Reforming TSOs: Using the 'Third Package' Legislation to Promote Efficiency and Accelerate Regional Integration in EU Wholesale Power Markets

The EU is developing new legislation – the so-called ''Third Package'' – to foster competition in its electric power markets. These proposals could be improved by adding more focus on regional integration of wholesale power markets, allowing more leeway for arrangements that fit the diverse existing patterns of transmission ownership and control, and addressing upfront new regulatory concerns that arise when transmission is divested as an independent, for-profit business.

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I. Introduction

For over a decade the Europe Union (EU) has been working towards liberalizing its electric power and natural gas markets, long dominated by national incumbent monopolies. Previous rounds of EU-level legislation,[1] starting in the mid-1990s, have required utilities to give open access to their transmission and distribution networks, with the aim of establishing a level playing field for owners of generation to compete in supplying energy at wholesale level, and for retailers to compete in selling energy to consumers. While the legislation focused initially on large consumers, all consumers in the EU—including households—now have the right in principle to choose their supplier.

In practice, however, liberalization has met with many obstacles. While a few EU member states, such as the United Kingdom and the Scandinavian countries, have developed effective and mature competition at both wholesale and retail markets, the general picture shows very limited progress. Most markets remain national in scope and dominated by the incumbent utilities. This pessimistic appraisal was confirmed by an extensive inquiry carried out by the EU's competition authority, the European Commission's Directorate General for Competition (DG Competition), in 2005-07, the so-called ''Energy Sector Inquiry.''[2]

The Sector Inquiry's findings focused heavily on the issue of vertical integration between transmission businesses and their generation or retail supply affiliates.[3,4] It argued that vertically integrated utilities have restricted their competitors' ability to access consumers on equal terms, both through operational means (e.g., in setting rules and prices for balancing power) and through systematic under-investment in transmission infrastructure. It singled out the problem of vertical integration as a fundamental cause of the continued high levels of market concentration, and the weak and uneven development of competition.

II. The ''Third Package''

To address the problems identified by the Inquiry, the EU is now considering a third set of legislative proposals, which are expected to be finalized this year.[5] At the core of this ''Third Package'' is a set of measures designed to ensure that the operation and development of transmission networks is made independent of incumbent interests. The initial drafts of the legislation aimed to achieve this through structural measures, with a requirement that vertically integrated utilities either divest their transmission assets (''ownership unbundling'') or give control to an independent system operator (ISO) that would take charge of not only operations but also investment planning. Political opposition from key member states such as France and Germany has led to some watering down, and a consensus has now been achieved among the EU members that would allow each country to choose whether it imposes these structural measures, or settles for a less radical approach that would rely on strict behavioral measures aimed at ensuring the independence of transmission so as to prevent discrimination in favor of affiliates.

Initial drafts of the legislation aimed to achieve this through structural measures.

The Third Package also contains additional measures aimed at furthering integration of national markets. This integration is an aim in itself (since a fundamental goal of the EU is the creation of EU-wide markets), but it is also widely viewed as providing a solution to high levels of concentration in national markets. Drawing in part on experience in telecoms, EU policymakers expect that former national utilities will develop into pan-European companies that act as entrants in each other's traditional ''home territory'' and so develop genuine competition. The measures include provisions for an EU-level regulatory agency, the Agency for Cooperation of Energy Regulators (ACER), albeit with rather limited powers, along with requirements on transmission system operators (TSOs) to cooperate at the regional and EU levels so as to harmonize operational procedures and coordinate investment planning.

The current draft of the Third Package remains subject to approval by the European Parliament, but is generally expected to be approved in its current form by the end of 2008. While the watering down of the requirements concerning divestiture makes the final

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