Business Europe/ *By Edward Kee*

Will Monti Pull the Plug on State Aid?

Europe's electricity sector has been operating in a twilight zone between full government ownership and full liberalization for years. The result has been little investment from either governments or the private sector, as neither wants to invest in the face of an uncertain future. But this underinvestment has now reached the point where there are legitimate concerns about the reliability of electricity supply and transmission in Europe. To correct this, Europe needs to complete a process of liberalization that has already dragged on far too long.

There are some signs that the commission is turning up the heat on the electricity industry. Sometime before the end of this year, Mario Monti, European commissioner for competition policy, is likely to announce that Electricité de France must repay up to €1 billion in unlawful state aid. That case is just one of several in the electricity sector, including other forms of state aid to EdF and the U.K. government's assistance to British Energy.

Mario Monti

These high visibility state-aid investigations in the electricity sector come just months after the new European Electricity Directive was approved in June. Electricity industry reform is a major goal of the EU, with the June directive including firm targets for reform and full market opening. Given France's track record as rather a reluctant liberalizer, an aggressive commission stance on state aid will be vital to reducing the role of governments in the electricity sector and ensuring that these reforms are carried out in full.

The traditional model of electricity-industry organization involves government-owned, vertically integrated electric utility monopolies. In this model, historically the dominant one in Europe, governments facilitate infrastructure development and regulate the monopoly electric utilities. This approach has consistently failed to produce efficiency, productivity and price outcomes that would have been achievable in a competitive market—leading to new industry models that use markets to organize the competitive parts of the industry.

Introducing markets into industries, including electricity, that were once considered natural monopolies has created significant and beneficial changes. These benefits include encouraging the right type and level of capital investment; more efficient and productive use of assets; more efficient allocation of resources; technical and operational innovation; improved customer service and more demand-side involvement in the market. The EU's electricity directive is aimed at delivering such benefits, among other things, from the reform of Europe's formerly monopolistic electricity sector.

Electricity-sector reform divides the industry into two economic categories. The first, transmission and distribution, remains regulated, perhaps under government ownership, to facilitate open access and effective electricity markets. The second, retail/supply and generation, is deregulated and the companies function as commercial entities in wholesale and retail electricity markets.

In electricity reform, significant benefits come from the combination of well-designed electricity markets and commercial participants competing in those markets. But no matter how well-designed and implemented the new European electricity markets are, few benefits will result if market participants are sheltered from the effects of the markets by virtue of government ownership.

In functioning electricity markets, operating and investment decisions of commercial participants are driven by price signals, tempered by the discipline of potential financial failure. Well-designed markets are incentive-compatible, so that participant actions to maximize profits have the additional result of producing better overall market outcomes. The actions of individual market participants combine to produce greater industry output, lower costs, and increased reliability from the same level of capital investment. As market participants compete, cost savings by producers are reflected in lower market prices to consumers.

Government-owned electricity companies might, under some conditions, behave like private competitors in the market, but it is difficult to reconcile government ownership with real commercial participation in electricity markets. Even where there has been a fairly successful effort to transform government-owned electricity companies into competitive market participants, in New Zealand for example, some issues remain unresolved. For similar reasons, it is also difficult to persuade governments to fully implement industry reform when these governments have multiple and conflicting roles, including regulator, asset owner, financial beneficiary, employer and people's representative.

Which is where the commission—and its investigations of British Energy and Electricité de France—comes in.

The British Energy case will likely set new precedents for applying rescue and restructuring aid in the electricity sector. Among the issues under consideration by the commission is whether the initial BE state aid package was ever likely to restore "long-term viability of the enterprise within a reasonable time scale and on the basis of realistic assumptions as to its future operating conditions."

The BE case may mean that the hurdle for obtaining commission approval for rescue and restructuring aid in the electricity-generation sector becomes higher and that the "one-time, last-time" rule will be applied. The BE investigation may also establish some important precedents with respect to the application of EU state-aid rules to such things as nuclear plant decommissioning and long-term fuel disposal, important issues as other countries look to privatize nuclear generators.

The EdF case involves indirect fiscal state aid, with EdF to repay significant amounts to the French government. The commission is also looking into French government guarantees to EdF and other arrangements to determine whether these constitute unlawful state aid. This application of state-aid law to indirect fiscal aid in the electricity sector suggests that a wider range of activities, from tariff-setting to dividend policies for state-owned companies, might be considered as potential state aid.

These cases come at a time when the commission is developing new guidelines for rescue and restructuring aid and is looking at more subtle and complicated forms of state aid. The commission also seems to be moving to a more active and aggressive enforcement of state aid rules in the electricity sector, using state aid control to help drive electricity industry reform. These cases, and others that will surely follow, should help move governments away from their historically tight control over the electricity sector and may even make full privatization a more attractive option. Decreased government involvement, either as owners or industry participants, will help ensure that there are viable, competing market participants when new European electricity markets are in place.

This is good news, as further delays in European electricity sector reform may create problems. Any further delay in the introduction of competitive markets, and the price-driven new investment from those markets, may mean extensive new government investment to address reliability concerns. Instead, it is time to complete the liberalization of the electricity sector. Aggressive enforcement of state aid rules will help to do this.

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