Regulatory issues in the German Gas Industry

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ABSTRACT

As a result of the second EU Energy legislation package the German Government passed a new Energy Act (‘Energiewirtschaftsgesetz’) in July 2005. Due to the new legislation the German energy market – predominantly the gas market – is now facing a major turning point that will bring significant challenges for the energy companies. This is particularly true for the following two issues:

- third party access, and
- the introduction of incentive regulation (electricity and gas)

The paper covers these two issues by highlighting their implications and E.ON’s position on these matters.
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REGULATORY ISSUES IN THE GERMAN GAS INDUSTRY

1. INTRODUCTION

In comparison to other European energy markets, energy regulation started relatively late in Germany. This is mainly based on the fact that the German Energy market – in particular the gas market – has one of the most complex market and organizational structures in the world not only because there are about 1,000 energy companies but also because of the way the energy market has evolved historically. Nevertheless this situation has changed significantly in the last decade and with the implementation process of the First EU Gas Directive. Further gas liberalization and harmonization process has been considerably accelerated with the implementation of the Second EU Gas Directive. As a result of the second EU Energy legislation package the German Government passed a new Energy Act (‘Energiewirtschaftsgesetz’, hereinafter referred to as ‘Energy Act’ or ‘legislation’) in July 2005. Due to the new legislation the German energy market – predominantly the gas market – is now facing a major turning point. That will bring significant challenges for the energy companies. This is particularly true for the following two issues:

- third party access, and
- the introduction of incentive regulation (both for electricity and gas).

The following analysis will cover these two issues by highlighting their implications and E.ON’s position on these matters.

2. INCENTIVE REGULATION IN THE GERMANY ENERGY MARKET: E.ON’S “Pro+Model"

After an initial phase of a cost-based rate-of-return regulation, the Energy Act requires the introduction of an incentive regulation system.

Incentive regulation differs from purely cost-based regulation. In the latter case, network operators’ revenues are established on the basis of their actual costs, with an appropriate return on investments. This ensures that the companies can invest to a sufficient extent in the network infrastructure to guarantee security and reliability of supply. A purely cost-based regulation system on the other hand offers no direct incentive for productivity increases and the resultant cost reductions.

Incentive regulation is different: its goal is precisely to give companies incentives of this nature. To achieve this, the companies are set upper limits or caps for their revenues (or prices) over a period of several years, i.e. they are given a budget to perform their services. The caps decrease during the regulatory period in accordance with a predefined rate of productivity increase. In this way, the customers benefit from the specified increase in productivity. Individual network operators have an incentive to increase their productivity beyond the specified value, since the additional productivity increases are for their own benefit if they succeed in generating them.

By 1 July 2006, the German regulatory authority (hereinafter ‘regulator’) must submit a report to the Federal Government containing an appropriate plan to implement an incentive regulation system. The incentive regulation will then be set out in detail in a decree. Up to now it is unclear what the concrete details of a German incentive regulation scheme will be. As part of a wider consultation process with the regulator, industry players and other stakeholders are currently debating different approaches. E.ON is proactively involved in this process and has proposed an own model – the so-called “Pro+ Model”. The model has received a positive feedback by many stakeholders. The following section will briefly illustrate its core elements:

- The general problem with incentive regulation lies in setting the correct incentives. Experience with incentive regulation in other countries shows that this is a difficult balancing act. In many cases, companies have been able to achieve the required cost reduction only by postponing and neglecting necessary investments. While customers get to enjoy lower prices in the short
term in this way, this is often at the expense of security and reliability of supply. In the longer term, delayed investment in the neglected assets results in higher costs to the customers and economic damage.

- Therefore E.ON believes that specific mechanisms for capital expenditure (CAPEX) and operating expenditure (OPEX) must be provided to avoid these risks on the one hand and to make it possible to pass the specified productivity increases on to the users on the other. Specific mechanisms for CAPEX and OPEX reflect the particular importance of capital expenditure in quality of supply.

- In the case of CAPEX, upper limits for capital expenditure have to be set on the basis of individual network company investment budgets to this end. For this reason network operators should submit an investment plan to the regulatory authority at the start of a regulatory period which is then checked by comparing key parameters (e.g. specific costs per connection). The checking process should focus on granting an investment budget rather than checking individual investment projects. Network operators would then be free to decide which specific investment project they wanted to implement, and when and where they wished to do so. They would have the certainty that the costs of their investments were being fully taken into account in the calculation of their network charges, as long as they did not exceed the investment budget. This provides an adequate limitation of the regulatory risk which is necessary to create investment conditions that support reliable and secure networks. Specifying an investment budget makes it possible to create the necessary incentives to increase productivity, at the same time as providing a reward for not exhausting the budget whilst achieving the agreed investment goals.

- In the case of OPEX, the caps decrease in line with the average increase in productivity for all structurally comparable network operators. This gives individual network operators an incentive to increase their productivity by more than the average, since they keep any surpluses generated by exceeding productivity targets. Competition develops between network operators to achieve the greatest possible increase in productivity, which causes average productivity growth to accelerate. All productivity growth is passed on to network users. At the same time, measures are put in place to prevent the sector from becoming overstretched by unrealistically high productivity targets and being forced into asset sweating.

   Not all companies are equally efficient at the start of the incentive regulation process. Those that have already implemented extensive measures to increase productivity and already demonstrate a high level of efficiency may not be disadvantaged as a consequence. For this reason, higher individual productivity targets must be set for the less efficient companies during a limited transitional stage. This gives them a chance to catch up with companies that are already more efficient. To implement the necessary adaptation, the efficiency of structurally comparable network operators is compared at the start of the regulatory process. It is important that only those companies whose supply tasks are actually comparable are compared with each other. There are a range of methods to compare efficiency. Several procedures must be applied in parallel to obtain the most robust result possible. The companies are then given individual productivity targets based on the efficiency comparison. The companies that are already efficient are given a reduced productivity target, adjusted to allow the less efficient companies to catch up. At the end of the catch-up phase, which may run for several regulatory periods if appropriate, all companies will be set the average productivity increase as a target. Efficiency comparisons will be performed again at the end of the regulation period. The goal is to check the quality of the initial benchmarking against a database that has been improved in the meantime and either to confirm the productivity targets derived from it or to adjust it for future application. To avoid compromising incentives for productivity increases, savings in operating expenditure that exceed the productivity targets must remain with the network operators.
To sum-up the advantages of such an incentive scheme are:

- Strong incentives for network operators to increase productivity.
- Complete transfer of average productivity to increase to customers via accordingly reduced prices.
- Appropriate planning limitation of regulatory risk and therefore reasonable investment climate to deliver adequate network quality and security.

3. THIRD PARTY ACCESS: THE NEW GERMAN ACCESS MODEL

Probably one of the issues most debated during the negotiation process of the new German Energy Act were the rules on third party access to German gas networks. Even after the law’s implementation process all involved stakeholders heavily discussed how the new network model shall be designed and work in the future. These ongoing debates illustrated very well the different interests of the involved parties.

The provisions on third party access are laid down in the law and in the related gas access decree. Generally speaking, according to the Energy Act gas network operators must grant access to all parties without discrimination. The terms and conditions, including sample contracts and charges, must be published online. However, the organisation of third party access is governed in greater detail by the network access decree. One of the key elements of the access decree is the requirement that each network operator to introduce an entry-exit regime for their network system. Apart from this core provision of the network access decree the Energy Act included a clause (section 20 (1b) of the Energy Act), which was subject to many difficult discussions between the regulatory authority, network users and operators. According to section 20 (1b) of the Act the network operators must work together to ensure that, in the case of transport via several networks, the transport customer has to conclude only one contract for entry capacity with the network operator in whose network the in-take takes place, and one for off-take capacity with the network operator from whose network the gas is withdrawn. However, the network users are still allowed to book separately capacities at regional and/or city gate level. This allowed all involved parties – particularly traders – to have greater flexibility for network use.