

## **Editorial from the Guest Editor**

In the novel “Vingt ans après” by Alexandre Dumas, the three Musquetaires come back to their affectionate readers 20 years after their first unforgettable adventures and show that their emblematic “*One for all, all for one*” is less true now: they are divided in their political standing between the Princes and cardinal Mazarin.

Most European energy regulators are not yet 20 years old (and their association, the Council of European Energy Regulators is not yet 10) and they are under pressure from their governments to support nationalistic approaches rather than the European design of a single open market and free competition among producers within a clear frame of rules in the interest of consumers and of all citizens. Is it inevitable that their support of the European design should weaken and they should become just ordinary, national bureaucracies?

### New institutions for a new type of regulation

In a way, it is surprising enough that they have been and still are anything different. After all, they are national institutions. Yet the energy regulators have been strongly in favour of all steps towards a single European energy market; often more strongly than their governments. They are not political bodies, and their primary commitment is to establish good practices in the highly technical fields of their mission and find workable solutions to the specific issues of market coordination. Yet there is a substantial innovation in making the good practices common and in overcoming the barriers to the integration of energy markets: it is a technical way of performing a political task.

The rise of the European energy regulators, the shaping of their tasks and procedures, their mutual cooperation, their interaction with the evolution of companies, markets and political institutions, all this is an interesting story which deserves being told and analysed. The present issue of EREM

provides contributions for a better understanding of some present issues and materials for future research.

The behaviour of any institution having power over the life of people, including commercial companies, has to be limited and oriented in order to prevent abuse. Markets provide a great help in this direction when they work properly, and they make the task of direct control lighter. But markets themselves need rules and supervision to work properly; they need special control in presence of market power by few (like the network managers and system operators); they do not always develop without a favourable context. To take care of all this is the task of sector-specialised regulatory institutions.

It is evident that the contents of their mission change when the shape of the markets change. The process of services liberalisation which was undertaken in Europe between the mid 1980s and the 1990s produced a radical change in the shape and working of the markets for services, among which energy services. Consequently regulation, which existed in some way under the previous monopolistic setting, had to be reinvented.

Tariffs for production and supply have been re-designed and set ready to be gradually replaced by free prices whenever competition is sufficiently developed. Tariffs for “naturally” monopolistic services have been adjusted to include incentives towards efficiency (like a diminishing price cap and mechanisms of prize-penalty linked to performance indicators). Access to networks is granted to all competitors and users under new (and sometimes necessarily complex) rules, including the unbundling of monopolistic activities from competitive activities. Cross-border trade requires transport tariffs neutral with respect to the number of political borders crossed. Regulated power (and later gas) exchanges provide transparency of prices and ease of trading. Congestions are managed so that the formation of rents can be prevented and the inevitable rents can be used in the general interest. An increasing amount of rules and control procedures raised criticism and had to be counterbalanced by possible simplifications, such as a reduction of the traditional controls on investment by network companies and the introduction of the much less intrusive controls on the quality of the service provided. Consumer’s protection against possible abuse by service providers had to be strengthened in presence of a stronger orientation of companies to (short-term) profits due to privatisation and to an increasing pressure from the financial markets.

### Institutional evolution

New tasks imply a renewal of institutions, and in many European countries this meant not just refurbishing the existing regulatory offices but setting up brand new bodies. New public operators faced the new challenge with enthusiasm; the feeling of a common task acted as a natural glue, so the creation of an association (the CEER) was a natural consequence of the new climate.

The “new” regulators have a common character, a substantial degree of independence. Independence applies first with respect to the energy companies, and this appears to be an obvious requirement; but it should be remembered that the traditional arrangement in many European countries was to have a state-owned company officially operating in the public interest, both providing the service and setting the rules for itself and for the minor local companies which were allowed to exist and operate. The former monopolist had all important information, know how, skilled personnel. For the new regulators, achieving independence with respect to the former monopolistic company was easier said than done.

But also important and mostly new and controversial was independence with respect to government itself. Such requirement is not obvious at all, and had to be argued on the basis of theory (agency and conflict of interest), analogy (the central bank) and experience (the World Bank requires independent regulation when promoting investment in infrastructures).

The European Commission encouraged the creation and growth of competent and independent regulators; once they were in place and robustly interacted with a genuine orientation to the implementation of a single energy market, the EC called their group to become its advisory body (the ERGEG). A direct link with the regulators was useful to the EC, in that it provided a more stable, less politicised and often more Europe-minded partner than the Member states governments.

In a way, the new European setting recalls the US system of (sufficiently) independent energy regulators: the public utility Commissions at the State level and the Federal Energy Regulatory Commission. Important differences remain: in most European states regulation is more forward-looking and market-oriented than in most US states; but at the EU level there is nothing as powerful as the FERC, and this is a weakness in regulation.

An important aspect of the present institutional evolution in Europe is the recognition that the common treatment of the whole EU and its relatively separated electricity markets, which are at very different stages of development, market opening and integration with neighbouring markets, reveals the need for a regional approach. **Asta Sihvonon-Punkka** describes the progressive perception by both policy makers and stakeholders that regulation should be coordinated at the level of the existing regional electricity markets, the consequent adaptation of institutions and processes, and some encouraging results. Later the same path has been followed for the gas markets. A unified European single market is a final target to be approximated by progressively integrating and widening the regional markets, themselves being an extension of previous national markets.

Strict mandates: regulating networks and promoting energy markets

The present issue highlights some of the most urgent and complex issues in European energy regulation.

First come networks. Since networks are essential facilities, their regulation is crucial to the working of the system. **Laurens J. De Vries, Rudi Hakvoort and Jeroen De Joode** present an accurate survey of the main issues in the regulation of transmission (as distinguished from local distribution) networks and of the alternative solutions that have been tried and/or are available. They underline the crucial importance of network governance and confirm the well-known drawbacks of vertical integration. Probably the most important aspect of network regulation consists in the incentives it provides both to commercial operators for their decisions regarding location and operations and to the (actual and potential) investors in the networks. Incentives can be adverse as in the case of bad congestion management, which may create an incentive for network operators to increase rather than eliminate congestions. New investment runs the opposite risks of being excessive or insufficient, and various regulatory regimes provide different combinations of risks: the authors fear the risk of underinvestment more than the opposite in the present European situation.

Energy markets should raise fewer problems to regulation: under a simplistic approach they should only be deregulated, prices should be freed, competition should be guaranteed by an antitrust authority. Well, there are many obstacles to competition and there are many arguments, some grounded and many groundless, in favour of maintaining tariff controls;

particularly if prices have long been set below costs and users have become accustomed to them. **Patricia De Suzzoni** provocatively asks “are regulated prices against the market?” and goes on analysing the expected role and the serious drawbacks of regulated end-user prices, which are still dominant in the French retail market but also apply to the majority of European consumers, despite the full legal opening of the retail market. She surveys a variety of cases and national regimes, providing the reader with ample evidence on which to ground one’s judgment and answer to the initial question; she remarks, though, that while the idea that end-user price regulation systematically favours household customers should be rejected, consumer empowerment rather than protection through regulation is the real goal.

It is generally accepted that good regulation of the networks is a necessary (although not sufficient) condition for having a healthy competition in energy markets. But such regulation can be much lighter if an appropriate structural reform, including separation, has been introduced beforehand. The predominant importance of structural questions rather than questions of behaviour is stressed by **Callum McCarthy**, on the basis of his experience as British regulator, and he goes on discussing the issue of the borderline between the duty of a specialised energy regulator and the duty of the general competition authority.

The first British electricity regulator and McCarthy’s predecessor **Stephen Littlechild** critically reviews the traditional good practices of regulators, including the incentive-based methods of tariff setting such as the price-cap, whose development is largely due to his ingenuity of twenty years ago. He remarks that there has been some wearing off of the traditional approach and advocates efforts to refocus regulation as a means of helping the market process to work rather than replacing it. If a regulator succeeds in removing the monopoly element and letting the better organised parties negotiate, rather than replacing the market with administrative decisions, then there is a better chance of re-igniting the discovery mechanism that is necessary to overcome the information asymmetry. And he points at some interesting experiences.

#### Broader mandates such as sustainability and security

The mandate of an energy regulator was originally targeted to promoting efficiency through competition where possible and through fair regulation

in the case of inevitable (natural) monopoly. This was the simple definition of a regulator's mission and it was coherent with the political climate of the UK in the 1980s, where a substantial effort was done to free the economy from an excess of traditional barriers.

Having only one goal, the task was easily transferred from a democratically accountable administration made of elected bodies to an independent, technical institution, which is steered by administrators appointed for a rather long period of time, who are accountable, within that period, for the implementation of their mandate but not subject to political negotiations and to possible reversal of political decisions. This is a notable advantage: as it was once said with respect to the central banks, the advantage of political institutions "tying their hands".

But soon it was clear that such a definition was too narrow. A regulator has also the task of protecting the consumers in front of heavy and inevitable asymmetries (both in information and in power), and with special regard to the weaker ones. Moreover, decisions in energy regulation imply consideration of such different goals as security of energy supply, protection of the environment, sustainability of the present energy systems. The broader the mandate, the more difficult it is to maintain it in the hands of a technical body, acting independently under few and general indications from the political institutions.

Here lies the practical difficulty of independence of the regulators. They are inevitably involved in political decision-making. They have to act as wise and knowledgeable advisers to government and parliament, and as competent and reliable executors of the decisions taken in the political institutions. In implementing the general indications they have to work out practical, detailed lines of action, and this requires ingenuity together with professional skills. And their task includes reconciling the different goals and applying a common approach to various actions; the common basis being reliance on the market as an efficient tool whenever possible and maintaining an acute concern for fairness to all stakeholders regardless of their political or economic weight.

This is a very practical issue that worries any regulator, and here again we have wise considerations from **McCarthy's** experience.

**Alberto Pototschnig** throws light on the use of market-based instruments in environmental policy and specifically in facing the energy-environment issue. While the EU has a historic primacy in setting up a market for tradable emissions rights, it is now moving ahead, not only by improving on the same instrument, but also by extending the same approach to the promotion of renewable sources and of more efficient uses of energy. He shows, though, that an overall preference for incentive-based instruments (which should provide greater efficiency in principle) has been very imperfectly transferred into the norms. The recent abandonment, by the European Council, of tradable certificates of origin for renewable energy will produce a less efficient discipline than the one the Commission originally proposed; governments seem to refuse the distinction between the financial responsibility for the development of renewables and the physical location of the same development. Similarly, limitation of emission caps to some sectors and resistance to auctioning emission rights reflect an overwhelming concern over the immediate consequences of environmental policies over the trade competitiveness of national industries. This national bias is even increasing due to the rising anxiety over the security of energy supply, for which a common European approach is still lacking.

**Elena Fumagalli** and **Luca Lo Schiavo** discuss the regulatory approach to the quality of electricity service by providing a first-hand report on the Italian experience. While the basic mechanism of performance standards set by the regulator and accompanied by economic incentives appears reasonable and rather simple, success in practical implementation is more complicated than it can be imagined in a classroom. It crucially depends on a patient and time-consuming collection of the relevant data, a continuous process of consultation, an ability to learn from experience, a progressive adaptation of the rules to reflect an improved understanding of the companies' reactions. Success requires prolonged dedication by a professional, independent regulator.

As a practical support to those involved in this activity, the same authors (with Florence Delestre) had previously written a handbook on the regulation of the technical quality of electricity supply. **Viren Ajodhia** reviews the handbook. He is an author in the field himself, being both a scholar and a consultant. Diffusion of good regulatory practices should be incremented by the availability of such reports on regulatory experience and theoretical developments interacting.

### Challenges

These are only examples of broader mandates blurring the borderline between policy- making and regulation. The present European uneasiness reflects the difficulty of reconciling the need for an independent, technical regulation and its inevitable intermingling with exquisitely political issues such as the defence of European independence from (state-owned, domestically monopolistic) producers of oil and gas; and also reconciling the jealously kept independence of member states in delivering the public service of a secure energy supply to citizens with the undeniably European (if not even larger) dimension of most issues which condition the possibility of delivering the same public service.

The first president of the European association of energy regulators **Jorge Vasconcelos** looks back at the accomplishments and ahead at the challenges, with an eye to the American experience of state and federal regulation. Food for thought on both sides of the Atlantic.

Pippo Ranci  
Guest editor