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# The Energy Union: why liberalisation matters

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- Energy security can best be achieved by removing the distortions, both physical and regulatory, which prevent the market from properly working. Common bargaining for gas is inconsistent with the liberalisation framework of EU policy, and it is likely to endanger rather than improve energy security by further politicising the process.
- Sustainability must be reconciled with the effective functioning of energy markets. More integrated markets can allow for better use of existing capacity by driving out the least efficient suppliers. Distortionary subsidies must be eliminated in accordance with state aid guidelines and to remove contradictory incentives to investment.
- Liberalisation must take place to allow for greater market integration. This will involve the full implementation of EU directives to prevent protectionism, as well as the removal of barriers to cross-border infrastructure. National capacity schemes should be open to foreign participants and fully exposed to market forces. To avoid regulatory capture and barriers to entry, state-controlled suppliers should be privatised.

On February 25, 2015, the European Commission released a package on "Energy Union" (EC 2015a, EC 2015b, EC 2015c). The Commission's strategy has five dimensions: energy security, solidarity, and trust; a fully integrated European energy market; energy efficiency; the decarbonisation of the economy; and research, innovation, and competitiveness.

The Energy Union can be an important step towards more effective liberalisation of EU energy markets, which still lags behind (EC 2014a) despite significant progress in recent years. But it could also lead to a new wave of regulation, increasing costs, market distortions and red tape instead of making energy more abundant, affordable and clean. It is key to make liberalisation a priority of the Energy Union in order to promote market integration across Member States. Liberalised energy markets are also likely to improve security of supply and contribute to the EU's decarbonisation strategy.

**Security**

The EU is strongly dependent on imports for oil (86.4 per cent in 2012) and natural gas (65.8 per cent) (EC 2014b). Oil markets are global and flexible by nature, meaning that it is easy to switch to alternative suppliers. In contrast, natural gas markets tend to have a regional scope, and it is much more difficult to switch to a different supplier, mainly because most natural gas is moved through pipelines. In this context, there is a strong push within the EU to reduce dependence on Russia (32 per cent of gas imports), for example by introducing common purchasing. Options for a common purchasing mechanism, although on a voluntary basis, will be assessed by the Commission (EC 2015a). If this approach is confirmed, it will likely result in higher prices and more pervasive regulation, instead of more security.

Common purchasing is deeply inconsistent with the liberalisation framework that underlies the design of EU energy markets: under EU directives private operators, not national governments or the Commission, are in charge of concluding contracts and they bear the full market risk. Collective bargaining would centralise any relevant decision, and the subsequent risk would be socialised. Private operators would be left with the task of delivering natural gas, but both the amount of imported volumes and their price would become a political decision. As for import infrastructures, private operators can and do build them. Existing infrastructures are more likely to be under- than over-utilised (CEER 2014). Public funding of infrastructures would only crowd out private investments, by socialising the investment risk of politically favoured infrastructures.

Moreover, energy security is not necessarily a public good that requires public intervention: the risk of supply interruptions is normally dealt with in any market, including energy markets. Market operators are perfectly able to price such risk and to incorporate it in their own contracts. For example, financial tools are available to insure operators—either on the supply or the demand side—against the risk of being under-supplied (Robinson 2006).

What can really improve energy security within the EU is the achievement of a greater degree of market integration. In other words, if the Energy Union package is aimed at energy security, it should encourage the efforts to remove the distortions—both physical and regulatory—that prevent the market from properly working.

**Sustainability**

The EU has made a strong commitment to decarbonise its economy. This commitment is currently being reviewed, introducing stricter targets: in particular, carbon emissions are to be reduced by 40% below 1990 levels by 2030 (starting from a 20% reduction in 2020) and the share of renewable energy is planned to grow from 20% in 2020 to 27% in 2030.

The 2020 targets are most likely to be met. The main drivers of this are EU policies, national policies, and the economic recession. At the EU level the most important policy has been the Emissions Trading Scheme (ETS), whereby emissions

allowances can be traded among emitters, subject to a cap. At the national level, subsidy schemes have been introduced for renewable energies. Finally, energy demand fell because of the recession, which, all else being equal, has contributed to a decrease in carbon emissions and an increase in the share of green energies. However, the likely achievement of the 2020 targets has not come free of charge: massive costs have been imposed on European energy consumers, while the large distortions in the market due to a growing and significant share of subsidised generation capacity (Borenstein 2011) are preventing the benefits of competition from being fully secured. Indeed, countries with heavy subsidies for renewables (e.g. Germany, Spain, Italy) are also among the Member States where electricity prices are highest (CEER 2013, EC 2014c).

Whether or not a unilateral carbon reduction target is meaningful, it is important that the Energy Union package reconcile climate policies with the functioning of the market. A more integrated market can allow for better use of installed capacity by driving out the least efficient power plants. The negative externalities produced by fossil fuels should be incorporated into the market price of carbon-based energy, but the task of finding the optimal technological mix should be left to the market. Discretionary subsidies should be eliminated, consistent with the most recent guidelines on state aid in the energy sector. The adoption of several interacting schemes—as opposed to a single one like the ETS—creates contradictory incentives to investment and confusion on the real targets of the policies, making them harder to achieve (Abrell and Weigt 2008).

**Liberalisation**

Both energy security and sustainability can best be achieved through the promotion of competition within, and greater integration among, energy markets, especially as the degree of market openness at the level of Member States is still very heterogeneous (IBL 2014, Koske et al. 2014). Several countries, e.g. France, Sweden, Denmark and Greece, still have a long way to go in opening up their domestic energy markets (IBL 2014). Others, notably the UK, are taking steps back towards more government involvement (Robinson 2013, Littlechild 2014). Yet the least-liberalised energy markets also boast some of the highest retail prices in the EU (EC 2014c). Successful liberalisation will require full implementation of the EU directives on energy markets as well as the removal of regulatory barriers to competition and investment.

Full implementation of EU directives is particularly relevant with regard to retail markets (Benedettini and Stagnaro 2015) and network unbundling (Pollitt 2008, EC 2015a). The EU should also enforce state aid rules in order to prevent national governments from picking winners through discretionary policies. One particularly salient example are renewable subsidies, which in recent years have been handed out in a way that is totally unrelated to the alleged environmental benefits.

The removal of barriers involves three areas. Firstly, cross-border infrastructures can significantly improve the performance of energy markets, both in electricity and natural gas (EC 2015c). The Commission is aware of this, but it seems to want to address the problem by directly financing infrastructures. There may be a case for this in specific instances, but as a rule public funding of infrastructures crowds out private investment. Moreover, it is often the case that cross-border power lines or natural gas pipelines are not built due to government opposition at the Member State level, rather than market failure.

Secondly, as far as electricity markets are concerned, several Member States are introducing capacity support schemes in order to pay for conventional backup capacity that is supposedly required to counterbalance intermittent, subsidised energy sources such as wind and solar power. Capacity schemes—even when they are designed as capacity markets, as in the UK—can distort the market by switching from an energy-only framework (where consumers pay for the energy they demand) to a system that also pays for the capacity made available. While in the former case the relevant choices are decentralised and the risk is placed upon market operators, in the latter at least some choices are centralised (for example, the amount of backup capacity to be provided) and some risk is socialised. Intermittency can best be dealt with by making intermittent generators liable for the costs or inefficiencies they cause and allowing scarcity prices to freely fluctuate. If capacity schemes are adopted, they should at least be open to foreign participants, should be technology-neutral (including demand-side management technologies), and subject to cost-benefit analysis.

Finally, electricity and natural gas markets are still dominated by state-owned or state-controlled incumbents: according to the most recent OECD Product Market Regulation Indicators (Koske et al. 2014), this is particularly the case in the Czech Republic, Denmark, Estonia, France, Ireland, Slovenia, and Sweden. Even though such markets are formally liberalised, the very presence of a state-linked entity reduces potential competition and increases the probability of regulatory capture. The protection of “national champions” often provides the rationale for closing the market or raising entry costs to newcomers (Stagnaro 2014). Therefore, public incumbents should be privatised and, where needed, networks should be unbundled.

The Energy Union can further the process of opening up and integrating energy markets within the European Union. However, there is a risk that behind the proposal a new wave of regulation looms, both at national and EU levels. If Energy Union is really about increasing energy security, sustainability and competitiveness, the most efficient policy is to broaden the scope of competition by creating the conditions for more effective market integration and removing existing barriers.

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