

THE EMERGENCE OF DISTRIBUTED GENERATION UNITS IN EUROPE

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The views presented in this paper can be referred only to author who is sole responsible for them.

ABSTRACT

In this paper, we will focus on the relationship between innovation and industrial organization in electric power industry. With the deregulatory reforms in Europe, the influence of new generating technologies on the current evolution of the power sector seems to be relevant to study. Recent technological advances have resulted in the emergence of distributed generation units. Reactions of several American and European electric utilities to the emergence of these new units have to be underlined.

RESUME

Dans cet article de recherche, nous nous intéressons à la relation entre innovation et organisation industrielle dans le secteur de l'électricité. Avec le processus de dérégulation en Europe, le rôle des nouvelles technologies de production apparaît fondamental dans l'évolution de l'industrie électrique. Les récents progrès techniques ont favorisé le développement d'unités dites de production distribuée. Les entreprises traditionnelles américaines et européennes adaptent leurs comportements à l'émergence de ces nouvelles petites unités de production près des lieux de consommation.

INTRODUCTION

Worldwide, for the last two decades, energy network industries have undergone major changes in terms of industrial organization and competitiveness. Led by a combination of economic, technological and political forces, these industries are now less and less protected and controlled by governments. Deregulatory initiatives have been taken in the electric power industry to eliminate traditional constraints and

protectionism. A new era has emerged : in some segment of the value chain, electric monopoly activities are now open to competition.

In several industrial sectors, especially in networks industries, monopolies are regarded as either directing or delaying innovations. There is an obvious link between the form of industrial organization and the dynamic of technological progress. Thus, one concern is raised : the role of technology in the new emerging structure of electric industries and more precisely, its contribution to change monopolistic situations in various activities.

With the deregulatory reforms, the influence of new technologies on the current evolution of the generating power sector seems to be highly relevant. In power generation activity, current deregulation entails a fundamental shift from guaranteed cost recovery to open market competition. The traditional utilities have to adopt new strategies if they want to survive. The need to reduce costs has been the key driver of the present transition which has been furthered by a technology push. Result of the last years of generation research has been the evolution of thermally efficient technology for the production of electricity at much smaller unit sizes than those which dominated the industry. Recent technological progresses have resulted in the emergence of so-called distributed power generation system. Reactions of electric utilities to the emergence of these new units have to be underlined.

In this paper, we will focus on the relationship between innovation and industrial organization in electric power industry with the case of distributed generation units in the liberalizing European electricity market. **In the first part**, the theoretical impact of new technologies on industrial organization and vice-versa will be discussed in Economy (keeping in mind that technological progress' dynamic is different in a regulated market than in a competitive one). Then, **in the second part**, the evolution of power generating system towards new highly efficient distributed generation units will be studied. These technological improvements might revolutionize not only generation activity but the whole power industry. **Finally**, the emergence of distributed generation units in the liberalizing European electricity market will be presented in order to underline the drawing forces and obstacles of the development of some small generators on site.

These new distributed generation units represent technological advances which are capable of reducing much of the monopoly in the power sector. The liberalization of the European electricity market accelerates the development of innovative small scale power generation. The pressure of competition will push incumbent utilities as well as new entrants to look for any source of economic efficiencies in order to secure a competitive advantage and sufficient margins. In the United States, electric utility companies have shown agility and strength in controlling the new technology rather than letting their positions erode. In Europe, the explosion of interests in distributed generation units over the last years has resulted in intense competition with new rent-seeking players.

1/ INNOVATION AND MONOPOLY

Network industries such as natural gas, electricity and telecommunications are defined by the need to dispatch goods or services over a *network* that constitutes a natural monopoly. They have long been structured in accordance with the belief that a single company can provide services more efficiently. An industry is a natural monopoly "if total costs of production are lower when a single firm produces the entire industry output than when any collection of two or more firms divide the total among themselves"¹. This single firm is characterized by² economies of scale existing when the average costs of production decrease as output expands. In Economics, the old concept of "natural monopoly"³ refers to an industry

where the technological advantages of large scale production preclude efficient competition among smaller companies.

By the beginning of the twentieth century, it was recognized that railroads, telecommunication and local public utilities possessed to certain extent some degree the characteristics of a natural monopoly. For nearly a century, worldwide these sectors had been thought of as a natural monopoly industries where efficient production required reliance on monopoly suppliers subject to government control of prices, entry, investment, service quality and other aspects of firm behavior. Concerned for the public interest, these industries were regulated in the United States and publicly owned elsewhere. "*The essence of regulation is the explicit replacement of competition with governmental orders as the principal institutional device for assuring good performance*" (A.KHAN, 1970, p.3). Regulation initially required detailed authority over the levels and type of services, revenue amounts, minimum and maximum rates in order to prevent sector concentration, to hinder destructive competition, to develop the infrastructure and to protect consumers.

Despite these goals, the reality of regulation became different. The lack of competition caused by the regulatory regime left firms and entire industry structures frozen over the decades. They had no incentive for innovation. In a regulated market, companies are not incited to invest in technology to improve operational efficiencies. For example, H.AVERCH & L.JOHNSON (1962) argued the rate-of-return regulation leads to an inefficient use of capital. When regulators set the allowed rate-of-return above the cost of capital, the utility uses more capital than if it were unregulated. This constraint creates an incentive for the utility to accumulate an excessive amount of capital relative to the cost-minimizing level. Excess capitalization (the so-called "*Averch-Johnson effect*") arises from the absence of competitive pressure on producers.

Conversely, technological performances can be stimulated by regulation. In some situations, protection and constraints imposed by regulators favor development of new technologies. Competitive firms could not afford to invest in some new technology. A regulated firm can be more able to support such costs. For instance, in France, during the mid-80s, E.D.F. innovated in building large efficient power plants (≈ 1400 MW)⁴.

The majority of **academic literature** has not focused on the regulated firm's incentive to adopt new technologies. The effects of regulation on technology are not so clear (R.VIETOR, 1994). One intuitive reaction is that monopolies stifle innovation and are technologically obsolete. The general perception is that regulation discourages innovation. According to A. KAHN "*It seems a fair generalization that regulation has on balance been obstructive both of competition and the innovation that it helps stimulate and justify*" (1988, p.247). Although regulated companies operated under the regulatory constraints, their financial health was guaranteed. Authorities were careful to ensure financial viability of these firms by shielding them from competitive forces and other risks. In one of the few theoretical analyses of the issue, G. SWENNEY argues that "*in many circumstances a regulated monopolist can maximize the present value of profits only by delaying adoption of an innovation*" (1981, p.437). In the specialized press on energy, interviews with top executives indicate that they also believe regulated firms are slow to adopt new technology. Traditional electric utilities avoided to developing new technologies which could erode their situation.

As economists have recognized for many decades (F.SHERER & D.ROSS 1991, W.SHEPHERD, 1996), monopolies tend to delay technological progress in a variety of industries. Different technologies would have been developed in the absence of regulation. AT&T would have digitized its network much earlier in a competitive environment. Similarly, prior to deregulation, airlines favored large aircraft for trunk line operations which were dominant before 1978. Regulation did not require maximum of utilization of airplanes for continued service. After deregulation, hub-and-spoke operations called for smaller planes.

In a deregulation process, innovation can be the key to **erode or eliminate monopolies** by giving new comers special advantages as it has also occurred in many sectors. The state of technology in the past must be considered as well. An important argument to defect regulated monopoly is its failure to recognize that new technologies evolve over time that they are efficient at much lower level of output than old methods of production. The dynamic of technological progress depends on the degree of competitive pressures (N.ROSE & P.JOSKOW, 1990, R.VIETOR, 1994 et W.SHEPHERD, 1997).

In the **electric power industry**, regulation is often thought not to incite innovations. For instance in the United States, capital cost disallowance based on avoided costs, thus penalizing high costs or low performances outcomers, discouraged the adoption of new technologies which performance is uncertain. In the past, significant speed variations with which American utilities have adopted new generating technologies have been demonstrated (P.JOSKOW & N.ROSE, 1985). The electric power industry's organization has evolved through new technologies and progressive deregulatory laws. In 1978, the Public Utility Regulatory Policies Act (*PURPA*) helped to stimulate innovations in combined cycle generating technologies using natural gas as fuel. Ever since, independent producers, appeared with *PURPA*, have built most of the new generating capacities. During the eighties, smaller power plants with shorter construction cycle than traditional plants have been built by an increasing number of independent producers. The 1992 Energy Policy Act (*EPAAct*) has promoted competition in the wholesale market by expanding opportunities for independent producers to sell electricity to utilities for resale. Competition and innovation have been increasing gradually.

2/ DISTRIBUTED GENERATION UNITS

For two decades, the electric utility industry has undergone a major transformation from a regulated market place to one exposed to the influence of market forces (JM. CHEVALIER, 1997). It is still unclear what kind of organization will emerge from these changes. Potentially competitive segments are being separated from the natural monopoly segment. The changes are designed to foster competition in the power generating activity and to reform regulation of the transmission and distribution functions, which continue to be viewed in some extent as natural monopolies.

Although claims about "natural monopoly" continue to influence public policies and academic discussions, this concept has become less relevant to some activities of modern power industries⁵. It is sometimes argued that creating a separate generation sector now makes sense : as a matter of fact the generation of electricity is no longer a natural monopoly due to technological change. The most important assumption underlying the proposal to deregulate electricity generation is that once deregulated, the electric generation market is expected to perform much more like a competitive market than one that has been historically plagued by natural monopoly. In the deregulation process, the power industry has virtually abandoned the idea of continuing to build large expensive central power plants which take years to build, require miles of distribution wires and take decades to pay off (see the discussions on stranded costs).

As soon as the total cost of new power plants became smaller than the operating cost of traditional plant, new units have been developed. Obsolete facilities have lost a lot if not all of their financial value. Thus, such facilities provide the bases for claims of **stranded costs**. For J.SCHUMPETER⁶, obsolete investment (stranded costs) is the price that incumbent firms pay for technological progress. He deplored policies that slowed innovation or compensated those that it harmed. But in the absence of stranded cost recovery, some utilities might have to divest some assets in order to remain financially viable. Probably the most critical issue associated with new power technologies is : how to address stranded generation costs.

In power generation activity, current deregulation entails a fundamental shift from guaranteed cost recovery to open market competition. The need to reduce costs is the key driver of the present transition which has been furthered by a technology push. For the past years, result of generation research has been the evolution of power technology for the production of electricity at much smaller unit sizes than those which dominated the industry. Recent research and development progresses have resulted in the emergence of **distributed power generation units**. This is a term for a diverse group of technologies aimed at generating electricity close to the place where it is used, instead of generating at large centralized power plants and transmitting the power to users over long stretches of wire. More precisely, distributed generation consists of integrating in the electrical system small or medium power range distributed resources facilities sited either on or in close, proximity to the end-use customer's premises. Some of the technologies that can be placed near users include microturbine generators, windmills, solar cells, photovoltaic and fuel cells⁷.

Many analysts say that future demand will be met by smaller generators which are closer to where the electricity will be used. Gas microturbines are the latest distributed generation option. Small natural gas turbine plants can generate electricity at a lower cost and therefore more efficiently, than more traditional and considerably larger coal plants. At the current low prices of natural gas, these smaller units compete favorably with traditional coal units.

Table 1 : Comparison with gas microturbines.

| | Gas Microturbine | Gas turbine | Fuel cells | Gas turbine combined cycle power plant | Existing coal power plant |
|---|------------------|-------------|--------------|--|---------------------------|
| Capacity | 5 -300 kW | 1-30 MW | 3 kW - 3 MW | 400 MW | 300 MW-400 MW |
| Efficiency (% converted to electricity) | 21%-30% | 21%-42% | 40%-65% | 60% | 32%-35% |
| Cost (installation per kilowatt) | \$300-\$900 | \$650-\$900 | \$900-\$3000 | \$350-\$400 | \$900-\$1300 |
| Maintenance (per kilowatt hour) * | 0.3¢-1.0¢ | 0.3¢-0.8¢ | 0.5¢ - 1.0¢ | 0.2¢- 0.4¢ | 0.5¢- 1.0¢ |
| Emissions (nitrogen oxide, pounds /MW) | 0.1-0.5 | 0.1-2.0 | 0.1-0.2 | 0.2 | 4.0-10.0 |

* Costs do not include price of fuel, which varies depending on source. ¢ = US\$ cents

Source : Web sites of Electric Power and Gas Research Institutes (1998,1999).

Manufacturers of microturbines are promoting them as low-cost and low pollution method of generating electricity on site. While the generator may be a perfect fit in remote areas like oil rig sites and gas fields, where it can produce electricity from natural gas which is often simply burned up, manufacturers have come up with 300 other applications, from powering supermarkets to making pizza, and helping power companies meet peak demand. With generation on site without long lines, electric power transmission (not environmentally wanted) or might disappear. A transmission problem still persists : the natural gas supply which is costly is necessary to microturbines. Table 1 indicates how gas microturbines stack up against other energy sources currently available or under development.

An advantage inherent in all of these distributed generation technologies is a reduced reliance on the electric grid. Customers served by a neighborhood fuel cell or small gas turbines would not have to worry as much when the wind blew. Distributed generation could be especially valuable to customers who want to build

new homes in remote areas without incurring the cost of building several miles of new wires. These new units could also help utilities to keep down costs for customers by easing congestion on existing wires. Decentralized generating systems draw a competitive supply advantage as a result of the location close to the load or near congestion points of the network. If a new subdivision or industrial park threatens to overtax the existing wires, the utility could either upgrade the lines (the traditional choice) or put a small generator in the area of new growth. As the new technologies are refined, the latter choice will become much more cost-effective. These new technologies offer significant environmental benefits. They are clean, quiet and small. Many have no air emission, and even those involving combustion are insignificant sources of emission because of their size and location.

With these technological advances and the loss of significant economies of scale in production (C.BAYLESS, 1994), a new generation market is emerging and is about to revolutionize the electric power industry's organization. Distributed generation units have changed the fundamental premise that shaped electricity systems for more than a century. Small, prepackaged generating units give customers and competitors the technical ability to run their own power plants. History just might repeat itself : distributed generation units have the same relationship to large power plant that the PC had to the mainframe ; it puts the source of power at the user site. These new generating units can do more than reduce the costs of electricity. Some believe that distributed generation may be the "wave of the future" and even begin to displace large, central station generators. With or without less wires, the maintenance costs of the grid diminish. But what is the interest of a grid with units generating on site ? The functions of power transmission and distribution should be transformed as the whole network structure. The probability of this happening, the timing and the implications are difficult to forecast in Europe as well as all over the world.

3/ IN THE EUROPEAN ELECTRIC POWER MARKET

The on-going process of liberalization of the European electricity market is driving an compulsory integration of technologies to the electricity industry. Power generation and communication technological progresses combined with deregulation reduce barriers to entry into electricity industry, increase competition and accelerate the commoditization of electricity.

The integration of power generation unit on-site or close to end-user premisses without additional constraints for end user is a potential source of economic efficiency. These system enable to meet the needs of customers at an attractive price and, beyond this, to free capacities for power exchange through the grid. These new practices lay the basis for distributed generation business which should experience significant growth in Europe over the next decade assuming that technologies meet efficiencies as announced. Distributed generation technologies have achieved much progress in the past five years. Further improvements can be expected over the next ten years : prices will be cut by 30% and electric conversion efficiency will rise by 10%.

The economic of distributed generation in Europe are driven by a rapidly decreasing capital cost of these technologies with a good prospect of further price decrease. The market development of distributed generation technologies is promising in several European countries : United Kingdom, Germany, Netherlands , Spain and Italy. Overall the annual market for these units should average 700 – 1000 MW over the next ten years in Europe. The market is expected to decrease over the next three years as a result of a persistent decrease of electricity to gas price ratio. Subsequently, the market is expected to increase sharply under the combined effect of a more favorable electricity to gas price ratio, increased competition between utilities, stricter emissions standards and improved economic performance of technologies.

Electric deregulation in Europe will introduce new competitors that will seize the opportunity of available distributed technologies for market entry and market share growth. The differentiation between segments such as centralized generation and distributed generation beats not only on the capacity range but also on the market channeling process that emphasize serial economy instead of scale economy. Despite the location of the distributed generation system at customers' site, the transaction is not founded on equipment sale but on the service provided. As a result a market actor that seeks a competitive advantage in distributed generation will need to secure at least several capabilities : multi energy transactions, access to a competitive technology, system packaging and servicing, and technical and economical data management. Technological advances have the potential to create new efficiencies as well as ways of doing business.

Most traditional European electric utilities will have to adapt their business strategy if they are to remain competitive. Distributed generation units offer potentially a solution. Indeed, electric utilities could retain control of the electric power used by consumers. And they could sell associated services with their power. These new generating system has several features that can be attractive to electricity suppliers in order to achieve superior efficiency and capture additional margins. The most important is the opportunity for arbitrage between grid purchase and operating a distributed generation. Distributed generation units allows to take advantage of the spread between gas and electricity prices.

These changes in generation technology, combined with economic theory, suggest a move away from large companies to small units built by a host of new companies. Five years from now, the list of generating companies will hold names that have not appeared yet. Microturbines and fuel cells, if powered by natural gas, promise to bring new players into the electricity market. These next technologies could prove that deregulation is not just for electric players but for anyone affiliate with natural gas. But plopping down a gas microturbine next to the local supermarket and connecting to the grid to sell excess power is not without its pitfalls.

In the United States, instead of implementing these technologies, some electric utilities are accused to have suppressed the researches and **strategically delayed deployment** of distributed generation technologies in order to maintain high profits, enable "stranded cost" recovery and position themselves to fully control distributed electricity generation in deregulated markets. Alternative energy advocate alleges industry collusion. Some analysts point out unlawful activities of the utilities (B.ALTHOUSE, 1999) : withholding information, obstructing grid-interconnections (by imposing financial penalties on customers that attempt to self generate), bribing those entities that threaten to self generate with below cost rates, perjuring themselves by explaining the nature of stranded costs as something other than the obsolescence of central power generation... Leading independent producers of microturbines have been co-opted by utilities to prevent others from accessing these technologies. One of the most cost effective small power generator may be Allied Signal's new microturbines, but utility holding affiliates have already bought all of Allied's production even before the construction of their microturbines factor. In 1997, the Department of Justice (DOJ) settled out of court a lawsuit against a utility accused of preventing competition. According to the DOJ, faced with losing customer or being forced to lower rates to compete, the utility agreed to provide a customer with deep-discounted electricity. In return, the customer promise to keep its supplier for seven years and agreed not to study any alternative sources of electric power and gas supply.

There is a number of American states that are looking closely to the role distributed generation can play in bringing down electricity costs, increasing reliability and improving the environment.

In Europe, although markets prospects will be enhanced by electricity and gas market deregulation, such deregulation can take several years in some Europe countries. Some incumbent utilities may use predatory tariffs to delay true market transparency at retail level. Likewise, the future of distributed generation will be brighter when climate change regulations are enacted...

CONCLUSION

While turbines generators have been in use for years, the distributed generation units are quieter, cleaner, relatively maintenance free and does not require long power lines. There is some alternative on the horizon in continuing to expand the thousands of miles of wires that deliver electricity to home and businesses around the world. Clearly, the generation activity is undergoing major changes which will affect the industrial organization of power industry. Not everyone sees the distributed generation as a surefire blockbusters as there are skeptics who say that small scale generation will never be economically viable. The optimism regarding distributed generation units may be premature because they have yet to be commercially proven. Their markets vary with geography, be reliant on favourable net metering policies and require extensive environmental and regulatory licensing. These new units have to face two main challenges : the supply of natural gas and the connection to the grid. Gas delivery infrastructure needs changes. Gas companies say that they are...And the other problem is to manage the interconnection of distributed generation to the network, and more precisely to determine the price of transmission.

Distributed generation is an illustration of number of technologies which are about to transform the electric power industry's organization and competitive profile of the players. In Europe, with these decentralized generation units, two barriers to entry (high cost and specific technical expertise) have evaporated : however the regulatory barriers still persist. Some regulators and utilities may be able to keep barriers intact longer than others. Nonetheless, when private and independent producers pressure lawmakers to deregulate, the remaining barriers will fall. These innovations will be indeed capable of reducing much of the monopoly in the power sector : they will speed up the move. New technologies are one of the most potent drivers of industry change today. It is only the beginning...

These new highly efficient small generators are eroding economic advantage of traditional plants generating electricity at lower costs. Some traditional electric utility companies have chosen : they have shown agility and strength in controlling the new technology rather than letting their position erode. New technologies can be captured by firms, such that their control is extended rather than ended. Future technological development can provide the strategic advantage needed by utilities to thrive in the newly competitive market place. Traditional utilities which are about to know competition, have to evolve in order to survive. They have to adapt the newest technology and cut costs. With the deregulation of the generating segment in Europe and the convergence gas-electricity, vigilant enforcement of antitrust laws will be essential for the preservation of an open competitive industry.

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FOOTNOTES

¹ Cf. pp.603 The New Palgrave, ed. Eatwell, Milgate and Newman (reprint 1994), McMillan Press Limited.

² Generally a natural monopoly is characterized by subadditivity of a representative firm's cost function. If all prospective firms in the industry have the same cost function, or if one firm has a uniformly better technology, then subadditivity implies that industry costs are minimized if only one firm is active in the market. While subadditivity is a purely technical condition, it is also possible for natural monopoly to arise from purely economic forces if imperfectly competitive outcome is inefficient.

³ A.Marshall (1890) was one of the first to identify formally the technology in the form of the representative firm's cost function, as the fundamental determinant of industry structure. Industries with increasing average cost of production were generally competitive or monopolistic. J.Clark (1923) contributed to the understanding of natural monopoly through his careful analyses of the economics of overhead costs (economies of non convexities). He was also a pioneer in the empirical study of declining average cost industries.

About theory of natural monopoly, see Sharkey W.W. (1982), Baumol W.J., Panzar J.C. & Willig R.D. (1982) and Train K.E. (1992).

⁴ But, regulation can also lead to technological excessive considerations : the French electric monopoly is sometimes perceived as "over-engineered". See Bouttes J.P. & Leban R. & Lederer P. (1993).

⁵ See Boiteux M. (1996), Mourre B. (1996)...

⁶ See Schumpeter J.A. (1934).

⁷ One of the most intriguing new technologies is fuel cells, which use hydrogen to produce the electrons that constitute electricity. This is done without burning. The fuel can be natural gas, with the waste consisting in water and carbon dioxide. Fuel cells can be of any size.

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