The Gas Deregulation Process in Europe:
Economic and Political Approach

By Jacques Percebois*

Abstract

This paper analyzes the efforts to deregulate the market, to remove the monopolies and introduce competition, both at the European Union level (European Commission) and national levels. The first part of the paper describes the present situation, with an emphasis on the institutional disparities among the European countries. It presents the outlines of the Gas Directive, recently adopted by the European Commission. The second part analyses the perspectives of such deregulation for Europe. Particular attention is given to the strategies implemented by the oil companies on the market. The third part of the paper consists of the pending questions; the transposition of the Gas Directive into the national laws of the European countries gives rise to several questions which have yet to be answered.

Introduction

Europe may be liberal, but it is more than a simple free trade area. Abolishing customs duties and tariff barriers between signatory countries of the Treaty of Rome (in 1957) was the first stage in building Europe. Customs union was then followed by the free circulation of factors of production within Europe (capital and labour). Economic union is the next stage, and will also involve converging economic, social and monetary policies. Eventually, economic union could also lead to a federation with not just converging, but shared and monetary policies. Eventually, economic union could also lead to a federation with not just converging, but shared or even single policies.

In fact, the Brussels Commission is forced to admit that certain products and services do not circulate freely within Europe, not for technical reasons but for institutional reasons: the existence of legal monopolies. This is why for almost a decade it has been working towards abolishing these obstacles and introducing real competition, ensuring that European consumers will no longer be victims of discrimination. Several Directives (or European laws) have been adopted: the electricity directive of 19 December 1996 and a draft gas directive on 8 December 1997. This directive will gradually open up the internal natural gas market through increased competition between operators. The first part of this paper presents the institutional framework within which this liberalization process is implemented. We lay emphasis on the main outlines of the gas directive. However, the players’ strategies and the relative influence of some of them must not be underestimated. There is thus a risk of collusion, and competition in tomorrow’s European gas market will not be genuine and perfect, especially since today’s energy strategies are global. The second part of this paper mentions that industrial strategies are taking place in relation to the opening process. A purely competitive structure is not liable to substitute for the present oligopolistic one, contrary to a current opinion. Deregulation is only just beginning, apart from a few exceptions where it is already at an advanced stage

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As is the case with electricity, the key component of the Gas Directive is the possibility of allowing certain consumers to obtain their gas from the supplier of their choice. This will inevitably lead to the disappearance of the gas importing monopolies (which still prevail in France, for example). "Regulated" or "negotiated" TPA (Third Party Access) is set to be introduced for the wholesale market. It should be noted that, unlike the electricity industry, the gas industry is rarely fully integrated. Gas is generally produced by oil companies and gas companies are then responsible for importing, transport, storage and distribution. Some of them are involved in the early stages of the gas chain (e.g., with a stake in production) but these are in the minority. The gas networks will be opened gradually, in three stages over ten years. This opening-up process will be based on two main parameters:

1. A definition of "eligible" consumers: these are all electricity producers who use gas (including cogeneration) as well as industrial customers exceeding a consumption threshold per site. This threshold is set at 25 million cubic metres (about 20 000 t.o.e.) when the Directive comes into effect (in the year 2000), then at 15 million in 2003 and 5 million in 2006.


The Directive also makes allowance for two other principles: access to the network by third parties and unbundling. Eligible customers will be able to arrange for transport of the gas they have purchased against payment of a toll with toll rates being openly displayed or negotiated with the network managing company (each member State will choose the system that it prefers). A form of TPA is also planned for the upline offshore delivery pipes. Like the electricity Directive, the gas Directive makes provision for the possibility of constructing direct lines for the exclusive supply of an eligible consumer. However, each of the 15 States of the European Union has a wide margin for manoeuvre to apply these rules by virtue of the so-called "subsidiarity" principle. It should be remembered that the initial situation differs from one country to another in the European Union, as illustrated in the following table. The Directive authorises the States to impose public service obligations (especially security of supply) and allows a gas distribution monopoly to be maintained for those that so desire. Moreover, waivers with respect to TPA are provided for when the security of supply is endangered. A protection system, therefore, exists, the "take or pay" contracts which are long-term supply contracts concluded with foreign exporters.

The narrowing of the gas market explains how the leisurely consumers have to find suppliers and producers have to find customers is much less than in the case of oil. The bilateral nature of the relations between gas importers and importers leads to long-term supply contracts and explains why gas pricing generally is based on negotiated compromises rather than spot prices. Gaz de France officials once said: "an import contract is equivalent to a marriage settled 10 years in advance for a term of 20 years". Today, with the larger part of natural gas in the European energy balance, we may observe a relative harmonization of contract terms but it is not yet possible to speak of a spot market for natural gas in Europe. In Europe all the gas contracts contain constraints on both sellers and buyers, in the form of obligations to supply and to take gas respectively (the level of these TCF constraints is generally very high: 75 to 90% of the amount of the gas sold). The liberalization imposed by the European directive may jeopardize the relationships between the sellers and the buyers, in particular when Third Party Access is explicitly introduced. In the future the gas contracts will probably be negotiated with more flexible clauses between the seller and the buyer.

In the event that an importer should risk having to pay a penalty to his foreign supplier as a result of taking some eligible customers (previously supplied by him) this operator could refuse to transport the gas to these customers. However, each of the 15 States of the European Union has a wide margin for manoeuvre to apply these rules by virtue of the so-called "subsidiarity" principle. It should be remembered that the initial situation differs from one country to another in the European Union, as illustrated in the following table. The Directive authorises the States to impose public service obligations (especially security of supply) and allows a gas distribution monopoly to be maintained for those that so desire. Moreover, waivers with respect to TPA are provided for when the security of supply is endangered. A protection system, therefore, exists, the "take or pay" contracts which are long-term supply contracts concluded with foreign exporters.

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European Gas Deregulation (continued from page 19)

been privatised (Spain, Germany).

3 those in which the deregulation, disintegration and
privatisation process is at an advanced stage (United
Kingdom).

The gas directive project was pending until the adoption,
at the end of 1996, of a common point of view among the
various European governments about the electricity directive.
The consensus was difficult to obtain because of large
initial divergences but a compromise solution was at last
possible. It is necessary to bear in mind that the European
countries have very different positions: some of them are net
exporters of natural gas, others import it; in some countries
the gas market is already mature, in other ones it is nascent.
Some countries use natural gas for most of their electricity
generation; other countries do not.

The liberalization expected by the European directive
will affect the transmission, distribution and commercialization
of natural gas. It does not concern gas production, which
remains the job of a small group of oil companies. The
European gas oligopoly is composed of Gazprom (a quasi
monopoly in Russia) Sonatrach (a monopoly in Algeria), GFU
(an export monopoly in Norway) and Gasunie
(an export quasi monopoly in the Netherlands). (See Table
II).

The main stake of the electricity directive is the opening
of the electricity production. The main stake of the gas
directive is the opening of the transmission and distribution
activities of natural gas in Europe. Gas production is already
theoretically open in Europe. Practically, that is not exactly
the case in all European countries. Another directive, pub-
lished in 1994, mentions that the natural gas reserves are not
European but national reserves. Upstream the impact of the
recent directive will be limited. Downstream it will be
greater.

<table>
<thead>
<tr>
<th>Country</th>
<th>Production</th>
<th>Consumption</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.K</td>
<td>84.6</td>
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</tr>
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<td>75.8</td>
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<td>32.3</td>
</tr>
<tr>
<td>Spain</td>
<td>0</td>
<td>9.3</td>
</tr>
</tbody>
</table>

II. Player’s Strategies A Future Risk of Collusion?

Atomistic competition will not result from this deregula-
tion movement because, hidden beneath this process are
industrial strategies often of global significance. The stakes
involved include the constitution of industrial groups capable
at international level of profiting from the combined action of
gas and electricity which would eventually lead to a real oil-
electro-gas oligopoly. The main players in ongoing restructur-
ing operations are 1) the anglo-saxon oil companies like
Shell and Exxon, but also Gazprom, Sonatrach, Statoil or Elf.
2) gas transport-distribution companies such as Ruhrgas, Gaz
de France, Transco, Gasunie, some of which are hesitating
between either forming an alliance with the oil companies by
investing upline of the gas chain, or entering the electricity
production market even if this means competing with the
electricity companies which are currently their customers.
3) As far as the electricity companies are concerned, they

Table I: European Gas Industry Structure in 1998

<table>
<thead>
<tr>
<th>Country</th>
<th>Import or Export</th>
<th>Exploration-production</th>
<th>Transmission</th>
<th>Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRANCE</td>
<td>Legal monopoly of GDF (100% public owned)</td>
<td>Open (ELF)</td>
<td>Quasi monopoly of GDF (ELF)</td>
<td>Quasi monopoly of GDF (+ a few local public utilities)</td>
</tr>
<tr>
<td>ITALY</td>
<td>SNAM (ENI) (ENI is being privatized)</td>
<td>AGIP (ENI)</td>
<td>SNAM (with limited TPA)</td>
<td>Local utilities (75%) + ITALGAS (SNAM) (25%)</td>
</tr>
<tr>
<td>BELGIUM</td>
<td>DISTRIGAZ (TRACTABEL 42%, SHELL 17%, STATE 17% and private 24%), TRACTABEL controlled by SHGC-LYONNAISE-EAUX</td>
<td></td>
<td>DISTRIGAZ</td>
<td>DISTRIGAZ and local utilities (singly controlled by ELECTRABEL, i.e., TRACTABEL)</td>
</tr>
<tr>
<td>SPAIN</td>
<td>GAS NATURAL (REPSOL) (private)</td>
<td>REPSOL</td>
<td>ENAGAS (GAS NATURAL-AL) (TPA since 1996)</td>
<td>ENAGAS (50%) GAS NATURAL (40%)</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>GASUNIE (SHELL, EXXON, NM (Shell, Exxon) and STATE for 50%)</td>
<td>ELF, CFP-TOTAL</td>
<td>GASUNIE</td>
<td>Largely public</td>
</tr>
<tr>
<td>GERMANY</td>
<td>RUHRGAS (and WINTERSHALL)</td>
<td>BEB (SHELL, EXXON)</td>
<td>RUHRGAS, BEB, MOBIL, WINTERSHALL</td>
<td>5% local utilities (i.e., STADTWERKE)</td>
</tr>
<tr>
<td>UNITED KINGDOM</td>
<td>Open to competition</td>
<td>Several oil companies (BP, SHELL, EXXON, CONOCO, TOTAL)</td>
<td>BRITISH GAS (TRANSOCO)</td>
<td>-open to competition</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Monopoly with regulated TPA</td>
<td>-several distribution firms (among them CENTRICA)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>BG is private</td>
<td>-several traders and brokers</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>-TPA largely adopted</td>
</tr>
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Table II: Natural Gas Production and Consumption in Europe (billion cubic meters)

<table>
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have no hesitation, in certain countries (cf. United Kingdom, Italy, Spain, Portugal; even Germany) in planning direct strategic alliances with oil-gas companies, imitating certain major chemical groups (cf. Basf, Montedison) which bypass their usual suppliers (gas transport companies) by obtaining their supplies directly from oil-gas producers. The progressive setting up of TPA will tend to reinforce these alliances because each of the operators knows very well that he must diversify and also acquire a multilateral dimension. The deregulation process observed in the United States makes Europe the prime target for restructuring operations. The mergers observed between oil and gas companies or between gas and electricity companies in the United States are just a prelude to the growing list of take-overs within the European gas and electricity industries. These American companies, in fact, occasionally use capital resulting from the recovery of their stranded costs (on their protected home base) to finance the purchase of European companies.

Since the law of 1992 (EPACT), American electricity companies are entitled to expand their growth outside the United States. Thus, seven of the twelve British RECs (Regional Electricity Companies) responsible for electricity distribution, have been purchased by American companies. For example, the Southern Company (American company) took control of Swb in the south-west of Britain while at the same time acquiring a stake in the German electricity distribution industry (Bewag in Berlin). The American gas company, U.S. Enron, which was a specialist in gas transport, progressively increased its growth in gas sales and subsequently in the independent production of electricity from natural gas and then took over a major American electricity company, Portland General Electric. This electro-gas group now has European ambitions. At the same time, the European oil companies have entered the independent electricity production market: using gas, whenever this has proved to be legally possible (thanks to the market: being opened up to competition which, in any case, will become the rule in Europe after 19 February 1999). This is the case in Britain where independent electricity production already represents more than 15% of the electricity supply available on the National Grid.

Oil companies are therefore looking for opportunities downstream in the gas industry (gas distribution and trading) and to enter the electricity production business. Electricity companies are themselves looking to forge links with gas companies, especially at the distribution level (benefiting from the gas-electricity synergy). As far as gas transport companies are concerned, it is in their interest to enter the chain further upstream and take a stake in the gas exploration-production business. However, alliances with oil companies are occasionally difficult because the balance of forces is favourable to the oil companies and does not favour the gas companies (cf. British Gas opposite British Petroleum or Gaz de France opposite Elf Aquitaine). The game is complicated by the fact that major chemical industries, often controlled by oil companies, are or will be capable of forging direct links with gas producers (oil companies) by using the transport infrastructure managed by the gas companies (via TPA). These gas companies are, therefore, hesitant about forming alliances with oil-gas companies upstream or with electricity companies downstream (as with Gaz de France opposite Elf and EDF). It is still too early to say what the European energy scene will look like tomorrow, but gas deregulation, following on from electricity deregulation, will undoubtedly be the catalyst for strategic mergers and alliances. Agreements are possible and national regulators such as the Brussels Commission will have to make sure that competition rules are respected.

### III. Pending Questions

The transposition of the Gas Directive into the national laws of the European countries gives rise to several questions which have yet to be answered:

1. **Who will be the regulator tomorrow?** Should an independent Commission of ministries and operators be set up (as is the case in the United States or Britain) or should the State be left to take on this mission through a simple ministerial department (system preferred in France)? How will the fields of competence be divided between the Brussels Commission and the various member States and what will be the role of the European Court of Justice? How will disputes connected with the regulator’s decisions be settled? Should the regulator’s function be transferred to Brussels? How can we make sure that the functions of regulator and those of shareholder will be kept separate when it is the State itself which controls public companies?

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3. **How will the transition be made between the old and the new institutional system?** In particular, how will “stranded costs” be financed, i.e., costs incurred as a result of decisions taken or imposed within a different regulatory context? How can we be sure that these “stranded costs” will not cover part of the costs linked to inefficiency in the behaviour of historical operators? How can we be sure that these “stranded costs” are not simply a pretext to reduce the beneficial effects that are expected to be achieved from greater competition? (Certain European countries tend to overestimate these costs to protect re-structuring of their national industry).

4. **How will infrastructure tariffs be determined once TPA has become widespread in Europe?** (for the time being, tariffs have been established only in the United Kingdom and, on an experimental basis, in Spain). Should access charges be established in relation to a “postage stamp” concept (dump sum toll), or would a “cost-plus” type tariffing system be better, based on the distance actually covered by the gas transported, or should a RAMSEY-BOTHEUX price-cap, hybrid price-cap system be chosen (i.e., a tariffing system which takes into account demand price elasticities) or EPR (Efficient Component Pricing Rule)? The RAMSEY-BOTHEUX tariffs correspond to a second-best pricing. The principle is the following: the difference between the price paid by the user and the marginal cost supported by the supplier must be low when

(continued on page 22)
European Gas Deregulation (continued from page 21)

the demand-elasticity is high and high when this demand elasticity is low.

The ECPR system was proposed by BAUMOL and SIDAK. The toll includes both the mean incremental cost borne by the network operator as a result of the arrival of a new supplier, and the opportunity cost that he incurs since this supplier takes a customer from him. The mean incremental cost is the cost supported by the operator to satisfy an additional demand on the network. The opportunity cost corresponds to a drop in earnings for the operator when this demand is satisfied by a competitor. Such a system could only be imagined in the case where the operator of the transport infrastructure is also a gas producer and supplier. In addition, measures must be taken to ensure that these tolls are transparent, non-discriminating and do not encourage by-passing of the networks in place, which would be inefficient from an economic standpoint.

The European gas industry is undergoing drastic change. A wind of competition is blowing and this should promote the development of gas, especially for electricity production. However, this competition is also the prelude to industrial restructuring and integration operations and the member States, just like the Brussels Commission, must remain vigilant especially as, in the long term, Europe will become increasingly dependent on imported natural gas (from Russia, the Middle East or Africa). In Europe buyers and sellers have managed to ensure security of supply globally with a network of connected pipes and to impose the net-back logic within long-run purchase contracts. The European gas market was “regulated” through stable relationships among a few number of actors. One of the basic interests that the producer and the distributor have in common is without any doubt ensuring a continuous outlet for the quantity of gas for which both have invested. This supposes a favourable environment that will encourage the gas industry to invest in exploration, production, transmission and distribution. This is the main reason why some minimum level of regulation is necessary in the gas industry. Competition is useful to introduce incentives to efficiency. The role of the European Commission is to limit monopoly rents and to improve the welfare for each consumer. Now it is necessary to organize the “new regulation” inside Europe. First of all, this regulation will be set up by each Government. In the future (in a few years probably) it will be implemented by the European Commission itself. But a European energy policy is not easy in a context in which the U.K. is oil-oriented, the Netherlands gas-oriented, Germany coal-oriented, France nuclear-oriented and Italy dependent on its imports. For European countries natural gas has tended to be an element of complementarity and cooperation, rather than an element of dissension.

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Conference Announcement

Corporate Restructuring of the Global Energy Industry: Driving Forces and Implications

SNS Energy Day, Stockholm, Sweden

October 18, 1999

SNS Energy Day 1999 will review the dramatic changes in the corporate structure of the energy industries that have occurred since the mid-1980s: (a) an extended cross-border reach, both in terms of activities, ownership and financing; (b) a deepened vertical integration; (c) corporate separation of production and transmission in gas and power; (d) emergence of independent middlemen in transport and trade, providing an additional source of supply; (e) mega-mergers of multinational oil and gas giants. Liberalization of trade and investments, deregulation of power and gas, privatization and advances in information technology are the main triggers behind this change. The conference will discuss where the ongoing developments are likely to take us and what they will imply for energy producers and consumers and for society at large. Though the vistas is global, some emphasis will be given to the industrialized market economies, and Europe in particular.

The group of prominent contributors to the conference comprises: Kevin Lillis, Senior Analyst, U.S. Department of Energy; Lars Bergman, Professor, Stockholm School of Economics; David Humphreys, Chief Economist at Rio Tinto; Bjell Roland, President of ECON, a Norwegian research and consulting group; Keith Palmer, Vice Chairman Investment Banking, Rothschild; and Dennis Mueller, Professor of Economics in Vienna. Contributors from Shell International and EDF will also take part.

The deliberations should be of immediate interest to high level representatives from energy related industry and banking, to academics with energy oriented specialization, to policy makers in government and to media. The conference should be especially attractive to those interested in broadening their contacts with the energy industries in the Nordic countries. For information contact Judit Weibull, telephone: 46-8-5070-2574; fax: 46-8-5070-2515; email: judit.weibull@sns.se

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