Foreword by European Commissioner for Energy Günther Oettinger

TOWARD A COMMON EUROPEAN UNION ENERGY POLICY

Problems, Progress, and Prospects

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Chapter One

EU Internal Energy Market Policy: Achievements and Hurdles

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It is now more than 20 years since the European Commission (hereafter: the Commission) issued its first Green Paper on the internal energy market in Europe in 1988 (CEC 1988). The major idea was that *free and fair competition* between energy companies across the European Community would lead to large efficiency gains, lower and more similar prices for consumers across the community, increased competitiveness for energy-using industries, economic growth, and increased welfare. An important part of the proposal was a "common carrier" system for gas and electricity, which meant that European electricity and gas infrastructure should be operated and further developed by agents that were independent from the production- and supply-interests (Eikeland 2004; Lyons 1992). Such independence would allow consumers to purchase energy from any supplier in the internal energy market, regardless of who owned the grid. The visionary concept emerging was nondiscriminatory *third-party access* to the grid.

Internal market policy has since gone through distinct stages ending with revision of legislation aimed at bringing speed to market opening. These are now called the first, second, and third internal energy policy packages, denoting clusters of directives and regulations targeting different aspects of liberalization of the electricity and gas markets. The first package took several years to negotiate and ended up with the 1996 Electricity and 1998 Gas Directives as major outputs. The second package was enacted in 2003 and contained revised Electricity- and Gas Directives as well as specific regulations to harmonize trade and operation of infrastructure across national borders. The third package was finally enacted in July 2009, containing further revisions of the Gas and Electricity Directives, the cross-border regulations as well as an additional regulation establishing

an independent agency for boosting cooperation between national energy regulators.

Gas and electricity supply in Europe were historically organized as separate businesses. Most European Union (EU) countries evolved with self-sufficiency in electricity supply. In natural gas supply, however, only a few countries, notably the United Kingdom (UK) and the Netherlands, had sufficient resources to cover their own demand. Most countries became dependent on imports from the main surrounding gas producers Russia, Norway, and Algeria. Until the deregulations of the 1990s, gas and electricity supply were organized in entities enjoying exclusive rights to supply all customers within a specifically defined area. Wholesale supply was in most countries operated by public utilities. These figured as dominating national electricity producers and gas importers, with monopoly control also over national transmission lines or the major gas pipelines. Private ownerships were allowed in some countries but still kept under governmental control in exchange of exclusive monopoly rights. Lower levels of supply (electricity and gas distribution) enjoyed similar monopoly rights, but here, the evolving ownership structure differed significantly across the countries.

The UK had chosen a model of two major public utilities responsible for all generation, transmission, and distribution within the electricity and gas sector, respectively. A similar structure evolved in France. The German electricity and gas sectors evolved with mixed ownership—several major private generators and wholesale suppliers, and a great many distribution companies owned mainly by the regional and municipal governments. The Scandinavian countries (Norway, Sweden, and Denmark) evolved with major state-owned electricity generators and wholesale suppliers, but with considerable parts of the business owned by lower governments or private shareholders.

Irrespective of ownership, the structures evolving entailed strong vertical linkages in the electricity and gas supply chains, in the form of vertically integrated companies or vertical chains established through long-term supply contracts between foreign producers and gas utilities with exclusive rights to import. An important part of EU's efforts at establishing an internal energy market was to restructure energy supply—abolishing de jure and de facto monopoly rights. Since electricity and gas grid operations would still have a natural monopoly character, separating these from the commercial businesses (electricity and gas sales) became paramount to avoid anticompetitive practices of cross-subsidization and grid access discrimination. The Commission admits that these efforts have partly failed and that the

European electricity and gas markets are still characterized by structures that hinder free and fair competition. Its January 2007 final report from the energy inquiry instigated in 2005 identified serious shortcomings in the electricity and gas markets, including inadequate levels of unbundling between network and supply interests and too much market concentration in most national markets (CEC 2007a).

Instead of a common internal market, the EU has developed into regional and local markets characterized by different market structures and competitive conditions. Some member countries, notably the UK, made a full transformation of the electricity and gas industries—abolishing legal monopoly rights and splitting up and privatizing the gas and electricity industries to reduce market concentration. Full ownership unbundling was mandated for electricity and gas transmission companies. Similar ownership unbundling was carried out swiftly in Scandinavia. Other countries, notably Germany and France, lagged behind and did not implement ownership unbundling, a strategy shared by many of the Eastern European countries that got access to the EU in 2004 and later. In 2007, the Commission concluded that wholesale electricity market concentration was *very high* in seven member countries (including France), *high* in nine countries (Germany included), and *moderate* in seven countries (including the UK and Spain), (CEC 2007a, 12). The situation in the wholesale gas market was no less worrying. Here, ten countries appeared with very high concentration (France included) and five with high concentration (Spain included), (CEC 2007a,17). In parallel, horizontal and vertical mergers and acquisitions have created major energy conglomerates doing business in both electricity and gas supply, something that may have aggravated the initial market concentration problems in many countries (Domanico 2007).

Given this long history and background it would not be unnatural to discuss how far the EU has come in establishing an energy policy that adheres to the principle of free and fair competition. Free competition should mean that energy consumers are free to choose service from companies across Europe, whereas the suppliers in turn should encounter no barriers to transport of electricity and gas across Europe's national borders. While necessary, securing such freedom of choice is far from sufficient for competition to be fair. This would depend on market conditions free from dominant actors as well as harmonized governmental regulations across national contexts; the latter is important to ensure that companies in one country do not enjoy far better opportunities at home than other companies, with the competitive advantage this would also give in the greater internal market.

The remainder of this chapter is structured in four parts. The section "Brief History of EU Internal Energy Market Policy Development" provides a brief historical description of EU internal energy market policies, highlighting the most important parts and how the situation was evaluated before the most recent round of policy-making (the third package). The section "The Third Internal Energy Market Policy Package" focuses on the third and hitherto final package of internal energy market policies, the proposal of the Commission, and what was finally adopted by the European Council. Specifically, we look at the Commission proposal to mandate transmission system operators (TSOs) to separate by ownership the operation of transmission grids and that of other commercial production and supply businesses (mandatory ownership unbundling—MOU) and why this was not adopted in the final directive. We place this European Council decision within the long-term context of internal energy market policies and apply a historical-institutional framework to answer the question. This framework looks at the development over time (shifts) in coalitions supporting and opposing the idea of a free-market solution to European energy problems. We identify the key stakeholders, their positions, and how these positions have changed or remained stable over time. Particular focus in the explanation is on the evolution of the relative power of Member State governments and EU institutions, especially the Commission and the Parliament.

The section "Evaluation of Progress in Completing the EU Internal Energy Market" evaluates the progress made in the course of the years and how far the EU still is from realizing the vision to create a common free energy market characterized by fair competition between the suppliers. The evaluation discusses the development over time in several indicators, information disclosed by the Commission in annual benchmarking reports on national implementation of internal energy market policies. The last section "The Road Ahead—Prospects for Free and Fair Competition in the European Energy Market" rounds up with a discussion of future prospects for the internal energy market. Here, we show that EU internal energy market policy is more than the directives and regulations provided by the successive packages. We explore three different procedures pursued by the Commission in pursuit of a free and fair energy market. In addition to directives and regulations, these include application of the general EU treaty competition legislation and more bottom-up methods of coordination initiatives (coregulation).

Brief History of EU Internal Energy Market Policy Development

Toward the First Policy Package

In 1987, the EU Council adopted the Single European Act revitalizing the *general principles* guiding community cooperation—removal of barriers to trade and movement of capital across the Member States as a means to increase growth and welfare in the region. It strengthened supranational authority in a number of EU policy areas, allowing for greater use of qualified majority voting in decisions on EU-wide market rules and thus removing blocking votes of Member States skeptical of increased harmonization of national policies.

Although energy was not initially part of the reform program, the general drive toward common internal market rules created a new dynamic where energy market actors became more active in redefining traditional energy policy issues (Andersen 2000). European enterprises also argued for deeper integration of national energy markets, as a way to make energy supply more efficient, to align and cut energy prices across the region, and thereby to increase global competitiveness of European industry. From 1986 onward, the Council of Ministers discussed greater integration of the domestic energy markets (Stern 1990; Andersen 2000), and the Commission set out to identify procedures for the creation of an internal energy market.

The 1988 Commission communication *The Internal Energy Market* envisioned the electricity and gas grid in Europe as a "common carrier" system across the Member States. Any consumer should be able to purchase energy from any supplier across the community without discrimination in access to grids, regardless of ownership of the grid structures (CEC 1988).

The electricity and gas sectors were viewed as particularly challenging, characterized as they were by nationally dominant, vertically integrated utilities (Lyons 1994, 6–7). Dismantling these structures was viewed as pivotal for free and fair competition to prevail in the internal energy market. The Commission again discussed different *decision procedures* for restructuring these sectors specifically. One was the application of EU competition rules (then Articles 85 and 86 EEC—European Economic Community) against the utilities to dismantle dominant market positions. Another was to initiate infringements procedures according to Article 169 EEC against the Member States. It also acknowledged the need for specific directives for the

electricity and gas sectors, which could either be formulated unilaterally by the Commission based on Article 90 (3) EEC, or on the basis of Article 100a EEC-Treaty, a consensus-based procedure allowing other EU bodies to participate in deciding the pace and scope of the liberalization package (Eising 2002; Lyons 1992, 23).

Acknowledging that energy was widely regarded as a public good within European Member States, with dominant public utilities a normal structure in energy supply, the largest part of the Commission (including its energy policy service), the Member States and the European Parliament preferred a consensus procedure (Article 100a) to allow for *incremental* change (Eising 2002). Directorate General for Competition (DG-COMP), on the other hand, opted for a faster breakup of monopoly structures by using competition rules and Article 90 for pressing forward Gas and Electricity Directives (Eising 2002). In fact, the Commission allowed DG-COMP to start up proceedings against gas and electricity import/export monopolies and sent letters to Member State governments asking them to justify their national monopolies, warning that the Commission would act aggressively in order to achieve a single market in energy (Lyons 1992, 23). DG-COMP was inspired by a March 1991 judgment by the European Court of Justice (ECJ) upholding that the Commission could use such procedures to force greater competition in the *telecommunications* sector (Lyons 1992, 13).

Intense lobbying of commissioners by national governments, energy industries and the European Parliament, however, sent clear signals to DG-COMP to keep its hands off the internal energy market. And, in 1994, the ECJ formalized this lesser role of DG-COMP with its rulings in the so-called *Almelo* case of Dutch electricity distributors asking for dismantling the exclusive import and export rights granted to the electricity generators (Lyons 1998, 34). The ECJ found that Articles 85 and 86 of EU competition rules had been breached, but that Article 90 offered the companies opportunities for derogation if operating under public service obligations (PSOs). It did not make any judgment on whether the obligations necessitated the monopolistic behavior in the specific case, however.[1] DG-COMP was therefore unwillingly constrained in playing any active role in EU energy market policies during the decade. To be sure, the Commission continued to remind European politicians that an option existed under European Community (EC) Treaty rules to apply general competition rules, which was used to press Member State governments' adoption of the first liberalization package (Lyons 1992, 24).

The main procedure adopted for internal gas and electricity market policy development was therefore Article 100a, the development

of directives through deliberation and consensus-seeking. The process of getting directives adopted became thorny and lengthy, and only toward the end of the decade, after long deliberations with the Commission, and with active mediation from the European Parliament, did the Council adopt the 1996 Electricity Directive and the 1998 Gas Directive. These were heavily watered-down versions of the Commission's initial plan of a common carrier system for Europe. They entitled only a limited number of high volume gas and electricity consumers the right to freely shift suppliers. The Electricity Directive set quantitative goals and a deadline for the reforms whereas the Gas Directive left open for the Member States to decide (Stern 1998).

To ensure a de facto right for these entitled consumers, the Commission sought to establish harmonized terms of access for third parties to existing networks and gas pipelines. This effort largely failed, however. True, Member States were instructed to ensure that the TSOs kept separate accounts (unbundling of accounts) for activities subject to competition (production and supply) and those considered a natural monopoly (operation of transmission grids). No agreement was reached, however, on uniform rules for how TSOs should facilitate access by third parties. In the end, the directive merely listed different options: grid owners could openly list access terms, such as tariffs for using the grid and capacity of the grid (called a system of *regulated* third-party access), leaving traders with information in advance of striking new deals. They could also choose the less transparent system of *negotiated* access (allowing the TSOs to negotiate separate deals with each eligible customer). The Commission also had to accept that Member States could restrict trade across national borders with a "single buyer" system adopted, allowing a single national firm to retain full control over imports. The failure in providing for invariable instructions as to how owners of power lines and gas grids should secure access for alternative suppliers meant that vertically integrated companies were still left with great opportunities to obstruct access for competing power supply businesses.

Toward the Second Policy Package

EU decision-makers acknowledged that there were additional barriers to the creation of an internal energy market that were outside the scope of the new directives. The directives therefore instructed the Commission to go on reporting on *additional* needs for harmonizing national regulations to remove barriers to trade and physical

flow across national borders.[2] In the first communication report on the Electricity Directive, which came in 1998,[3] the Commission addressed the problem of reconciling the community's environmental policy with the goal of creating an internal energy market. More specifically, the report discussed the need of ensuring that provisions in the 1997 White Paper on renewable energies[4] were not at odds with free and fair competition in the internal energy market. The Commission concluded that the existence of various schemes for the promotion of renewables in Member States would most likely lead to trade distortions. The Commission concluded that further analysis of existing national support schemes for electricity from renewable energy sources would be needed, and announced plans for a directive on the harmonization of national schemes by the end of 1998.[5]

New follow-up reports in 1999 on the Gas Directive and in 2000 on the Electricity Directive addressed these issues and concluded that great variation in transmission prices, congestion management systems, and outright lack of cross-border transmission capacity across the Member States restricted cross-country trade (CEC 1999; 2000a).

Acknowledging the limited success of the top-down legislative approach applied for the Electricity and Gas Directives, the Commission this time chose another strategy—to involve a broad range of stakeholders in a bottom-up process to identify and seek consensus on the harmonization of cross-border transmission system rules and technicalities. Organizing these processes, stakeholder forums (the Electricity Regulatory Forum of Florence—the Florence Forum and the Gas Regulatory Forum of Madrid) involved participation by national regulatory authorities, Member State governments, the Commission, TSOs, electricity traders, consumers, network users, and power exchanges.

While giving high priority to these bottom-up processes, the Commission also continued to push Member States on implementation of the Electricity and Gas Directives, with benchmarking reports used as a major new tool. A 2001 benchmarking report concluded that large asymmetries in implementation had jeopardized the process of creating a level-playing field in the internal market for energy. While some Member States had over-fulfilled their obligations under the directives, ensuring third-party access through a system of full ownership separation of infrastructure and production/supply businesses (*ownership unbundling*), other countries maintained systems that seriously deterred consumers from changing suppliers in the market (CEC 2001). The 2001 Gothenburg European Council Summit

agreed on this diagnosis and asked the Commission to prepare a second energy liberalization package.

When adopted by the Council in June 2003, the new Electricity and Gas Directives required full electricity and gas market opening for nonhousehold consumers by July 2004 and for all consumers by July 2007 (European Parliament and the Council 2003a; 2003b). To prevent discrimination by TSOs in transmission system access issues, the directives mandated organizational separation of units operating transmission activities from those operating generation and supply activities (*legal unbundling*). Full ownership unbundling had been proposed by different agents but the Commission failed to include it the proposal due to great opposition by many Member States.[6]

In addition, the directives instructed Member States to set up national regulatory agencies with well-defined functions and greater transparency was called for in that the directives mandated publication of network tariffs by the TSOs (regulated access) instead of case-by-case negotiations. A separate Regulation sought to strengthen the bottom-up processes by establishing a separate EU-level committee, the European Regulators' Group for Electricity and Gas (ERGEG), constituted by Member State regulatory authorities, with the mandate to develop guidelines for harmonization of technical and market factors constraining access to cross-border infrastructure and cross-border trade (such as rules for inter-TSO compensation, national transmission tariffs and on allocation of cross-border interconnection capacity (European Parliament and the Council 2003c).

The Third Internal Energy Market Policy Package

The Commission Proposal

Despite this new second package, energy consumers continued to voice dissatisfaction, allegedly experiencing higher tariff levels than before and discrimination in access to grids from vertically integrated companies. In June 2005, the Commission launched gas and electricity sector inquiries, with a preliminary report adopted in 2006 concluding that flaws in access to energy infrastructure in many Member States had caused unnecessarily high energy prices in Europe and the loss of welfare opportunities for European energy *consumers*. Vertically integrated energy producers had constrained competition

through discrimination of others in the use of infrastructure and held back on new infrastructure investments, causing problems for independent producers of electricity and heat. This was also viewed as a barrier to producers of indigenous renewable energy and hence to the alleviation of climate change and security of supply concerns in the EU.

These new concerns made the Commission in March 2006 propose that a new energy strategy for Europe should be developed, aimed at creating greater coherence between the Member States and consistency between policy measures dealing with the three primary objectives: competitive energy for European consumers, security of supply, and environmental improvement of EU energy systems (CEC 2006a). This strategy was approved at the European Council Spring Summit 2006.

January 2007, the Commission adopted the strategic energy review as part of an energy and climate package that also included the full energy sector inquiry (CEC 2006b; 2007b). The package proposed new quantitative goals, tabling the so-called "20–20–20" goals: a 20 percent unilateral reduction of climate gas emissions by the EU, a 20 percent share for renewable sources, and 20 percent reduction in energy use compared to "business as usual"—all to be attained by 2020. The action plan proposed to achieve the larger energy and climate policy goals had listed further measures to ensure access to and investments in new infrastructure as top priorities.

The review concluded that European gas and electricity markets remained national in scope and had maintained from the preliberalization period a high level of concentration and scope for exercising market power (CEC 2007a). Lack of access to infrastructure was highlighted as a major barrier to free competition, causing, together with higher primary fuel costs and environmental obligations, significant rises in gas and electricity wholesale prices (CEC 2006b).

The review elaborated in detail on vertical integration between network and supply interests as a mechanism causing negative repercussions for market entry and incentives to invest in networks, despite the existing legal unbundling provisions. Vertically integrated operators of the networks (in gas, also storage and liquid natural gas terminals) were suspected of favoring access to their own affiliates (discrimination). Operation and investment decisions had been made on the basis of own supply interests. Vertical integration of generation/import and supply activities had reduced incentives to trade on wholesale markets and thus a lack of liquidity in these markets, in turn an entry barrier. The review also added insufficient or unavailable cross-border

transmission capacity as a barrier to integration of national markets together with lack of transparency, reliability, and timeliness of information on network availability (electricity interconnections and gas transit pipelines).

Based on this description, the Commission proposed to go forward with a *third legislative package*. The proposal included many different measures, with ownership unbundling of network and production assets placed at the top. An alternative Independent System Operator (ISO) was proposed as a fallback position, the latter retaining joint ownership with returns on network operations regulated and operation, maintenance, and development of networks no longer decided by the vertically integrated owner. The long list of proposals included the following:

- measures to harmonize the levels of powers and independence of national energy regulators from industry and government;
- strengthening the EU-level regulatory function with a new body that could beef up governance required for satisfactory progress in the work of harmonizing standards facilitating cross-border trade across the Member States;
- instead of the *voluntary* cooperation approach pursued by ERGEG, the Commission envisioned new EU-level powers to develop binding standards;
- new harmonized minimum standards for transparency of information provided by the TSOs and generators to facilitate market-access by new entrants and prevent price manipulation;
- measures to beef up planning and approval of priority trans-European gas and electricity networks;
- the setup of a new Office of the Energy Observatory to monitor the demand/supply balance in Europe;
- the development of an Energy Customers' Charter to ensure PSOs; and
- the setup of a solidarity mechanism assisting Member States particularly import dependent and vulnerable in the supply for oil, gas, and electricity and other measures to improve the security of supply within the EU.

The European Spring Council in 2007 endorsed the integrated energy and climate package and the 20–20–20 percent goals set for energy efficiency, renewable energy, and climate gas reductions in the EU. They also consented to a third internal energy policy package but asked the Commission to come up with more specific drafts

for the Energy Council meeting in June 2007. This meeting showed that a blocking minority rejected full ownership unbundling as a mandatory measure, while still acknowledging "the need for action on... unbundling of network operations from energy production and supply activities."[7] The Energy Council also rejected any EU-level arrangements that would interfere with Member States' exclusive right to decide on their energy mix, such as the idea of an EU Energy Observatory. Energy Commissioner Piebalgs, attending the meeting together with Neelie Kroes, the Competition Commissioner, admitted that the "majority of the countries did not support 'ownership unbundling' legislation" and that the Commission would have a very difficult time ahead in putting together a new energy liberalization law.

Despite the signals given, the Commission had not abandoned "ownership unbundling" as the preferred mandated option in its September 19, 2007 proposal. To be sure, the "Independent System Operator" was retained as a fallback-option. Another last minute "reciprocity clause" was included, specifying that would have barred companies from nonmember countries from exercising decisive influence on transmission assets, unless a bilateral agreement on mutual market access to transmission assets in the investors' country of origin had been concluded (Grätz 2009, 77). This was aimed at preventing the takeover of transmission systems by vertically integrated companies from outside the EU, with Commission powers to intervene in acquisition matters.

The Final Output

Nearly two years of negotiations followed. In July 2009, the European Council finally adopted the third internal energy policy package: new Electricity and Gas Directives And new regulations for harmonization of cross-border trade in electricity and gas as well as a specific regulation providing for the establishment of the new regulatory body ACER (Agency for the Cooperation of Energy Regulators).

The new Electricity and Gas directives did not provide for MOU but allowed the TSOs to choose two other unbundling methods: the ISO model that had been proposed as fallback position by the Commission and the Independent Transmission Operator (ITO) model that had been proposed by a group of eight Member State governments, led by Germany and France, during the negotiations. Under the ISO model, big energy companies would retain ownership of the transmission lines, but hand managing control over networks to an

entirely separate operator not sharing any shareholders with the parent company. The ITO-model also foresees a parent company retaining ownership of transmission networks, but owned by the same set of shareholders. To compensate for the continuation of shared ownership, the model envisages supervision by a national regulator. Among other things, there will be a mechanism preventing top management from moving freely between a company's production and transmission wings. An executive involved in the transmission business will not be permitted to work three years before and four years after in the parent company. In addition, the national regulator will examine the transmission operator's development and investment plans and may require changes.

There were few changes to other proposals in the package that had been backed by the Energy Council meeting in June 2007. It settled the principle of more power to and the harmonization of duties for national regulators so that they are able to issue binding decisions on companies and impose penalties on those that fail to comply with EU regulation. National regulators would have authority over their own budgets and strict rules for management appointments for true independence of industry interests and government intervention.

The creation of a new European Agency for the Cooperation of Energy Regulators (ACER) was agreed with the tasks to oversee and improve cross-border regulatory cooperation for gas and electricity transmission between Member States. The agency would not have any direct regulatory authority at the national or European level, but it would have the power to intervene in the event that national regulators fail to cooperate effectively. ACER will inter alia submit to the Commission nonbinding framework guidelines on cross-border flows of electricity and gas, which will serve as a basis for the network codes adopted by the Commission. ACER will also complement at the European level the regulatory tasks vested with the national regulators by adopting individual regulatory decisions in a number of specific cross-border situations as well as decisions on technical issues when so provided for in the package.

Cooperation between national TSOs for gas and electricity, formerly taking place on a voluntary basis, was formalized through the establishment of a European Network for TSOs (ENTSOs). The main tasks given the ENTSO-E and ENTSO-G (electricity and gas, respectively) were to harmonize codes for access to and use of pipelines and grids, and coordinate and ensure proper network planning and investments in order to prevent blackouts.

The third-country reciprocity did not prevail in its proposed form. It only requires companies from non-EU countries to demonstrate compliance with the same unbundling requirements as EU companies before they are certified to operate in the common market and does not demand changes of market rules in the investor's home market country, as initially proposed (Grätz 2009, 78). To be sure, the new regulation says that Member States must refuse certification if it is deemed to "put at risk the security of energy supply of the Member State and the Community."

Why Was Ownership Unbundling Proposed and Not Accepted?

The Proposal: Looking first at the question why the Commission proposed ownership unbundling, we find this measure to be the logical endpoint of the vision the Commission has pursued since the internal energy market was proposed in the late 1980s: to create a truly independent grid accessible for transport of energy by all parties without discrimination. Separation of ownership of grids and commercial activities would simply provide the best guarantee for such independence. The Commission had been an active promoter of this idea since the start (Lyons 1992). It had long opted for MOU but failed to propose this when the first two packages were up for discussion due to major opposition by the Member State governments.

There is clear evidence that the decision to finally table it as a proposal in 2007 reflected Commission confidence that it had surely gained clout vis-à-vis Member State governments reluctant to hand over powers to the EU in energy market affairs. An important part of this new clout was the new and greater role played by DG-COMP in applying its powers under general EU treaty rules. This new role is well illustrated when seen through the lens of history. Back in the late 1980s, when the Commission formulated its first ideas about the internal energy market, it acknowledged that the national vertically integrated gas and electricity utilities represented a challenge to real market opening and, as noted above, mooted various decision procedures for dealing with this challenge, but DG-COMP thus found itself constrained from playing an active role in EU internal energy market policies.

The Commission nevertheless continued to threaten Member-State governments with EC Treaty competition rules unless implementation was forthcoming, as in 2001, to press acceptance of a

second liberalization package (CEC 2002). By then, moreover, several Member States backed the idea of MOU. Six member countries had by then voluntarily implemented ownership unbundling in their national electricity sectors and two in their national gas sectors (CEC 2003). Fronting the pro-group, the UK had implemented ownership unbundling back in the 1980s. British politicians, championing neoliberal thinking in Europe, had a central role when the Commission drafted its first internal market directives (Lyons 1992). The Scandinavian countries and the Netherlands were also among the early reformers. In addition, most European Parliamentarians now supported radical market opening, with strong Parliamentary voices calling for MOU (Eikeland 2008). Fronting the antigroup were France and Germany, which even argued against "legal unbundling" (Council of the European Union 2002).

Energy consumers continued to voice dissatisfaction, complaining of discrimination in access to grids from the vertically integrated energy groups and the resultant higher tariff levels. The new Commission appointed in 2005 under the presidency of José Manuel Barroso therefore took a new line in internal energy market policies. As part of his overall plan to revitalize the Lisbon agenda, Barroso promised a more proactive role for DG-COMP in the screening of industrial sectors for barriers to competition (CEC 2005). The internal energy market was chosen as a pilot case, with DG-COMP and the Directorate-General for Transport and Energy (DG-TREN) jointly launching a major inquiry into competitive conditions in European electricity and gas markets.

This joint project ushered in a new era of close cooperation between the two directorates in internal energy market policies. When the first results of the energy sector inquiry came in, DG-COMP was convinced that a new liberalization package was needed. DG-TREN was not fully convinced, but the preliminary report of early 2006 tipped the scales, leading the two DGs and commissioners Neelie Kroes and Andris Piebalgs to agree on the need for a new, more radical energy liberalization package.[8]

In January 2007, the Commission adopted the strategic energy review proposed a year ahead and endorsed by the Council (CEC 2006a). This put gas and electricity market liberalization on top of the list of further action needed to achieve community energy policy objectives. The Commission also proposed a third legislative package that put MOU at the top of priorities. The European Spring Council 2007 agreed on the need for new legislation but the Energy Council in June warned the Commission not to propose ownership unbundling

(EurActiv 2007). The Commission did not give in to these warnings, however, and presented its proposal with MOU included. Interviewees in Brussels give DG-COMP much credit for this decision.

The proposal was coauthored by DG-COMP and DG-TREN—an unusual procedure in the Commission, which was normally bound by the high-level agreement that DGs should not interfere in each other's policy domains.[9] The alternative ISO model was secured as a fallback position, clearly more in line with the incremental consensus-seeking procedure preferred by DG-TREN. The new extended role of DG-COMP became evident also in the toning down of "regionalization" as an option for step-wise full internal market integration—a strategy promoted by the electricity supply industry and supported by DG-TREN back in 2003. DG-COMP feared such a procedure could increase the chances of regional cartelization.[10]

The extended role of DG-COMP in internal energy market policies was further demonstrated in its initiation of investigations and court-filing against major companies suspected of breaching community competition rules such as: allegedly using long-term contracts to abuse their dominant position (Distrigaz, EDF, and Suez-Electrabel) and manipulating wholesale and balancing markets. DG-COMP proceeded to prepare cases for the ECJ, the most highly profiled one being against the company German Energy On (E.On).

DG-COMP presented these companies with deals that would reduce fines for infringement of EU competition rules in return for the sell-off of their network businesses, in turn weakening their incentives to lobby Member-State governments and providing leeway for other national forces to convince the governments to alter their stances. The Commission knew that energy-intensive industry associations in Member States supported ownership unbundling. For example, the German Steel Industry Association, in a policy statement to Germany's EU presidency in 2007, made it clear that "If, as a result of the current regulations on grids, the intended market inputs fail to materialize in the medium term, an ownership unbundling of grids must be considered as a further step, as this is the only way to ensure that the structure of grid access is really free of discrimination for all potential grid users" (*Wirtschaftsvereinigung Stahl* 2006). Supporters of MOU also included the Federation of German Consumer Organizations, which refuted arguments from the government that it would run contrary to constitutional guarantees for property (*Europe Energy*, 2007). In addition, BNE, the German association for new energy suppliers, opted for strict unbundling to prevent market-dominant companies from exploiting their position, and their EU-level federation European Renewable Energy Council (EREC) took a clear pro-MOU position (Eikeland 2008).

Interviews show that central officers within DG-TREN and DG-COMP expected companies to eventually sell off their grids even without regulatory demands in place. This was based on perceptions of the future electricity grid coming to resemble the Internet, with many small agents dispatching renewable energy to fulfill the new EU climate goals, dramatically changing the current business of serving a few central producers and making specialized grid operators better commercially prepared.[11] The tendencies toward stricter national rules on ownership conduct and national regulators squeezing grid tariffs were other factors reducing the commercial rationale of owning electricity grids. The Commission expected companies to sell off their grids voluntarily, and that this in the next round could change the political dynamics at the national level, leading Member-State governments to shift their position on MOU.

Hindsight proved the Commission right in assuming that major companies would eventually strike deals that included ownership unbundling, to avoid fines for infringing EU competition regulations. On February 28, 2008, the German energy giant E.On confirmed such a deal (*Economist* 2008),[12] but this did not change the anti-MOU position of the German government.

The Commission added the third-country reciprocity clause to the proposal as a carrot intended to appease Member States reluctant to accept MOU for fear that Russian Gazprom might seize the opportunity to buy networks on sale and gain a firmer grip on the European gas market. The last-minute "third-country clause" was particularly important in getting new eastern Member-State governments to accept MOU. With many of these states eager to connect to the EU and the NATO umbrella after leaving the much hated planned economy and Soviet sphere of interest, the Commission obviously hoped for their support in its strategy to combine market forces internally with a united voice in talks with Russia. They proved split on the issue, however. Planning economy structures are still evident in many of their energy sectors, and some of these states remain hesitant about yielding to a new international structure that might limit their own national sovereignty.

To sum up, we see clear evidence during the Barroso presidency of a shift in the will and power of the Commission to push market integration a major step forward. This will was shared also by the other major EU supranational institution, the European Parliament. On July 10, 2007, the Parliament Plenary Session backed the Commission's

January 2007 proposal, including ownership unbundling. The vote was based on a report prepared by the Committee on Industry, Research, and Energy (ITRE) representative Mr. Alejo Vidal-Quadras, Spanish MEP and leader of the EPP-ED group (Group of the European People's Party—Christian Democrats—and European Democrats in the European Parliament), lashing out against efforts by certain governments, such as France and Germany, to create "national energy champions" as a form of protectionism.[13] The report went far in its critique of national energy industry structures, portraying France's public companies European Development Fund (EDF) and Italy's Ente Nazionale per l'Energia eLettrica (Enel) as noncompatible with free competition, suspecting them of subjecting the functioning of the internal market to national political considerations. The Commission therefore had strong reason to expect continued support from the Parliament when tabling its proposal. In fact, the Parliament majority was supportive also of the second liberalization package adopted in 2003, a change from the 1990s when the Parliament was less enthusiastic about radical market opening when discussing the first energy market package.

The Final Outcome: The new will and power of the supranational institutions were not sufficient, however, for the proposal of MOU to prevail. Opposition from the Member-State governments was too strong. Germany and France headed a group of Member States that tabled the alternative ITO-model, only a slightly revised version of the existing unbundling model. The group included the ministers from Austria, Greece, and Luxembourg as well as those of the new EU members the Czech Republic, the Baltic states, Slovakia, and Hungary, all hosting vertically integrated energy groups and lagging behind in implementing previously adopted internal market policies (Eikeland 2008). In 2007, the countries that had voluntarily implemented MOU had increased to 13 for the electricity sector and 10 for the gas sector (CEC 2008), but this was still short of a majority vote in the Council.

To gain a deeper understanding of the differences in the dispute, we need to look into deeper perceptions concerning a free market's ability to deliver on PSOs such as security of supply and environmental protection. We see clearly that the skeptics of full MOU argued that dismantling their strong national champions would weaken their power in negotiations with major foreign upstream companies, thus reducing national security of supply (Eikeland 2008, 2011). Those in favor, backed by the Commission, argued that MOU would guarantee the independence of TSOs, as well as bolstering crucial trade and

investments in new infrastructure, beneficial for security of supply (Eikeland 2008).

These differences were not new in Europe. Back in the 1990s, the first energy liberalization package was adopted only after the Council had insisted on the inclusion of a provision in the directives that gave Member States the right to derogations if opting to instruct their national industries to take on PSOs. Article 3 of the 1996 EU Electricity Directive defined public services as related to "*security, including security of supply, regularity, quality and price of supplies and environmental protection*" Also, the French Government's insistence on including the option to allow a central agency to be responsible for the purchasing of the country's electricity, the so-called "single buyer" model, was justified by the need for governments to retain powers to induce PSOs on their national firms.

When climate change rose higher on the agenda in the late 1990s with calls for an increased share of CO_2-neutral renewable energy sources in the EU energy mix, conflicting views surfaced again. Some Member States, notably the UK, argued strongly for market-based policy instruments, which they viewed as compatible with trade and competition in the internal energy market. Other countries, notably Germany, argued that allowing the market to choose between renewables would not stimulate the broad technological change viewed as necessary for long-term combat of climate change. The competitive market would be too shortsighted, the German government argued, picking only the least cost technologies that were not in need of much development support in the first place. Instead, Germany, which had already introduced a feed-in tariff system in 1990, giving renewable energy investors fixed prices independent of the market tariff, took the lead and convinced a majority of Member States to clamp down efforts by the Commission to make mandatory a system of renewable electricity certificates as part of the new directive on the promotion of renewables in electricity production, adopted by the Council in 2001.

From 2000 onward, energy security gained new topicality in EU energy policy, due in part to fresh energy growth figures showing an increase in import dependencies[14] and other figures showing an aggravation of the situation after the 2000 Nice Summit opened the EU up to new applicant countries from Eastern Europe in 2004. The years 2002 and 2003 added to the concerns, as massive blackouts caused havoc in California, Italy, Sweden, and Denmark. Voices were once again being raised questioning whether liberalized energy systems would bring about more vulnerability and short-term risks of

supply distortions than under the former centrally planned systems. A sudden and persisting growth in oil prices also fanned security of supply concerns. From 1999 to 2000, crude oil prices (the Brent Blend average prices) jumped from $17.88 per barrel to $28.39 per barrel, reflecting a series of geopolitical events: unrest in the Middle East and the rapid rise in oil demand in China and other South Asian countries. By 2007, the average price had reached $72 per barrel.[15] Oil prices continued to escalate in 2008, reaching peaks above $140 per barrel.

Early 2006, the security of supply concerns were evoked after Russia shut down its gas deliveries to Ukraine, which within the EU was taken as a sign of Russia's readiness to use its gas resources as a card in seeking geopolitical influence. Since vital gas infrastructure connecting Russia and the EU passed over Ukrainian territory, EU countries also felt a reduction in the volumes supplied in early January 2006. Thus a new sense of vulnerability now dispersed among European Member-State governments, which lifted long-term energy supply to the top of priorities for policy development with a call for the Commission to develop a strategic energy review for Europe.

The security of supply issue consolidated the split already existing between the Member States on the extent and pace that should be taken in internal energy market reforms, illustrated well also by the split in the European Parliament during the debate on ownership unbundling in July 2007. This debate showed a division along national lines rather than political party lines. Germany, France, and several new Member States formed an alliance against Commission demands for dismantling their national vertically integrated companies, arguing that this would reduce the companies' clout in negotiations with major foreign upstream companies. On the other side, the UK, the Netherlands, and the Scandinavian countries headed the alliance that backed the Commission proposal of further liberalization as necessary for increasing the security of supply. Full ownership unbundling would guarantee the independency of TSOs and bolster trade and investments in new infrastructure, pivotal to security of supply, according to these Member States.

A deeper understanding of the differences comes when looking at the strategies pursued by the governments of Germany and like-minded allies for securing their supplies from Russia. The German government has in combination with a bilateral diplomacy vis-à-vis Russia accepted Gazprom acquisitions of shares in national gas infrastructure in return for German acquisitions in Russia, based on the

philosophy that cross-ownership will give joint commercial interests in ensuring stability in supply.

The challenge for the Commission has not lessened lately, with Gazprom increasing its influence in several member countries. Illustrating this point, Gazprom in January 2008 signed a deal with Austria's state-dominated company OMV to turn the Baumgarten gas transmission centre near Vienna into a joint venture, robbing the Commission-supported Nabucco pipeline project of its planned outlet for supply from non-Russian sources (*Eurasia Daily Monitor* 2008).

Evaluation of Progress in Completing the EU Internal Energy Market

Looking at the 20-year history of internal energy market policies in Europe, we see considerable progress in institutional reforms paving the way for a free and fair energy market to evolve. However, the institutional reforms have still been insufficient, partly because of implementation failure and partly because the reforms adopted have not yet gone far enough.

As noted, the reforms carried out in 2003 (the second package) forced the Member States to ensure that all consumers would be eligible for switching suppliers by 2007. This reform also mandated grid companies to transparently inform market agents about terms of access to grids. Still, this reform did not solve fully the important organizational issue of how to ensure that grids were run independently of particular supply interests. It mandated an organizational split of grid and supply operations (legal unbundling) but not a full-fledged split of ownership. This latter solution was at the core when the Commission tabled its proposal for a third policy package in 2007. But after intense deliberations, MOU did not come through in the final decision in July 2009.

Looking beyond the institutional design to what the Member States have actually carried out in terms of policy implementation, the conclusion is strengthened that EU internal energy market policy so far can be denoted as only partially successful. The Commission has documented this well in its annual benchmarking reports submitted to the Council and Parliament since 2001. In its 2009 benchmarking report on implementation of the internal energy market rules, the Commission gave a mixed picture, stating that Member States still lagged behind in implementation. Günther Oettinger, European

Commissioner responsible for energy, said at the launch of the report: "The full and correct implementation of the energy rules has still not been achieved. This situation needs to change and the Commission will use all means available to make this happen. What is at stake is our ability to reach the goals set in the Europe 2020 Strategy through a secure, competitive and sustainable supply of energy to our economy and our society" (CEC 2010c).

As noted already in the first Commission benchmarking report from 2001,[16] asymmetrical implementation of the directives between the Member States had created different market conditions across Member States in Europe, affecting both energy consumers and energy companies. The 2003 benchmarking report added attention to yet another problem for free and fair competition: the *high degree of market concentration* found in the gas and electricity industries in many Member States. This problem was increasing because of the wave of mergers and acquisitions seen between companies in the gas and electricity industries, creating fewer and larger vertically integrated energy groups. Fears were voiced that companies operating in countries shielded from competitive pressure used their monopoly revenue to buy up companies in countries correctly abolishing monopoly conditions, which were less able to fatten up on monopoly rents.

In June 2009, the Commission initiated infringement procedures against 25 Member States for incorrectly implementing internal electricity market provisions and against 21 Member States for deficiencies in transposition of the gas market rules. The key violations identified were lack of transparency, insufficient efforts by TSOs to make interconnection capacity available, absence of regional cooperation, lack of enforcement by national regulators, and lack of dispute settlement procedures (CEC 2010a, 2). The benchmarking report for 2009 shows that most Member States have finally transposed the legal provision guaranteeing all consumers the right to shift suppliers in the national electricity and gas markets, with a few still lagging behind, however. Nevertheless, the report shows that the actual rate of shifts is rather small in many countries. Of those actually making these data available to the Commission, most members recorded no or close to no switching in 2008 in the retail electricity and gas markets (CEC 2010b, 7–8). This indicates that competition is still not very intensive in the retail markets. And to be sure, EU legal unbundling requirements are still applicable only for the major TSOs and not the many distribution companies operating in Europe. The 2009 Benchmarking Report shows that few of the electricity distribution system operators in Europe were ownership unbundled and that only

around 42 percent even had legal unbundling (CEC 2010b, 36). This indicates a clear lack of independence prevailing in European grid operations. Moreover, the benchmarking report shows that the market dominance problem continues in many Member States, with 15 Member States stated to have very highly or highly concentrated electricity market conditions, and the situation is no better for the gas market (CEC 2010b, 12–16). On top of this, lack of infrastructure capacity across the borders and, hence, lack of cross-border trade accentuates the asymmetrical situation across Europe, with some companies operating in home-markets shielded from and others quite exposed to competitive pressure.

The Road Ahead—Prospects for Free and Fair Competition in the European Energy Market

While failing to achieve full ownership unbundling as a guarantee of grid independence, and given the many problems with asymmetrical implementation still making the internal energy market characterized by deficiencies to free and fair competition, the Commission still records an increasing number of allies that share the idea that free market conditions should be realized in an all-European market. The growing number of Member States that have actually carried out voluntary ownership unbundling in the electricity and gas markets illustrates such a will. There is thus much to indicate that the Commission will perceive further proposals in the field as highly legitimate, and not stop with the results achieved through the adoption of the third policy package.

Next, the third policy package provides for new soft-law measures to create a level internal energy market. Alongside application of EU treaty rules and the specific framework directives targeting deregulation of the electricity and gas industry, soft law constitutes the third pillar of EU internal energy market policy, starting out with the establishment of the Florence and Madrid Forums in the late 1990s. This pillar emerged in response to needs for deepening implementation of legislation adopted through the traditional community method. In particular, the Commission acknowledged different harmonization needs (the need to establish common codes of conduct) for TSOs concerning operation of and investments in cross-border transmission infrastructure to enable free trade in energy across the community. More specifically, the Commission acknowledged that there would

be no well-functioning trade in electricity without harmonization of such factors as:

- transmission tariff structures;
- modes by which capacity is allocated when networks are congested, which is the normal situation since cross-border capacity is poorly developed (congestion management);
- modes by which TSOs are compensated for use of their networks in transition of power from one country to another (inter-TSO transit compensation);
- transparency for market agents concerning availability of capacity on interconnectors and tariffs for using them; and
- planning of investments in new interconnector capacity.

The Commission-established Florence Forum created a meeting place and a *process* whereby private industry agents (consumers, producers, and TSOs), national regulators, and EU institutions committed to work for *voluntary* joint solutions. European TSOs established the all-European organization ETSO in response, to coordinate internal discussions.

In 2003, soft law efforts were to a far greater extent codified with regulations adopted under the second internal energy market package. These regulations vested more control with the Member-State governments, notably the European group of national regulators, CEER, and proposed the new organization European Regulators' Group for Energy and Gas (ERGEG) (as CEER's extended arm functioning as the formal advisory group of CEER to the Commission) in leading further work on the development of guidelines for how such common codes of conduct should look. The new regulation meant that if agreement was reached through comitology, codes of conduct related to cross-border trade would be adopted by the Commission and included in the annex to the regulation and function as community hard law. Proceeding from pure voluntarism to community regulation (comitology) reflected the view that the former voluntarism had not created the results hoped for.

In the following years, national regulators (CEER, ERGEG) and the industry itself (ETSO) proceeded with efforts at detailing and negotiating guidelines and codes of conduct, now with a *regional* focus, expecting that splitting up negotiations in smaller groups could bring the process more effectively forward. By 2007, the Commission still voiced great dissatisfaction with the existing leadership of ERGEG. As part of the third internal energy market legislation package,

institutional change has been initiated with greater formalization of TSO cooperation in new EU-level bodies responsible for developing codes of conduct (ENTSO-E for electricity and ENTSO-G for natural gas) as well as a new EU-level regulatory body, ACER.

To be sure, the Commission has great hope that these bottom-up processes will produce results that will eventually increase transparency and harmonization of grid operation codes across Europe and manage to create agreement on investments in new infrastructure seen as pivotal not only for cross-border trade to increase competition in the internal energy market but also more security of supply and better conditions for independent producers of climate-friendly renewable energy. As such, the ambitious climate and renewable energy goals agreed upon by EU Member State leaders in 2007 are currently an important driver of continued internal energy market efforts to open up existing networks and invest in new energy infrastructure across the Member States.

Notes

1. In 1996, the Dutch appeal court, taking the Court of Justice ruling as its base, found that the public service obligations presented by the generators were not sufficient grounds for imposing an import monopoly, and thus the generators had acted contrary to the Treaty's provisions (Lyons 1998, 34).
2. Article 25 (1) of the Electricity Directive and Article 27 of the Gas Directive (European Parliament and the Council 1996; 1998).
3. COM (1998) 167 final. March 16, 1998.
4. COM (97) 599 *Energy for the future—renewable sources of energy.* White Paper.
5. Ibid., 9.
6. Interview with a senior Commission official, February 2008.
7. EurActiv. 2007. *EU states reject breaking up energy firms.* June 7.
8. Interview with Lars Kjølbye, Head of Unit Antitrust—Energy & Environment, DG-COMP, European Commission, Brussels, February 2008.
9. Interview with Matti Supponen, Electricity & Gas Unit, DG-TREN, European Commission, Brussels, February 2008.
10. Interview with Lars Kjølbye, Head of Unit Antitrust—Energy & Environment, DG-COMP, the European Commission, Brussels, February, 2008.
11. Information received in interview with Lars Kjølbye, Head of Unit Antitrust—Energy & Environment, DG-COMP, the European Commission, Brussels, February 2008.