry in the case of Germany. *The relevant body shall, in such a case, have the power to either approve or reject a draft decision submitted by the regulatory authority. These tariffs or the methodologies or modifications thereto shall be published together with the decision on formal adoption. Any formal rejection of a draft decision shall also be published, including its justification.*³⁷

The regulator is to act as a dispute settlement authority arising from disputes over network access.³⁸ Nevertheless Member States are required to *create appropriate and efficient mechanisms for regulation, control and transparency so as to avoid any abuse of a dominant position, in particular to the detriment of consumers and any predatory behaviour* in accordance with Article 82 of the EU treaty.³⁹

The Monitoring Report concludes that the scope for discretion left by the Directives shall be used to create an “efficient and non-bureaucratic” approach to regulation. The report names the RegTP as future regulatory body also for the energy markets. It remains to be seen whether this satisfies the aim of creating a non-bureaucratic Regulation as the RegTP as super-regulator for Telecommunications, Post, Gas and Electricity will have far more than 1000 employees. And it is still not clear whether the German federal states (Länder) will claim their share in the game by giving regulatory powers also to the state (as opposed to federal) authorities.

1.6. Regulatory Scenarios

So where do we go from here? The failures of the self-regulation model and the requirements of the new EU Directive have created a situation where the introduction of a German regulatory authority with ex-ante decision-making power has become inevitable. The precise nature and competencies of this authority will, however, only emerge with time, as will the extent to which the new regulator will be able to see off possible attempts at political intervention. The remainder of this article plots possible regulatory scenarios, not

³⁵ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, Article 23.1

³⁶ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, Article 23. 3

³⁷ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, Article 23. 4

³⁸ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, Article 23. 5

³⁹ Directive 2003/54/EC of the European Parliament and of the council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, Article 23. 8

with any claim to predicting realities, but rather with the aim of mapping out the boundaries within which future developments might lie.

1.7. Who should be the New Regulator?

As far as the location of the regulatory agency is concerned, three options had been under discussion prior to the publication of the Monitoring Report:

- Assigning regulatory authority to a sub-division of the Federal Cartel Office;
- Giving regulatory powers over the energy sector to the already existing Telecoms and Postal Regulatory authority and
- Creating an entirely new regulatory body for the energy sector.

Option c) has the fewest proponents in Germany. Option a) is favoured by the Federal Cartel Office, the Free Democrats (FDP)⁴⁰ and German Chamber of Industry and Trade (DHIK).⁴¹ Option b) is favoured by the RegTP⁴² and most of the large incumbent energy companies.⁴³

One might argue that the location of the regulatory authority is a secondary question to that of its ex ante and ex post duties and functions and powers to carry out those duties and functions. Also important will be its authority within the political process and the administrative procedures employed by the regulator. There are, however, several considerations to which location might prove to be pertinent:

- **The future competencies of the Federal Cartel Office:** Although repeatedly defeated by the political or appeal processes, the Federal Cartel Office has been making unambiguous market abuse decisions in the energy sector since liberalisation in 1999. The desire of incumbents not to see the Cartel Office also taking on ex ante regulatory competencies is hence understandable.

However, giving regulatory authority to an agency other than the Federal Cartel Office would also severely curtail the current judicial powers of the Cartel Office in energy sector market abuse cases. In the UK the Competition Commission remains the ultimate appeal body in energy sector market abuse questions, including

⁴⁰ See the FDP press release published in www.strom-magazin.de, 20.08.03

⁴¹ *Stellungnahme zum künftigen Ordnungsrahmen für die Strom- und Gasmärkte*, DHIK, 09.07.03

⁴² *Regulierungschef - Wir haben das nötige Wissen*, Stuttgarter Zeitung, 14.08.03

⁴³ *Deutsche Strombranche warnt vor US-Zuständen*, Handelsblatt, 18.08.03

regulatory decisions.⁴⁴ In contrast existing German law in the Telecoms sector makes the RegTP the first instance of appeal in the case of market abuse and the administrative courts the (notoriously slow) appeal body dealing with complaints against regulatory decisions.⁴⁵ Thus, a decision to give regulatory powers to an agency other than the Federal Cartel Office would effectively neutralise the authority which up to now has been one of the strongest proponents of competition in the German energy sector. The proposal of the Ministry in the Monitoring Report tries to reduce at least the effects on the judicial appeal process by suggesting that the Cartel Courts shall remain solely competent for appeals against decisions of the Regulator in the energy sector.

- **The probability of regulatory capture:** After the privatisation of the telecoms sector in 1998, the Telecoms and Postal regulator was created out of the government department previously in charge of telecoms and postal matters. It is still questionable to what extent a whole government department is able to undertake the great cultural shift required from being an internal lobbyist for the interests and funding of a sector to being its effective regulator to the benefit of current and future customers. This might in part explain why regulation in the German telecoms and postal sector has by some commentators not been regarded as a whole-hearted success as far as customer interests are concerned. However, the danger of regulatory capture will be minimized by giving one regulatory body supervisory powers for different industries. The mingling with and lobbying by one industry (or in the telecoms sector even with one market-dominant company, the Deutsche Telekom AG) will not be as easy if the Authority is responsible for different sectors. That is the reason why the Monopoly Commission in its last Main Study on Competition in Network Industries has proposed to designate RegTP as regulatory authority not only for energy but also for railway regulation.

In the case of the Bundeskartellamt, the question would be to what extent a judicial body with little experience in ex ante decision-making and in overseeing the implementation of decisions and sanctions would be able to culturally adapt to having to take a pro-active role in the energy sector with ex-ante powers.

- **The degree of economic and technical competence:** The RegTP has no energy sector expertise, but has experiences in exercising ex ante regulatory powers as well as in the enforcement of regulatory sanctions. Due to a likely lack of energy sector

⁴⁴ See, for example the MMC (the precursor to the CC) case of 1997 concerning Northern Ireland Electricity and the CC decision of 2001 concerning the Market Abuse Licence Condition.

⁴⁵ Wissmann, Zugangs- und Entgeltregulierung im Telekommunikationssektor – ein Modell für die Energiewirtschaft?, et 2003, 25.

expertise a possible danger will be that RegTP civil servants engaged in energy sector regulation will at least initially be less able to evaluate the validity and truthfulness of claims made by different market participants, especially by the network owners. The latter can claim an informational monopoly in many technical, rather than economic matters and might hence try to dominate the agenda and discussion with technical arguments. The Federal Cartel Office on the other hand has acquired energy sector expertise also in economic and commercial terms through the numerous network access and merger disputes it has heard since market liberalisation, but has no expertise in exercising ex ante decision-making powers.

1.8. Scenario 1: “The Toothless Tiger”

The “toothless tiger” suffers from regulatory capture or inadequate authority and competencies and hence fails to give customers a sufficient protection against monopoly power. This, understandably, would be a scenario rather welcome by the large incumbents in the German electricity industry. The Association of Electricity Companies (VDEW)⁴⁶, the Association of Municipal Companies (VKU),⁴⁷ the Managing Director of Vattenfall Europe⁴⁸ and the Association of Industrial Customers⁴⁹ have all been reported demanding that a new regulatory authority should have as few duties, functions and powers as possible.

Crucial in gauging whether a German regulatory authority is likely to turn out to be a “toothless tiger” are the duties, functions and powers including those concerned with ex-ante actions. This is especially important with regard to any licensing regime that is introduced, the setting of regulated tariffs, the terms and conditions for network access, and the initiation of market abuse proceedings. Ex post powers involving penalties including financial penalties are likely to be far less effective unless combined with appropriate ex-ante duties, functions and powers. On the basis of ex post powers, a suspected offence needs to be investigated and even if the party is found guilty, the fine anticipated might not be so great so as to make the original offence not profitable. Ex ante duties, functions and powers need to be combined with suitable powers of detection and deterrence.

One version of the “toothless tiger” scenario would be a situation in which the process of association agreements continues and the regulator merely rubber-stamps the agreements reached. Accordingly the Association of Electricity Companies (VDEW) continue to release statements to the press arguing that self-regulation is functioning well and the planned

⁴⁶ *Hinter den Kulissen gibt es erhebliche Differenzen*, Stuttgarter Zeitung, 14.08.03

⁴⁷ *Regulierung der Strom- und Gasmärkte: Der VKU stellt Forderungen an Gesetzgeber*, Pressemeldung 12/03, www.vku.de

⁴⁸ *Regulierungsbehörde sollte allenfalls Schiedsrichter für fairen Wettbewerb sein*, Interview mit dem Vattenfall-Chef Rauscher, Stern, 13.08.03

⁴⁹ *Streit um den Energie-Regulierer wird härter*, Süddeutsche Zeitung, 16.07.03 – The VIK is reportedly demanding a weak regulator so that the negotiation position of industrial customers in energy purchasing is not weakened.

introduction of a regulator is superfluous.⁵⁰ Continued association agreements forming the basis of regulatory decisions, however, are an unlikely development for several reasons:

- Regulatory authorities, once created, tend to develop a dynamic of their own, which includes the desire for independent decision-making.
- The regulator would still be required by the EU Directives to be the appeal body for disputes arising over network access. Through this appeal function the regulator is also given ex-post authority in the tariff-setting process. It is hence not in the interest of the regulator to simply accept association agreements which are very likely to lead to numerous complaints. A flood of complaints and a protracted appeals process would do little to enhance the regulator's authority and negate one of the main arguments for having him in the first place.
- It is unclear whether such a process would be able to fulfil the requirements of the EU Directives. In conformity with the Directive the regulator would approve and publish ex ante tariffs as suggested by network operators and the users of the networks. However, it is questionable whether such a model would be compatible with the independence regulators are supposed to have from industry interests according to the EU Directives. Furthermore there are pre-existing precedents in German law suggesting that the association agreements effectively form a cartel not only under German but also under European competition law. According to the *effet-utile* practice of the European Court of Justice a member state may not take measures which curtail the effect of the European competition law.⁵¹ Hence a regulatory process which bases its decisions on the results of a process which could be viewed as a cartel negotiation would not unambiguously fulfil the requirement that regulators should create mechanisms which avoid the abuse of a dominant position.

However, the cultural legacy of self-regulation is likely to remain and to develop into an extensive consultation process as part of regulatory decision making. The relevant question in this context is whether this will be a formalised and transparent consultation process, which draws in all network users and customer groups as well as the network owners on an equal footing or whether it will be a form of behind the scenes lobbying favouring those who are already well-connected. It remains to be seen whether the representatives of small customers, new energy suppliers and energy traders, will not only be permitted to participate in a new consultation process, but will also be given as much weight as representatives of more established interests.

⁵⁰ *Hinter den Kulissen gibt es erhebliche Differenzen*, Stuttgarter Zeitung, 14.08.03

⁵¹ ECJ, vom 19.02.2002, Rs. C 35/99 – "Manuelle Arduino"; von Hammerstein, ZNER 2003, 139 [141].

An important question in the German context, which probably supersedes that of the likelihood of regulatory capture, is that of the ability of a future German regulatory agency to see off political interventions. In this context the precise role and powers of the 'supervising' Ministry or Ministries will be essential. In the energy sector the German Economics Ministry has been generally very favourably predisposed to industry interests (as evidenced, for example, in its role in making possible the E.ON-Ruhrgas merger). This suggests that a desire to avoid a toothless tiger would favour arrangements in which supervisory powers are given to more than one Ministry and in which clear rules regarding the interpretation of this supervisory role exist.

1.9. Scenario 2: The "Elephant in the China Shop"

A strong regulatory authority has been demanded by the Association of Electricity Users (VEA),⁵² the Association of New Energy Suppliers (BNE),⁵³ the Consumer Association representing small consumers (VZBV)⁵⁴ and the German Chamber of Industry and Trade (DHIK).⁵⁵ The only large incumbent company which in the past has demanded the introduction of effective regulation is EnBW, who has a high proportion of customers outside its traditional monopoly supply area due to its national retail arm Yello.

The "elephant in the china shop" takes the interests of current customers very seriously, but does so at the cost of not necessarily providing companies with a reasonable prospect of cost recovery, thus endangering investment levels in the industry and hence the interests of future customers at least in the medium and longer term, though there may be some shorter term gains.

An "elephant in the china shop" scenario could develop in Germany, if a combination of the following developments takes place:

- The new regulatory authority is less experienced but activist and wants to see quick results (in the form of radical reductions in regulated tariffs). This desire might, for example, come from a politically motivated wish to generate publicity favourable to the new regulatory regime - incumbents with record profitability figures and reactions which could be portrayed as 'self-interested scare-mongering' would provide easy targets for such policies.
- A precondition for the success of any form of tariff regulation is an agreed set of unbundling, cost-allocation and accounting principles. Experiences in the UK suggest that regulators, if they lose confidence in the cost figures reported by

⁵² *Nutzung der Stromnetze bleibt zu teuer*, Pressemitteilung des VEA vom 05.08.03, www.vea.de

⁵³ www.bne-online.de/frameset/main.html

⁵⁴ *Hinter den Kulissen gibt es erhebliche Differenzen*, Stuttgarter Zeitung, 14.08.03

⁵⁵ *Stellungnahme zum künftigen Ordnungsrahmen für die Strom- und Gasmärkte*, DHIK, 09.07.03

companies are tempted to make alternative calculations of their own, leading to (non-transparent) discrepancies between the regulatory accounts used for tariff setting purposes and the companies' own accounting and bookvalues. Companies might find themselves in a situation in which claims that regulatory measures endanger cost recovery lose credibility, due to a regulatory perception that 'companies lie about costs anyway'.

- In view of such potential blocking tactics by companies, which make cost transparency in the network business difficult if not impossible, a new regulatory authority might resort for example to some form of regulatory benchmarking for tariff setting purposes.⁵⁶ In other jurisdictions there are several examples where regulatory authorities use benchmarking in the hope that detachment from the company's own costs and approved tariffs will give rise to some kind of positive incentives for companies to increase their efficiency. In the long term, companies only have a realistic possibility of covering their own costs, if the benchmarking methodologies which are used for tariff control are *transparent, robust and objective*. These criteria for meaningful benchmarking relate both to the treatment of different companies and also to comparisons over time.

International experience shows, however, that in practice benchmarking for regulatory purposes suffers from several fundamental problems:⁵⁷

- The methodology is often ad hoc, inconsistent and dependent on the available data material.
- Data often have to be adjusted on the basis of usually subjective assumptions.
- In general, therefore, benchmarking rarely produces robust results.
- It is not guaranteed that a company whose charges are fixed as a result of benchmarking can cover their costs.
- The uncertainty, which this causes increases the investment risk of the regulated supply company.

The results of benchmarking for regulatory purposes should therefore be interpreted with great care and used for information purposes only. On no account should the results be

⁵⁶ See also: *Sinn und Unsinn des Benchmarking*, Enese Lieb-Doczy & Graham Shuttleworth, Energie & Management, May 2002

⁵⁷ For recent regulatory disputes involving benchmarking see, e.g.: *Gutachten zu der Systemnutzungstarife-Verordnung 2003*, Ein Bericht für den VEÖ, Angefertigt von NERA, 21.08.03; *Kommentare zu „Benchmarking des Stromnetzbetriebs in Österreich – Methodik zur Auswahl von Strukturvariablen und vorläufige Variablenauswahl“*, Ein Bericht für den VEÖ, Angefertigt von NERA, 05.06.03; *Critique of DTe Benchmarking – A Report for NuonNet*, NERA, 2001; *Updated Critique of DTe's Benchmarking – A Report for NuonNet*, NERA, 2002

translated directly into price caps. Benchmarking can undermine the efficiency incentives of the regulated company if, as a consequence, it becomes impossible to cover costs.

1.10. Scenario 3: The “Economically Efficient” Regulator

The “economically efficient” regulator effectively represents the interests of both current and future customers and in the course of doing so provides companies with an acceptable prospect of cost recovery. Successful regulation presupposes:

- Scope for efficiency gains
- Agreed sets of accounting principles
- Legal or institutional protection of shareholders’ investments
- Ability to commit to fixed periods between reviews
- Understanding of cost drivers and trends
- Minimum quality standards
- Open regulatory process

Central to an economically efficient approach to regulation is the minimisation of regulatory risk, while avoiding the risks of regulatory capture. Cost recovery for assets with a long technical lifetime takes place over several regulatory periods. Regulation hence has the characteristics of a long-term implicit contract between companies and the regulator.

To maintain investment incentives, generation companies network owners and operators and trading companies have to operate in a credible and sustainable regulatory environment. This presupposes a regulatory system which uses *transparent, robust and objective* approaches and which has clear rules as to how to deal with eventualities including where possible unforeseen eventualities. This involves:

- Rules, such as complex price formulae, have to be elaborated in detail so that they can be predictably applied,
- The triggers for a regulatory review have to be clearly defined as well as the procedures to be used for reviews

Principles have to be determined as to how unforeseen eventualities are dealt with, while ensuring that cost recovery is not undermined (e.g. designating an arbitration authority, determining how disputed cost items should be dealt with until a final decision is reached etc).

Decisions of the regulator should be made in a transparent procedure involving all affected parties. Once such a decision has been taken, the path to a judicial review should be open but such a review should be conducted in as short a period of time as is necessary for proper consideration. Lengthy court proceedings as experienced in the German telecommunications sector do not in the end foster competition and investments. The Monitoring report has already given some thoughts to this important issue which need to be further developed.

An efficient regulatory authority minimises regulatory surprises for companies, while maintaining its central role in representing the interests of current *and* future customers.