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Through A Glass Darkly

ONCE UPON A TIME the regulator made clear that it wanted reform of the exit capacity arrangements for gas and proposed a vastly complicated alternative which will cost all users (and consumers) more and undermine investment.

The industry said *no*. It said *no* by letter, by discussion, by consultation response, as members of representative bodies, as members of working groups and, finally, when the change was proposed as a modification to the industry governing arrangements, it said *no* formally by representative industry decision.

None of these ways of saying *no* counted sufficiently and the regulator sought to impose the reform – conceding that the effects would not be a benefit of between £19.5-£66.5 million as it stated in June 2006, nor the much reduced sum of £8.2-£28.5 million it stated in February 2007, but costs of £1-£7 million or, if the lowest costs of just four shippers are included, £20-£28 million. (Those costs, say the industry, have been seriously understated.)

Essentially the proposal was to require all system users to book firm pipeline capacity and to remove the current possibility of buying *ad hoc* (or flexible) capacity. The rationale of imposing the modification, its “key benefits” were stated by the regulator to be:

- improved investment signals;
- removal of discrimination; and
- promotion of competition between pipeline users.

E.ON appealed the imposition, publicly supported by other gas users and by Centrica, which is now joined to the appeal.

If these companies had objected to the proposals as unhelpful or unattractive or as otherwise not wanted the regulator might expect to win the appeal. But they objected on grounds that undercut all the regulator’s reasons for its decision.

First: The basic economics are wrong. The entry-exit regime is not a good representation of the underlying network so signals from capacity auctions/bookings show little about investment needs. In addition, interruptible users don’t impose capacity costs - when capacity is utilised they are ‘switched off’. (A simple example of apartment rental is used to

illustrate the point.)

Second: There is no evidence of discrimination in current arrangements: Ofgem baldly asserts there is without citing evidence.

Third: There is no basis for dealing with future discrimination. Ofgem’s way of foreseeing future discrimination is astonishing as the basis of a decision to emerge from any public oversight body: “Whilst current evidence suggests that there is sufficient flexibility available to the market, *this may not necessarily be the case in the future.*”

Fourth: It gets its basic legal concepts wrong: Ofgem implies that different treatment of different users alone is discrimination. This, as we all know, is wrong.

Fifth: There isn’t any competition between firm and interruptible users. Ofgem just assumes there is with no argument.

For a summary of the case and the papers see the Competition Commission website at: www.competition-commission.org.uk/appeals/energy/current_cases.htm.

For the E.ON submissions (including the very clear witness statement and the NERA report) see the Gas Transporters site at: www.gasgovernance.com/Code/Modifications/NTSReform/.

You will not find any submissions from Ofgem except the minimum produced by the CC. Why not? It has served its own witness statements with warnings not to show them to others and it has not published its legal documents.

In doing this Ofgem is not in breach of any legislation, construed very narrowly. But it is concealing from its constituency reasoning which it has no justification for withholding - the very reasoning which led it to impose a change in industry arrangements and an increase in costs for much of it.

Ofgem can be accused of many things in its decision, not the least being a breach of its duty to regulate only when needed and to do so proportionally. In withholding the papers in the appeal it can also be accused of lack of transparency. It seems we are not to be permitted to come to understand the regulator’s thinking except by divination.



Divestment v Regionalisation

UNBUNDLING (or, more accurately, divestment) of networks and pipelines by vertically integrated companies was the main agenda item at the Energy Council meeting in June. As was to be expected, the Commission argued for full ownership unbundling on the ground that it was the most cost-effective and simple way to bring about the internal market in energy.

There is a great deal of support for the principle of ownership unbundling, with the UK in the militant forefront (it submitted a position paper to the Council arguing for it). There is also a great deal of opposition to it, particularly from France, Germany and Spain.

In the result, the Energy Council reached no agreement. It had been expected that the Commission would be tasked to appear at the next Energy Council meeting in September with draft legislation. It is, instead, required to come back with further proposals. (Unbundling of gas and electricity distribution is, for the moment, left to one side.)

Ownership unbundling is a legally problematic issue at the European level since it involves dealing with property (i.e., requiring Member States to legislate to effect divestment). Article 295 of the Treaty states clearly that it (and, therefore, actions taken by the Commission) “shall in no way prejudice the rules in Member States governing the system of property

ownership”. Put simply, they haven’t the power or the right to require divestment.

The obvious way to overcome this prohibition is to reach agreement with all the Member States (there can’t be room for dissent) and then leave them to deal with the issue at a domestic level within an agreed time. If Member States are unwilling or fail to implement then, without a change to the Treaty, divestment will not happen.

If the Commission is to persuade the currently very unwilling big three (plus a significant number of smaller States), it will need to convince them that the goal of a single market cannot be achieved without ownership unbundling. It probably also needs to show them that ownership unbundling is sufficient: as one official put it recently, they can’t go back and have a second bite of this particular cherry.

Does the Commission have a case? Nothing in the package of documents published by it in January setting out the ways in which the single market is not being achieved did more than provide an account of how *functional* unbundling is not working. The case here is that some network owners still favour their own companies, i.e., the Chinese wall between different functions is sometimes not adequate. But defective implementation of functional unbundling isn’t a basis for divestment.

The UK claims it has “strong arguments” in favour of full ownership unbundling. In fact, they are weak, at least as set out. It argues that the Independent System Operator system in Scotland is complex and the market there so small there is little incentive to discriminate, so it works. However, it says, in other contexts there could be greater discrimination incentives and the system would be more complex.

The too-hard argument doesn’t get us very far since a proposal also under serious review will be at least as complex - regional system operators with transmission assets owned by national companies.

The Commission, which supports the proposal in principle, recently conceded that if regional system operators are sufficiently independent, ownership unbundling will not be necessary. It can be predicted that the alternative proposals to be drafted by the Commission for the September meeting of the Energy Council will involve this proposal in one form or another and will have the appropriate functional separation built in.

If regional operators can be made to work without ownership unbundling, then ownership unbundling will be off the agenda for the time being. It will then be for the French and Germans in particular to ensure that the option works.

No Basis for Action

THE COMMISSION has published a study it commissioned* on electricity markets and claims it supports its own competition inquiry results.

According to the Commission, the report shows that wholesale prices are “significantly higher” than they would be in “perfectly competitive markets”. It believes this shows what it thinks it already knows, that competition in European energy markets (the ‘single’ market) is “not yet functioning properly”.

The report reviews wholesale markets in Belgium, Germany, Spain, France, the

Netherlands and Great Britain. It concludes, with major caveats, that these markets are “likely to be conducive to anticompetitive behaviour” and prices are “less keen” than they would be if the markets were different.

A commentary** rephrases this as “observed prices have been affected by the level of concentration in each market” and then criticises its “flawed” methodology as yielding “apparent problems of market power even when there are none”.

The commentary is so detailed and so negative as to derail the report. The

consequence is that the Commission does not have an economic basis for its periodically voiced ambition to unbundle the large vertically integrated energy companies.

Perhaps harder for it to bear, there must be doubt whether the report will be of any use in its pursuit of alleged anti-competitive practices.

*<http://ec.europa.eu/comm/competition/sectors/energy/inquiry/index.html>; **http://www.nera.com/NewsletterIssue/NL_ERI_EN454_Issue33-final3.pdf

Carbon Control

The Emissions War

IS THERE A FUNDAMENTAL conflict between Member States about the Emissions Trading Scheme? On the one hand a raft of countries is lined up to appeal Commission decisions about their emissions caps and, on the other, countries (notably the militant UK) are pressing for harder measures.

The next months will see two groups of countries with opposing interests at war over the reform of the ETS for 2012 and beyond.

Side One

Of the 20 Phase II proposed ETS emissions caps reviewed by the Commission, only three have been approved without reductions (France, Slovenia and the UK). An average 10% reduction was required from others.

Slovakia was the first to say it would appeal after the Commission cut its cap by 25.1%. It insists that the closure of two nuclear reactors means it must burn more coal and that this is a factor the Commission should have taken into account.

The Commission cut the cap for the Czech Republic by 14.8%. Czech government departments disagreed about whether an appeal was appropriate - but it has now announced it will do so.

The Commission cut Poland's cap by 26.7%. It, too, has decided to appeal the decision.

The three countries (supported by Latvia, whose cap was cut by 57%, and Finland, whose cap was cut by 5.2%) have decided to appeal on grounds the Czech Republic describes as 'discrimination' because the new caps will prevent these countries catching up with their western neighbours.

More importantly for the appeals, the three countries dispute the method of calculation, alleging that the Commission's is not sufficiently accurate. The Czechs assert that the Commission has consequently used "false data". They also accuse it of not consulting on the methodology to be used and claim it is not entitled to do its own calculations.

Since then, Hungary (whose cap was cut by 12.4%) has announced that it, too, will appeal, using the same arguments as the others about inaccurate data.

Side Two

On the other side of the reform divide are countries pressing for changes to the ETS to make it deliver more cuts and to do so in the same way across Europe.

On climate change the UK has a surprisingly influential voice in Europe - it is said the apparently unrealistic 20% renewable *energy* target (see last issue) was the UK's proposal and that agreement to it was reached despite widespread doubt.

The recent *Energy White Paper* sets out the UK's proposed negotiation position on ETS reform. The basic premise is that the caps for Phase I were too high, that the ratcheting down in Phase II is an improvement and that Phase III must go further. Key proposals are:

- harmonisation, to ensure a level playing field - Slovakia and Poland in particular are likely to argue that a level playing field is exactly what they shouldn't have;
- expansion of the Scheme to other sectors - also likely to be resisted on the grounds that it is 'unfair' to less developed Member States; and
- increased auctioning - whether or not all Member States sign up to the principle of a level playing field, it is likely there will be 100% auctioning in power.

The main remaining issue, predictability over the long term - is dealt with in two ways. First, a proposal for a long-term trajectory against which shorter-term caps can be set.

Second, other domestic means are to be considered to aid price stability. What this amounts to is unsaid, but the context of the statement is discussions by economists and funders of carbon taxes and/or price floors and taxes. This sound very much like a local sticking plaster for a European problem and should make us less sanguine about the final shape of the revamped Scheme.

A New Renewable?

THE *ENERGY WHITE PAPER* (together with the *Planning White Paper*) makes clear the government's policy objective of new-build nuclear, despite not being able to say so before conclusion of the current consultation on the issue.

When the policy paper following the consultation is published we should not expect to see anything much different from what is in the *Energy White Paper*. And what we see there is a government wanting nuclear new build, suggesting that it is necessary, but proposing nothing more than changed planning rules (so we will be disposed in favour of nuclear).

The capital costs of nuclear plant are roughly four times per kW higher than for gas, have a construction period of approximately five years to two for gas, although their operating costs are comparable or lower*. If carbon costs rise, nuclear operating costs may fall further, but in the medium term there can be no certainty about this.

There will be no subsidies for nuclear plant, the government has said again and again and there is no possibility of reclassifying nuclear generation as renewable generation, and so making it a 'must buy' fuel attracting green credits.

The US recently decided to build a new nuclear fuel-processing plant - using new techniques to recycle fuel**. A new renewable energy? Some say the new fuel-recovery techniques make it so.

At the same time the US is encouraging nuclear new build (at least five plants are in the early planning stages). All will receive some form of financial aid and all are being encouraged for two reasons - lower prices and, as important, climate change.

If the UK government wants to encourage nuclear plant it needs to consider whether it should take positive steps. If not, the *Energy White Paper* may be no more than a repository of unfulfilled wishes.

* *The New Economics of Nuclear Power* www.world-nuclear.org/reference/reports.html **www.uic.com.au/nip72.htm

European Markets

ROMANIA

Transgaz Sale

Privatisation of Romania's power industry is well under way, with the national networks and pipelines remaining in state ownership and with only the main gas producer, coal plants (and mines) and small hydro plants left to sell.

The main pipeline company, Transgaz, will remain state owned, as will the transmission company. But in Autumn the government will sell 10% of its Transgaz shares to, it hopes, institutional investors. At the end of the sale the government will have, just like the French government with EdF, a 70% shareholding.

Transgas provides gas transit for Turkey, Bulgaria, Greece and Macedonia through three pipelines and is building new pipelines – Romania-Hungary, Romania-Bulgaria; and part of the Caspian Sea (Nabucco) pipeline. The Nabucco project will require some form of government guarantee. It is by no means certain it will get one.

Enel in Romania

Enel is to buy 67.5% of Electrica Muntenia Sud, a supply company previously owned by Electrica.

Enel already owns 51% of the supply companies Electrica Banat and Electrica Dobrogea: the latest acquisition is its last in Romania.

It says, perhaps surprisingly, that it will retain the same number of staff as at present and will not recoup its costs by price increases.

CROATIA

Which Derogations?

Part of the June accession discussions between the EU and Croatia will concern what is described as the 'Energy Chapter'. This is presumably the Athens Treaty providing for implementation of the Energy Directives by a given date.

Like other accession and pre-accession states, Croatia can be expected to negotiate derogations. For example, Romania is exempt from the Large Combustion Plant Directive until 2013 and Poland is exempt from dust emissions controls until 2017.

ALBANIA

Retrieved Ambitions

Before the climate changed Albania had water and snow melt and plentiful hydro - enough for its own needs and for export. As the water dried up, so its generation failed and it was forced to import at high prices and to cut electricity supply.

Albania remembers that well. The government has just announced plans to construct four thermo-electric plants. It expects the first and largest to meet all Albania's needs at below market cost. The other plant will enable it, once more, to act as supplier to the region.

That means the prospective investors in the later three plants will be producing excess capacity and will need, before they invest, to be certain that their output will be bought.

UKRAINE

Accession & Reformation

Ukraine is a transit country whose energy security, according to the World Bank, is bound up with Russia's exporting interests. As a consequence it can (for the moment) buy Russian gas at lower prices than other countries in the region.

Last year Ukraine made two separate import purchases from Russia, leading to price increases. The World Bank, attempting to review the economic impact of the increases, said it was "hampered by the lack of transparency in the energy sector". Estimates of the price increases needed to cover import costs varied and information about the proportions of domestic and imported gas by consumers was "incomplete".



Despite the incompleteness of the information, price increases were imposed at a level which had *no major adverse effect*.

It is in this context that a project is underway to harmonise the powers and functions of the energy regulator and energy regulation with those of the EU.

Despite that work, MEPs have estimated that Ukraine will not finally accede to the EU until 2020.

SERBIA

Accession

Serbia has restarted accession talks with the EU, following the arrest and transfer of Hague indictees.

Serbia believes that it can become a candidate status country by next year, a goal the EU thinks not impossible, if ambitious.

EUROPE

New Presidency

Portugal takes over the EU Presidency from the Germans on July 1.

Its goals for its short six-month term ambitiously include completion of the European power market. Portugal will also 'promote' renewables (perhaps prefiguring the new draft directive expected in Autumn) and will work on the strategic energy technology plan.

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