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Energy provision, local government and the market – the German case

This entry on "the German case" will come in four steps

- first, an overview of the development and setting of the provision of public utilities (*Daseinsvorsorge*) by local government will be given.
- Second, the impact which recent EU deregulation policy has had on this sector.
- Third, energy provision will be dealt with as a case in point
- Finally, some concluding remarks will be made.

1. Historical background and institutional setting

Reaching back to the 19th century the scope of operations of the local authorities, under different organisational forms, in the public utilities and public services (*Daseinsvorsorge*) sector has traditionally been broad.
The mushrooming urban population obliged local authorities to take on new responsibilities in the crucial fields of gas, electricity and water supply, sewage, waste removal and public transport (cf. von Saldern 1999: 30 ff.; Püttner 1999: 541). This sector of activities, in German called *Daseinsvorsorge*[1], has traditionally been governed by the notion that local authorities should act in the interests of "the common good of the local community".

Thus, legally (and conceptually) this broad range of economic activities of the local authorities which forms a lion's share of what is called "communal economy" (*Kommunalwirtschaft*, see Püttner 1999) hinges on principle of "public purpose"/"general interest" (*öffentlicher Zweck*). This formula has been laid down in legislation adopted by the individual *Länder* aud it understood as legitimating and, at the same time, limiting such economic activities (see Held 2002). In curtailing the scope of activities of the local authorities it. By barring the local authorities from embarking upon such activities for the

[1] The term "Daseinsvorsorge" in its literal translation would sound something like "provision for the existence" and, in substance, covers the range of public services to ensure "the provision of existence". The term was cointed by *Ernst Forsthoff* in the 1930s. It has, in the meantime, entered the legal language in the legislation of several *Länder* (see. Held 2002: 12).

mere purpose of profit-making and by restricting them to their own territory, *Örtlichkeitsprinzip* it seeks to prevent the municipalities from venturing into economic activities of the private sector sort. In claiming to pursue "public purpose" and "general interest" the municipalities have, in past, often created "closed" or "protected" local markets and formed local "quasi-monopolies" in the production and delivery of certain public services (on such "local monopolies" see Ude 2006a). This is manifested by the adoption of local bye-laws (*Satzungen*) through which all local residents (and private enterprises) are obliged to exclusively link up and use (*Anschluss – und Benutzungszwang*), for instance, the local water supply system or local waste treatment system.

The intention to make use of the "general interest" formula and of the underlying mandate to do this "for the economic, social and cultural well-being" of the local residents (to quote from Bavaria's Municipal Statute) come also strikingly to the fore in the different approaches of the local authorities in setting prices, fees and charges for public utilities While, in the fields of water supply and electricity and gas, in many cases the policy has been to charge the full "production (or procurement) price" (and perhaps even more) on the local consumers, the user charges in other fields of local activities, particularly in public transportation and cultural facilities, have been, by political intention and decision, set way below the "production price"[2] in order to take social and other general political aspects into consideration. Moreover, the "general interest" and "public purpose" mandate was taken as a comprehensive and redistributional concept that would suggest and warrant to use revenues extracted from profit-making subsector of *Daseinsvorsorge* for (in what was called "cross-subsidies", *Quersubventionierung*) for compensating losses in other fields whose deficits are caused not least by social concerns (such as public transportation) (see Püttner 1999: 543; Reidenbach 1995: 85). While local authorities are not allowed to make, on balance, profits from their public utilities sector, they, thus, have been allowed, if not encouraged to "cross-subsidies" certain services. .

The repertoire of institutions which local authorities conventionally employ for the provision of public utilities (see Richter 2001: 401) comprises *Regiebetriebe* (municipal enterprises operated by an intra-administrative agency) *Eigenbetriebe (*which are run as organizationally and economically independent companies, but remain local government-owned) as well as

[2] For instance, in 1999, on the average, almost 100 percent of the costs which the municipalities incurred for sewage and waste removal were covered by the prices and fees paid by the citizens, while in the provision of

Eigengesellschaften (which, legally and organizationally, are limited companies or joint stock corporations, often mixed municipal-public-private ownership). For a long time the *Regiebetriebe* and *Eigenbetriebe* prevailed, mainly to ensure the influence of the local authorities on their operations (see. Held 2002: 16). More recently, increasing use has been made of *Eigengesellschaften*, "because the *GmbH* (limited) status gives the shareholder (the municipality) greater freedom to structure the partnership arrangements and agreements" (Richter 2001: 401). The, as it were, holistic concept of local policymaking that underlies the local provision of public utilities (*Daseinsvorsorge)* demonstrates itself in the strategy of using surpluses, made in "profitable" types of public utilities (particularly electricity and gas supply), for "cross-subsidizing" deficit-generating activities, e.g. public transport (cf. Püttner 1999: 543)

The "classical" and most important institutional form in which the local authorities have pursued these activities are the so-called "city works" (*Stadtwerke*) which, being mostly organised as legally self-standing "Eigengesellschaften" (limited companies or stock companies), typically are functionally integrated ("bundled") undertakings which are engaged in the supply of electricity and gas, water supply, public transport and other public utilities (see Reidenbach 1995: 84). With regard to energy supply where the functional and operational distinction is made between production, transmission and distribution, the *Stadtwerke* have involved in the entire chain with a focus on the latter two components. Throughout the development (and recently increasingly so) private investors and companies have become partners and shareholders in municipal undertakings in giving them a "mixed economy" (*gemischtwirtschaftlich*) pattern.

The share of public utilities and services provided by the local authorities in one of the organisational forms were (in the mid-1990s, following the estimates presented by Reidenbach 1995):

- production of electricity 11 percent
- distribution of electricity 29 percent
- distribution of gas 67 percent
- water purification 95 percent
- elimination of waste 95 percent

kindergartens only 40 percent, in that of theaters only 30 percent and in that of public libararies only 10 percent of the costs were covered by prices and fees (see Karrenberg/ Münstermann 2003: 49)

- water supply 85 percent
- public transport 64 percent.
- The municipally- and county-owned saving banks hold about 20 percent of the entire volume of bank deposits (see Püttner 1999).

In sum, in their perception and practice the realm of public utilities makes "makes for an important component of local self-government. The municipal enterprises which form the municipal economy are instruments in the fulfilment of the local government's tasks" (Deutscher Städtetag 1999: 113). This sector serves as the basis and the "manoeuvre space" for an array of local policy initiatives in the social, ecological and other fields.

2. The impact of EU deregulation policy on the public utilities (Daseinsvorsorge) sector.

Since the 1990s German local governments have been, in their public services (*Daseinsvorsorge*) sector, increasingly faced a clash with and repercussions from the market-liberalisation policy which has been conceived and engineered by the European Commission (EC).

In postulating, as the prime goal of the European Community, to create "a common market" (Article 2 of the Treaty Establishing the European Community, EC Treaty), the "internal market (is) characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital" (Article 3, Paragraph 1, lit. c EC Treaty). For this follows the general thrust of the EC to demand and enforce (in principle: EC/EU wide) "market competition" for the production and provision of all services. As, thus, all forms of "closed markets" and "monopolies" between, but also within the EU member states were bound to be seen a violation and distortion of competition and market liberalisation, the traditional forms of public services (*Daseinsvorsorge*) provision in the German local government system (with their "closed market" and "local quasi-monopoly" elements) were liable to become a prime target of EU market deregulation.

Two strategies pursued by the EC can be distinguished.

For one, the EC has pushed for establishing the principle of competition, by way of competitive tendering, between and within all members countries for services, whereby competition is also to include what, in EC terminology, are called "economic services of general interest" (which, by and large, is an equivalent to the German *Daseinsvorsorge*). While, on the one hand, determinedly pursuing the competition strategy, the EC was ready, in the face of opposition and objections on the part of member country governments, to settle with a compromise in which such all-out competition principle should take account and be moderated by specific national or local traditions in member states. The course of conflicts shows that Germany's local government tradition in the provision of public services (*Daseinsvorsorge*) loomed large in the controversy.

The contention and compromise surfaces.in the articles 16 and 86 section 2 of the EC Treaty which were inserted as part of the Amsterdam Treaty package of May 1999[3]. While in the latter it is made clear that the general principle of competition should also apply to the "operation of services of general economic interest", some allowance and reservation is made (albeit in vague rather than precise terminology) that the application of competition should "not obstruct the performance, in law or in fact, of the particular task assigned to them". In subsequent EC documents (particularly in the "information" published by the EU Commission on September 20, 2000, in the EC Green Paper of 2002 and the EC White Paper of 2004) the EU Commission made it clear that its long-term goal was to make "competitive tendering" in "economic services of general interest" prevail without exception, but that it was ready, for the time being, to accept national and local peculiarities (and deviations).

In the case of the German local authorities and their provision of public services this means that they are exempt from the rule of "competitive tendering" insofar as these public services are produced and delivered by local authorities themselves or by municipal units or undertakings over which the local authority exercised full control (which applies to Regiebetriebe as well as Eigenbetriebe, but also, in part, to Eigengesellschaften). In these

[3] see article 16 EC Treaty: „.....given the place occupied by services of general economic interest in the shared values of the Union as well as their role in promoting social and territorial cohesion, the Community and the Member States, each within their respective powers and within the scope of application of this Treaty, shall take care that such services operate on the basis of principles and conditions which enable them to fulfil their missions.". And see article 86 section 2: „2. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Community.

cases one speaks of "in house commissioning" which is exempt from the rule of competitive tendering.

However, the European Court of Justice has moved, in a series of decisions, to extend the rule of competitive tendering and to correspondingly, narrow the scope of local authorities to commission public services without tendering.

- First, the Court ruled (on January 11, 2005 in the "Halle case")[4] that, as soon as private investors and companies are involved in the municipal undertaking corporation, and be it only with a minority share, that is, in a case of "mixed economy", the rule of competitive tendering will apply.
- Second, the Court decided (on October 13, 2005 in the "Parking Brixen case")[5] that even when the undertaking is entirely (100 percent) owned by the municipality, but organised as private law stock company (Aktiengesellschaft), the municipality can treat this a a case of "in house commissioning", but has to go through competitive tendering.
- Third, the Court ruled on January 13, 2005 [6] that a municipality is not exempt from competitive tendering when and where it has formed an interorganisational cooperation (of the PPP sort) with other municipalities or other public agencies for the delivery of the service in question.

In line with trust to make competitive prevail the EC was also eager to extent its control over any kind of public aids" (*Beihilfen*), including "cross-subsidies" (*Quersubventionierung*") within municipalities. On July 24, 2003 the Court handed down a decision that subsidies that were paid do regional and local mass transport enterprises are not regarded as "state aids" (falling under EU regulation, if the are meant as a financial compensation for fulfilling public service obligations (*gemeinwirtschaftliche Verpflichtungen*). This decision was hailed by the German local government representatives as apparently implicitly applying to and upholding the principle and mechanism of "cross-subsidising" (see Deutscher Städtetag 2005: 17)

Thus, on the one hand, the local authorities are facing the increasing "deregulatory" pressure from the EC which obliges them expose an ever wider range of their economic activities in the public utilities sector (if organised in the "mixed economy", the PPP, but also in the stock company form) to competitive tendering, and hence to become part of the general market

[4] see European Court of Justice, "Halle", January 11 2005, C-26/03, see also Leutner 2005, Killian/Richter/Trapp 2006: 17 with further references.

[5] C-458/03)

competition. On the other hand, they are still inhibited by the still retained rules of the traditional legislation on "communal economy" which, through the "locality principle", obliges them to restrict their economic activities to their own territory and prevents them to seek, as the other side of the competition coin, their business opportunities outside their "locality" (see Held 2002).

3. Energy (electricity) provision as a case in point

The other strategy the European Commission embarked upon in pursuit of its market-liberalisation policy was target at particular sectors, first all, the energy sector (electricity and gas). In the following the deregulation of the electricity sector will be taken up as exemplifying its impact on the local government's involved in the provision of electricity as a traditional important component of public utilities (*Daseinsvorsorge*).

At this point the distinction should be recalled that needs to be made, in the provision of electricity, between

- production,
- transmission and
- distribution/sale/trading of electricity.

Until the late 1990s the German electricity market, it is true, was, to a large degree, dominated by the large regional energy companies, the likes of *RWE, Viag*, which produced 80 percent of the energy, owned most of the long distance (high voltage) transmission lines and also handled 70 percent of the distribution to the end consumer. But, municipal undertakings, particularly the some 1.000 "city works" (*Stadtwerke)*, were involved in some 10 percent of the production, owned a majority of the short-distance and local (low voltage) transmissions net and held some 30 percent in the distribution of electricity (see Vorholz 2006). Furthermore, due to a German peculiarity, the municipalities have the right to take a "concession fee" (*Konzessionsabgabe*) for allowing the energy undertakings (be it external ones or their own *cityworks*) for using the public space and the local roads for setting up and operating their transmission facilities. This local "concession fee" has become a handsome revenue source for the municipalities – amounting, for instance, in 2000 to total of 6 billion € (see Deutscher Städtetag 2001: 112). Well unto the mid-1990s the German electricity market

[6] see European Court, case "... Spain" of January 13, 2005, C-84/03)

has rigidly divided up, by way of "territorial agreements", among the big energy companies. Within their local turf the municipalities' *cityworks* fell in line by virtually establishing and exercising "local monopolies" (see critically Uhde 2006). Hence, price competition was practically absent, regionally and locally, on the German energy market

The EU intervention directed at introducing price competition in the electricity markets came in two rounds.

In compliance with a EC Directive of 1996 which obliged the EU member countries to ensure price competition of the national electricity markets in Germany the (federal) Energy Management Act (*Energiewirtschaftsgesetz)* in 1998 which was targeted at breaking up the existing oligopolist structure. The immediate effect of the federal legislation, somewhat ironically, was to strengthen the large companies (and, in effect, to accelerate the concentration process manifested by the merger of VIAG and Veba to become a the new energy giant E.on), while exposing the "city works" to pressure from the even more dominating "Big Four" (RWE, E.on, EnBW and Vattenfall)[7]. Besides finding themselves under the competitive pressure by what the local authorities called "dumping prices"(see Deutscher Städtetag 2001: 111) of external energy companies, they complained about increasing difficulties to pursue local energy related strategies particularly in the field of energy conservation and environmentally friendly energy production, such as as combined heat and power (*Kraft-Wärme-Koppelung*). production. Largely in reaction to demands from the local government associations federal legislation (Renewal Energy Act and Act on Combined Heat and Power Generation) [8] was passed which, entering in force on April 1, 2002, was to enable the municipalities and their *cityworks* to continue to engage in alternative energy production (see Deutscher Städtetag 2001: 111).

The second round was opened when in 2003 the EC, in the so called Acceleration Directive (on the electricity market)[9] pushed for a further move of market liberalisation in the electricity sector by focusing on the transmission of energy as the crucial link between production and distribution. The key concept was to ensuring the free and competitive access to the transmission net, both for producers and consumers, by breaking up ("unbundling") the

[7] see forum "Stadtwerke 2005" (City works 2005) www.innovations-report.de/html/berichte/energie_elektrotechnik
[8] Gesetz zum Schutz der umverträglichen Stromerzeugung aus Kraft-Wärme-Kopplungsanlagen, KWG-G)
[9] (RL 2003/54/EG

organisational and economic integration of the three crucial functions (production, transmission and distribution). As the "city works" have traditionally operated as functionally "integrated" undertakings which, in often owning the local (low voltage) transmission lines, exercised a factual "quasi-monopoly" on the access to (and also the "pricing" on) them, the "city works" were a prime target of the new EC regulation drive. Not surprisingly, the EC's "unbundling" imperative was resented by the local authorities. as "grave interference with the right of local self-government" (see Deutscher Städtetag 2005: 131).

In compliance with the new EC Directive an amendment to the *(federal) Energy Management Act* (*Energiewirtschaftsgesetz*) was adopted and went in force on July 13, 2005. It establishes an entirely new regulatory regime over the energy (electricity and gas) market.

- As a crucial organisational move the energy market was put under the regulatory agency (*Bundesnetzwerkagentur*) that had been created on January 1, 1998 for telecommunication and postal services and whose regulatory oversight has now (since January 1, 2006) been extended to the energy (electricity and gas) sector. Its main responsibilities are to approve and control the transmission net user fees and to ensure the discrimination-free access to the transmission grids. With regard to energy enterprises with less than 100.000 clients and with transmissions grids within *Länder* boundaries the regulation and control falls to the *Länder* authorities.
- Under the 2005 amendment of the Energy Management Act the companies operating transmission grids are obliged to open up their grids (without any discrimination) to all clients on the basis of an adequate ("*angemessen"*) fee.
- The system of *regulated* transmission net access replaces the previous principle of "negotiated" access (on the basis of agreements between the interested parties).
- The company operating the transmission grid can only charge such fee as approved by the regulation agency (*Bundesnetzagentur*).
- The regulation agency oversees the transmission grid company. The clients can turn to the regulation agency in all matters (complaints etc.). The regulation agency may intervene and rectify (and also sanction) violations.
- All (larger) energy providing companies (with more than 100.000 clients) are obliged to "unbundle" the transmission net operation from all other economic activities, particularly from production and distribution/trade. The "unbundling" mandate is seen as the key concept to prevent the production and/or distribution/trading interests from directly overshadow and prejudice the transmission function.

- It should be noted, however, that under the 2005 amendment the (smaller) companies with less than 100.000 consumers have been explicitly exempted from the "unbundling" obligation As this exception and exemption (revealingly) applies to many of the "cityworks" (Stadtwerke), it reflects the underlying legislative compromise through which the local authorities succeeded in warding off the full application of the EC's "unbundling" logic.

In belying earlier misgivings in which the imminent "death of the *cityworks*" ("*Stadtwerksterben*") was foreboded the *cityworks* have done remarkably well in coping with the changed competitive context. They have pursued a range and rate of activities which which point at maintaining, if not strengthening their role in the energy market..

- In order to economise and to join forces (not least for strengthening their "negotiating" power) *cityworks* have formed "transmission grid operation companies" (*Netzwerkbetreibergesellschaften*).
- In a similar vein, they have created "shared services" (with regard to billing, book keeping, call centres etc.).
- Furthermore they have formed joined offices to purchase energy "on the energy market".
- Moreover, in the light of ever increasing energy costs *cityworks* have begun to make capital investments into buying shares of energy production enterprises or into building new power plants of their own[10]

At the same time, however, a good many of the local authorities have shown to be ready, for financial reasons or in order to widen their technical competence and business base, to sell a share of their *cityworks* assets to outside energy providers. On the basis of a recent survey of energy undertakings of big cities only 30 percent of them are still entirely owned by the municipalities, whereas more than 70 percent have external (minority) shareholders (see Trapp 2006). Among the latter the big Four (E.on, RWE, EnBW and Vattenfall) have acquired (minority) holdings in about one sixth of the 1.000 city works and have thus further strengthened their entry and foothold in the regional and local distribution markets. (see Vorholz 2006).

4. The overall perspective in ambivalence.

[10] see Ernst & Young 2003 for the results of a survey of the directors of 105 city works and regional energy providers according to which 28 percent plan to become shareholders in power plants, while 10 percent even intend to invest in a power plan of their own.

On the one hand, many "municipal works" (*Stadtwerke)* (particularly those that supply electricity rather than those than generate it) seem to have adapted remarkably well to the new competitive environment (cf. Libbe et al. 2002: 11). Recent federal legislation, such as the Renewable Energy Act and amendments to the Act on Combined Heat and Power Generation of 2002, has significantly supported this development by enabling local power stations to continue pursuing environmentally beneficial concepts (cf. Libbe et al. 2002: 11). So local government's energy agenda looks still promising.

On the other hand, the market opening and market pressures, with their focus on short term profitability and yields, tend to squeeze out policy approaches which contribute to ensure long-term "sustainable" goals of energy provision, particularly through alternative energy generation and energy saving, but may fail on short-term gains (see Deutscher Städtetag 2002: 111, see. Müschen 1999: 68 ff particularly on local energy saving strategies).

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