3

The Evolution of the Sector-Specific Regulatory Framework

The essence of both the electricity and gas market directives is the introduction of freedom of choice to engage in the business of and trade in energy—the choice to build power plants and pipelines, the choice to export and import, the choice to select and negotiate with suppliers, shippers, and customers. In order to introduce freedom of choice it was necessary first to eliminate legal obstacles such as, and in particular, exclusive rights. This is a *sine qua non* condition for competition to emerge, but does not guarantee that it will emerge. A much more difficult task, therefore, is the elimination of commercial obstacles and the creation of a commercial environment where freedom of choice can effectively be exercised and result in competition. The example of the UK gas market in the 1980s demonstrated that the elimination of legal obstacles to competition did not bring about competition naturally. The UK gas regulatory authorities had to take a very proactive approach in order to move from the legal possibility of competition to its commercial reality. It was therefore always clear that 'market opening' could not be achieved overnight but would take place gradually. Another question, of course, is whether it has happened or should have happened by now—over 16 years since the first directives.

Both internal market directives are based on the same model, and approach, and use—largely—similar language. Some differences exist. The role of 'gatekeepers', dependence on non-EU suppliers (Russia, Norway, Algeria), and the existence (or at least the successful advocacy) of pre-existing long-term commitments as a temporary impediment to introducing competition have been much more pronounced within the gas industry than within the electricity industry, and are therefore reflected in the gas directives. For example, the management of pre-existing 'take-or-pay contracts' has, rightly or wrongly, played a much greater role in the derogations than might have been expected. Although, as discussed in this chapter, the main thrust of development has sought to minimize the importance of these differences. Today, the differences between both directives are minor. However, this does not suggest that the two markets should be regulated under the same principles or that the same regulatory choices should apply to both electricity and gas. On the contrary, there are considerable differences between the electricity and gas markets and the sector-specific regulatory framework should be sensitive to this. Currently, the differences are most visible in the application of certain provisions in various regulatory instruments (for instance, the exemptions granted under Article 17 of

the Regulation (EC) No. 714/2009 and Article 36 of the Directive 73/2009, discussed below). One of the most crucial and significant differences between these two markets is that electricity is generated within the EU in various locations, the choice of which is based on a number of factors, such as availability of sufficient transmission capacity and the proximity of a consumption centre. There are also generating facilities, which are mainly used as a back-up system. This is not the case for natural gas, although gas storage plays a somewhat similar role. Here, the EU is dependent on a very small number of external suppliers. Natural gas is only located in gas fields in areas geologically suitable for natural gas reserves to develop. Unlike electricity, natural gas is also a commodity that will be depleted at some point in time. These factors cannot be affected by any human measures, although technology can push the date of final depletion further into the future, as has been seen with the advent of unconventional gas. The impossibility of storing electricity is also a differentiating factor.[1]

These issues affect the optimal regulatory framework to be used and the application of the law itself. For example, in comparing the exemptions granted under Article 17 of Regulation (EC) No. 714/2009 and Article 36 of Directive 73/2009,[2] it is of paramount significance to heed the need to attract alternative sources of natural gas. Therefore, it seems quite natural that a very lenient approach to the exemption conditions is adopted where they concern regasification plants.[3] Similarly, as the pipeline gas is largely controlled by the dominant players, LNG represents a very significant alternative and an opportunity for new suppliers to enter the market. Shale gas could have a similar effect. This has to be taken into consideration. These considerations are not as relevant for electricity. New competition can be introduced through interconnectors, but also through new generation capacity. Furthermore, the dependence on a limited number of supply sources and the control of the existing import infrastructure by ex-monopolists has to be considered in cases relating to strategic under-investment. It is no surprise that all of the cases on strategic under-investment under Article 102 of the Treaty on the Functioning of the European Union (TFEU) relate to the natural gas markets. While the issue is of significance to the electricity markets, it is much more important for natural gas markets.

The key obligations under the regulatory frameworks for electricity and gas are:

- Member States must ensure that new facilities for production, transport, and distribution of energy (electricity and gas) are licensed on a non-discriminatory

[1] This was also discussed in K. Talus, *Vertical Natural Gas Transportation Capacity, Upstream Commodity Contracts and EU Competition Law* (Alphen aan den Rijn: Kluwer Law International 2011).

[2] Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, OJ L 211, 14.8.2009, 94–136.

[3] The US approach seems to be very similar, though more pragmatic and efficient. For this, see K. Talus, 'Access to Gas Markets: A Comparative Study on Access to LNG Terminals in the European Union and the United States', 31(2) *Houston Journal of International Law* (2009), pp. 343–76. The article argues that the similar approach on both sides of the Atlantic is due to competition over supplies and investment in the LNG supply chain. The recent progress in US shale gas has obviously changed the situation in this regard.

basis: i.e. there are no preferential or exclusive rights for established and/or state-owned companies, earlier monopolies, and 'gate-keepers';

- third party access (TPA) provisions, necessary due to the 'natural monopoly' character of the transportation segment of the electricity and gas markets, require effective (in law and practice) and non-discriminatory access for competitors. Over the years there has been progress in the right direction, away from a single buyer model in electricity (though not in gas); and from negotiated TPA finally to regulated TPA (as the only option);
- similarly to TPA, due to the 'natural monopoly' character of the transportation markets and transmission operators also acting as producers/buyers, traders, and distributors of energy, there is an inherent conflict of interest between their supposedly 'neutral' role as network operators open to all companies and their privileged position with respect to their competitors without control over transmission networks. There is an immanent temptation for them to capitalize in their competitive business on their control of the transmission networks: e.g. by cross-subsidizing their competitive business with monopoly rent. This can be done through a very natural favouritism in network transmission towards their own business over the demands of their competitors, and by using the confidential insight into the business of competitors gained by the network operator to help its divisions engaged in competition. The response to this contained in the directives has been to require different degrees of unbundling, ranging from the unbundling of accounts between the 'neutral transmission' and the other, competitive, activities of the transmission operators (i.e. a 'Chinese wall') to ownership unbundling, although this option has so far not been imposed on Member States;
- the transmission/network operators are given special responsibility for managing the system. This both affirms their current role and the perhaps greater need for such formal responsibility in an open system involving diverse actors in a diversified market;
- the directives do not directly impose 'public service' obligations, but encourage Member States to do so, with the proviso that these are verifiable, non-discriminatory, and transparent. The Commission reserves an oversight role to itself;
- with integrated monopoly and public ownership, the state's role was oversight of the operations of the monopoly. This role needed to be changed as a competitive market developed, with the problematic elements of still-existent or unavoidable natural monopolies. The crucial issue of access requires the presence of a regulatory authority to ensure that access is undermined neither in law nor practice by obstructive actions taken by the network operator to try to use its control over the vital network to thwart competitors. Initially, the directives fell short of requiring an independent energy regulator, but this has subsequently been rectified.

In addition to these elements in the directives, an initial key obligation was also to allow 'eligible customers' to choose their supplier and have access to the transport networks. Eligibility criteria were formulated so as to increase the number of eligible customers in phases, basically by lowering the minimum threshold of annual consumption to define eligibility to achieve a specified, phased increasing minimum market opening, which was finally completed on 1 July 2007.

Sections 3.1–3.5 focus on the developments and individual merits and drawbacks of sector-specific regulation in the areas of generation, third party access, unbundling, derogations and exemptions (including public service obligation and merchant exemption), and security of supply.

3.1 Generation

Articles 7 and 8 of the Electricity Market Directive allow Member States to choose between an authorization procedure and a tender procedure.[4] The authorization procedure obliges governments to apply a limited number of objective criteria when authorizing new generation facilities, to make the decision in a transparent way and to provide reasons and an appeals mechanism for refusals (to be notified to the Commission). It would seem that under these provisions, new entrants therefore must have a legal right to authorization, provided that they comply with the criteria set forth. This interpretation of Article 5 has a bearing on energy investors' rights under national law: if Member States do not explicitly establish such a legal right, the directive may generate one by 'direct effect' or by 'indirect effect': i.e. by a reading of national law in conformity with the directive. The procedure does not depend (unlike the tender procedure) on long-term forward state planning of required capacities put out to tender, but lets the market forecast future demand, supply competition, and commercial feasibility in a competitive context. In principle, it facilitates the establishment of technologically, commercially, and environmentally superior power plants to out-compete existing operations. The devil is in the detail of the criteria listed. These are very general and can easily be manipulated to undermine the policy of this 'freedom to build new capacity'. But if such manipulation takes place—which can be identified through its having a discriminatory effect, through lack of transparency and failure to comply with the criteria as used in practice, or through a visible attempt by state agencies to replace the new entrants' judgement of future energy needs with their own and thereby protect existing national producers from competition—a case of non-compliance will exist and can be challenged under international and EU law. The problem for a new investor, then, is not so much obtaining authorization to build a plant, but securing access to customers and transmission capacity.

While open in nature, the criteria laid down in both Articles plainly allow for discrimination in favour of generation of green electricity. This is clearly illustrated by Article 7, which refers explicitly to the protection of the environment, the

[4] For a very detailed analysis, see H. Bjørnebye, *Investing in EU Energy Security: Exploring the Regulatory Approach to Tomorrow's Electricity Production* (Alphen aan den Rijn: Kluwer Law International 2010).

nature of the primary sources (here security considerations might also come into play), contribution to the EU targets for renewable energy, and the contribution of generating capacity to reducing emissions.

The tender procedure is only meant as a backup, to be used when markets fail and security of supply is at stake. One might assume that a state would use long-term power purchase contracts as 'carrots'. It seems, however, that this option has not been used by Member States (including, surprisingly, France).

A final point is that, as the rationale of the provision is to allow market access under non-discriminatory conditions, there is no need actually to have a formal authorization procedure. For example, in principle there are no general energy-related authorization procedures for the construction and operation of power plants in Finland and, as such, power production is not subject to a specific licence or authorization. (Obviously, general concession procedures, which are linked to land-use planning and environmental protection, still apply.) A special licensing procedure applies for nuclear power stations under the Nuclear Energy Act of 1987 and for the exploitation of hydropower under the Water Act of 1961.[5]

3.2 Third Party Access

The EU electricity and gas markets are both network-bound markets, with the obvious exception of LNG markets in which large LNG ships can take the cargo wherever the best price can be obtained.[6] This means that the success or failure of a competitive market depends to a significant extent on the TPA provisions. Unless access to the transmission networks—usually natural monopolies in the hands of incumbents mostly acting as producers, importers, and suppliers, and sometimes distributors as well—both the freedom to produce and the freedom to purchase are pointless. TPA is therefore the pivot around which the push towards open and competitive markets turns. It is recognized that purely voluntary access—on the theory that the network owners might want to develop more of a profitable transport business—did not work and does not work. TPA means that the owner and operator of infrastructure must provide access to the capacity, either total capacity or only unused capacity, for eligible third parties on non-discriminatory conditions. As long as the network is in the hands of a vertically integrated company—that is, where full ownership unbundling has not taken place—the legislator has to take positive action in order to guarantee TPA, often against the will of the owner. The legislator has two main options to regulate TPA: negotiated access or regulated access. In addition, a single buyer model is possible.

As far as electricity is concerned, the first (1996) directive offered a choice between three options. The first of these was the single-buyer model (included on

[5] See, K. Talus et al., *Energy Law of Finland* (Alphen aan den Rijn: Kluwer Law International 2010).

[6] For example, see K. Talus, 'Access to Gas Markets: A Comparative Study on the Access to LNG Terminals in EU and US', 31(2) *Houston Journal of International Law* (2009).

French insistence), which was quickly recognized as not workable, and not adopted even in France. The second was the regulated access model. The third was negotiated access where, supposedly, the terms are freely negotiated but some pressure is exerted to push the recalcitrant network operator in the right direction if need be. As per Article 17(3) of the first electricity directive, negotiated access did not require 'tariffs', but 'indicative prices'. However, it is not practical to consider that any transmission might be based on separate detailed negotiations.

The 1998 gas directive did not include the single-buyer model. Where gas was concerned, Member States were able to choose between negotiated access and regulated access (under Articles 14–16). These access regimes were, in both cases, accompanied by the demands of objective, transparent, and non-discriminatory operating criteria. A mixed regime was also possible.[7] Denmark and the Netherlands, for example, applied a mixed system in which they opted for negotiated access for the transmission grid and regulated access for the distribution grid.[8]

As with electricity, under the negotiated access regime the gas companies were obliged to negotiate access to the gas network with the eligible customers in good faith and to publish the main commercial conditions for access.[9] Under the regulated access regime, the gas companies were obliged to provide access on the basis of published tariffs and other possible terms and conditions for use of the system.[10]

As distinct from the first electricity directive, the 1998 gas directive already mentioned the Member States' right to oblige gas TSOs to expand transport capacity if the customer is willing to pay for it. The gas directive also included access to 'storage', but this had very little practical effect.

To understand the TPA system prescribed by the first internal energy market directives from 1996 and 1998, one should envisage the first step as a legal right (of producers and consumers) of access against the network operator (and sometimes the distributor). This right of access is nothing but the transposition into the directive (and from there into national law) of the duty of the owner of an essential facility under Article 102 TFEU to deal with prospective users on reasonable and non-discriminatory terms. But this legal entitlement is then almost prohibitively limited in all sorts of ways. The main excuse for refusing access was (and is) lack of capacity. A refusal must be substantiated and the reasons given verifiable. The lack of capacity objection is a most malleable excuse. Since the network operator has control over technology, management, contractual commitments, capacity, and information, it is not difficult for them to formulate such an objection.[11]

[7] Article 14 of the first gas market directive. See also the Commission explanatory information at: <http://ec.europa.eu/energy/gas/legislation/historical_documents.htm>.

[8] M. Roggenkamp et al. (eds), *Energy Law in Europe* (Oxford: OUP 2008), p. 1305.

[9] Article 15 of the first gas market directive.

[10] Article 16 of the first gas market directive.

[11] This provision is examined in great detail in K.B. Moen and S. Dyrland, *EUs Gassmarkedsdirektiv* (Bergen: Fagbokforlaget Vigmostad & Bjorke AS 2002), pp.188–302. The authors discuss, among many other issues, the meaning of 'serious' and 'threat' and the role of the provision as a safety-valve for companies. They conclude that the effect of the provision will depend on the market trends and the approach of the Member States and the Commission.

The next set of excuses (which may overlap with the no-capacity excuse) were the pre-existing contractual arrangements (including those created by the network operator's own or affiliated competitive electricity sales operations), technical constraints (under the control of the network operator), and priority to be given to renewable energy sources and energy produced from indigenous fuel (e.g. German coal; Dutch gas, with 15 per cent of the total ceiling).

The last set of excuses (both from the network operator and Member State) lies in the public service obligation, if Member States can prove that such access would essentially undermine the feasibility of providing a mandatory public service and there is no less restrictive alternative available.

The logical strategy of the recalcitrant network operator keen to exclude newcomer competitors from the market it already serves is to rely on technical and environmental constraints in order to interpret capacity very narrowly and then to fill such capacity with its own, affiliates' and friendly companies' contractual deliveries (which may be secretly conditional). If access is requested and negotiated, the counter-strategy is to fill the network with 'friendly' capacity before the negotiations advance to detail. Proving that discrimination has taken place represents a very difficult, costly, uncertain, and protracted battle for any company seeking access.

Clearly, the first internal energy market directives can only be considered as having been a first step towards a regulatory regime able to enhance and support free EU-wide competition, instead of national and tightly regulated and controlled markets. A stronger and more clear-cut access regime was simply not a possibility at that time. The political compromise resulted in a choice of three different access regimes, to be selected by the Member States. However, even given the well-known shortcomings of these first directives, they represent an important start in the road towards a competitive EU-wide markets.

The second energy market package[12] pushed the energy *acquis* towards a regulatory system able to accomodate the emergence of a further degree of competition, and went considerably further in 'regulating for competition'.[13] The two new directives and accompanying regulations sought, with mixed success,[14] to rectify the failures

[12] Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC, OJ L 176, 15.7.2003, pp. 57–78; Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, OJ L 176, 15.7.2003, pp. 37–56; Regulation (EC) No. 1228/2003 of the European Parliament and of the Council of 26 Jun. 2003 on conditions for access to the network for cross-border exchanges in electricity, OJ L 176, 15.7.2003, pp. 1–10; Regulation (EC) No. 1775/2005 of the European Parliament and of the Council of 28 September 2005 on conditions for access to the natural gas transmission networks, OJ L 289, 3.11. 2005, pp. 1–13.

[13] P. Cameron, *Competition in Energy Markets: Law and Regulation in the European Union* (Oxford: OUP 2007), 30.

[14] Prospects for the internal gas and electricity market (COM(2006)0841); Progress in creating the internal gas and electricity market (COM(2008)0192); Progress in creating the internal gas and electricity market (COM(2009)0115). For the early effects of the new regime, see the national reports in P. Cameron, *Legal Aspects of Energy Regulation: Implementing the New Directives of Electricity and Gas Across Europe* (Oxford: OUP 2005). However, it must be noted that the legislative situation described in the book represents the situation in October 2004. Needless to say, a lot has happened since then—especially since a large number of Member States had not yet implemented this regulatory package.

and shortcomings of the previous regulatory regime. As far as TPA is concerned, the new regime eliminated the negotiated access regimes from electricity and limited its application to specific parts of the gas supply chain such as storage or linepack.[15] As such, the access regime relating to most of the supply chain in gas and electricity was now based on a regulated access regime. Tariffs had to apply to all eligible customers, including supply undertakings, and had to be applied objectively and without discrimination as between system users.[16] According to the ECJ, non-discriminatory TPA concerns both the potential supply undertakings and the eligible customers.[17]

The latest step along the way to competitive markets is the third energy package. The new regulatory framework extends the application of the TPA rules to new areas and pushes the obligations of the TSO to a new level by, for example, highlighting investments and the need to ensure the long-term viability of the system. Clearly, the visible trend throughout this development from the first to the second and third package is a move towards a more comprehensive regulation of TPA and towards shorter-term capacity reservations.

3.2.1 Regulation of TPA under the EU Energy *Acquis*

In general terms, TPA in the sector-specific regulation relating to EU electricity and gas markets is developed through three levels of regulation with very different levels of detail. The general framework was established in the general internal market directives,[18] which lay down the basic rules and principles of TPA. The content of these rules and principles are then further elaborated in the two access regulations (715/2009 (gas) and 714/2009 (electricity)), which specifically focus on access issues and complement the more general directives. However, the third and most detailed level of regulation are the network codes and guidelines which can be adopted on the basis of the regulations.[19]

At a general level, the access rules under the third energy market directives are not very different from those of the previous 2003 regime. In simple terms, the new directives require that the regulated TPA regime is based on published and

[15] The TPA regime of the gas market directive also includes the appointment of the operator and designation of certain tasks and duties. These issues will not be examined here. Instead, the focus will be on the substantial and directly TPA-related provisions.

[16] The exception was the TPA regime for upstream pipeline systems within EU.

[17] Case C-239/07, *Julius Sabatauskas and Others* [2008] ECR I-7523.

[18] Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC, OJ L 211, 14.8.2009, pp. 55–93 and Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, OJ L 211, 14.8.2009, pp. 94–136.

[19] Framework Guidelines on Capacity Allocation and Congestion Management for Electricity (FG-2011-E-002) 29 July 2011 and Framework Guidelines on Capacity Allocation Mechanisms for the European Gas Transmission Network (FG-2011-G-001) 3 August 2011. For comments and analysis, see A. de Hauteclocque and K. Talus, 'Capacity to Compete: Recent Trends in Access Regimes in Electricity and Natural Gas Networks', in B. Delvaux, M. Hunt, and K. Talus (eds), *EU Energy Law and Policy Issues* (Cambridge: Intersentia 2011).

pre-approved tariffs, which are applied in a transparent and non-discriminatory way. In addition, there are provisions addressing many related issues such as balancing, publishing requirements (though most elements are left for the national regulators to decide), and on fixing or approving the tariffs or the methodologies for their calculations (though, again, most of the details, including return on risk or investment incentives, are left for the national regulatory authorities), etc.

Access tariffs payable by shippers vary from Member State to Member State. However, the directives require that the tariffs or the methodologies underlying their calculation be approved by the national regulatory authorities and then published before entering into force. Therefore, renegotiation with particular customers is not possible. In particular, no rebates or special schemes may be offered to group companies.

The situations where access might be denied largely follow the old regime. Access may be refused where there is: (i) lack of capacity; (ii) a public service obligation imposed by the Member States; and (iii) a 'sudden crisis' under Article 46 for gas, and Article 42 for electricity (essentially a *force majeure* provision). In addition, access to the gas transportation network can be refused on the basis of serious economic and financial difficulties with a take-or-pay contract. Access refusal must be reasoned and Member States may choose to ensure that the TSO/Distribution System Operator (DSO) makes the necessary enhancements to the system when it is economical to do so, or when the customer is willing to pay for such enhancements in capacity or connection (Article 35 for gas and Article 32 for electricity). The case law of the ECJ indicates that this possibility to refuse access to the system must be assessed on a case-by-case basis. It does not give Member States the right to lay down derogations in a general manner without assessing the technical capacity of the system to meet third parties' access demands.[20]

Where gas is concerned, the upstream pipeline network is one major exception. This is not a novelty introduced through the third gas directive. On the contrary, all three regimes, from the first to the third Gas Market Directive, regulated access to upstream pipelines. Access to this section of the gas supply chain was organized and regulated separately from the general TPA provisions—an access regime in line with practice in the North Sea area. On discovery of new gas fields, access to the existing pipeline system was negotiated between the producer and the pipeline company or operator. However, the governmental control brought about by formal regulation of the access regime in upstream gas is a welcome addition.[21] Article 34 of the third gas market directive stipulates that natural gas undertakings and eligible customers must be able to obtain access to upstream pipeline networks, including facilities supplying technical services incidental to such access. The parts of the upstream networks and facilities used for local production operations at the site of a field where the gas is produced constitute an exception to the TPA

[20] Case C-439/06, *Citiworks AG Flughafen Leipzig v Halle GmbH, Bundesnetzagentur* [2008] ECR I-3913, para. 57.

[21] For more details, see M. Roggenkamp et al. (eds), *Energy Law in Europe* (Oxford: OUP 2008), p. 1305.

obligations contained in Article 34. This access must be provided in accordance with the objectives of fair and open access, achieving a competitive market in natural gas and avoiding any abuse of a dominant position, taking into account security and regularity of supply, the amount of capacity, which can reasonably be made available, and environmental protection. Access can only be refused under the conditions listed in the directive, although it must be noted that these conditions are sufficiently broad to enable a fairly broad recourse to such refusal. One condition, for example, is the reasonable needs of the owner, operator, or other users. To strengthen this upstream access regime, a dispute settlement mechanism must be put in place. This exception from the general TPA regimes seems logical, considering the many differences between upstream and downstream pipelines and the number of Member States where upstream pipelines actually exist (arguably, this market segment could have been left to subsidiarity).

Much like the 2003 directives, the new regime leaves Member States with considerably less discretion as to implementation.[22] However, this does not mean that differences cannot persist. Neither does it mean that the access regime is complete and perfectly functioning.[23]

To complement these basic rules on TPA, the EU energy *acquis* also includes access-specific regulation, which takes these basic provisions as a starting point and develops the access regime further by regulating the allocation of capacity where demand exceeds supply.

The two central issues raised by the transmission of electricity and transportation of gas in the context of the liberalization of the EU energy market are access to the network and the availability of capacity on the network. Initially, EU energy market regulation focused primarily on access issues.[24] The question of availability was only addressed later. For electricity, these questions were largely addressed in the 2003 regulation on conditions for access to the network for cross-border exchanges in electricity and the related guidelines.[25] Again, much as with the first energy market directives from 1996 (electricity) and 1998 (gas), gas regulation lagged two years behind and these issues were addressed in 2005 through Regulation (EC) No. 1775/2005 on conditions for access to the natural gas transmission networks. These regimes were then repealed and replaced by Regulation (EC) No. 715/2009 (gas) and No. 714/2009 (electricity). The objectives of these two regulations include: the setting of rules for cross-border trade and harmonized

[22] Many of the 46 (25 for electricity and 21 for gas) infringement proceedings initiated by the Commission in June 2009 related to access issues (lack of transparency, insufficient coordination efforts by transmission system operators to make maximum interconnection capacity available, absence of regional cooperation, and others). See the press releases IP/09/1035 and IP/09/1490.

[23] See, for example, Commission press release, 'Energy infringements': Country fact sheets (MEMO/09/296, 25 June 2009) and Commission press release, 'Q&A: the infringement exercise concerning cross-border energy network access and regulated prices' (MEMO/09/297, 25 June 2009).

[24] U. Hammer, 'The Relationship between Capacity Markets and Spot Market in the Gas Sector', in M. Roggenkamp and U. Hammer (eds), *European Energy Law Report II* (Cambridge: Intersentia, 2005), 230–1.

[25] Regulation (EC) No. 1228/2003 of the European Parliament and of the Council of 26 June 2003 on conditions for access to the network for cross-border exchanges in electricity, OJ L 176, 15.7.2003, 1–10.

principles for capacity allocation and congestion management; the determination of transparency requirements;[26] the facilitation of capacity trading; and the emergence of well-functioning wholesale markets.

Various methods—both market-based and others—are available to allocate the available transfer capacity. A market-based capacity allocation mechanism involves auctioning, where the capacity is auctioned and the highest price is the price paid for the capacity. An explicit auction will start at a minimum price and, depending on the demand, will rise until the entire capacity is used. While market-based allocation methods are used in some Member States' gas markets, they are much more extensively used in the electricity markets. There is no obvious reason for this differentiation. It also seems, as discussed below, that the approach used in the two markets is converging and that auctions will also become the method of choice in natural gas markets. Other mechanisms used include *pro rata* allocation, where the capacity is divided further on request of the market participants until all capacity has been allocated. Where demand exceeds maximum capacity, the market participants' requests are denied, using a specific mechanism. The obvious risk of this allocation mechanism is that a shipper's capacity is restricted to the point where it is no longer commercially attractive. Another risk is that the shipper anticipates high demand and requests more capacity than it needs. The first-come, first-served mechanism, in which capacity request orders are fulfilled in the order received, is another possible approach. The hoarding of capacity is the obvious risk here, where an undertaking books more capacity than is actually necessary, in order to block competitors from accessing the network. In all cases, a high degree of transparency can obviously alleviate these problems.

At a general level, Articles 37(6) (electricity) and 41(6) (gas) of the energy market directives require that the national regulatory authorities draft the procedures for the allocation of cross-border capacity and congestion management. However, in practice, the details of this requirement are largely left to the more detailed rules. At a basic level, Regulations (EC) No. 715/2009 and No. 714/2009 require that the capacity allocation must facilitate new investment and be market-based. Explicit and implicit auctions are the market-based methods compatible with these regulations. As in all parts of the energy *acquis* dealing with access issues, the requirements of non-discrimination and transparency accompany the more detailed provisions.[27]

On the request of the Commission and on the basis of Articles 6 of Regulation (EC) No 713/2009 and of Regulation (EC) No 715/2009 (for gas) and Regulation (EC) No 714/2009 (for electricity), the ACER has developed framework guidelines to deal with these issues (capacity allocation and congestion management).[28]

[26] Transparency is one of the most crucial issues for a functioning market both in terms of capacity reservations and capacity allocation. Essentially, the operations of the network must be so transparent that in practice—not just in theory—outsiders face no *de facto* handicaps in using the network as compared to insiders.

[27] Article 13 of Regulation (EC) No. 715/2009.

[28] Framework Guidelines on Capacity Allocation and Congestion Management for Electricity (FG-2011-E-002) 29 July 2011 and Framework Guidelines on Capacity Allocation Mechanisms for the European Gas Transmission Network (FG-2011-G-001) 3 August 2011.

Without going into the detail, these guidelines[29] require, in line with the directives and regulations, that TSOs offer both firm and interruptible and both short-term and long-term TPA, and they provide detailed guidance in this regard. Existing contracts also need to be adapted to the new guidelines (also for gas).[30]

The objectives of the TPA provisions of both the electricity and natural gas regulations are very similar: to create capacity to compete. However, the specific features and development stage of these two commodities result in different routes towards this common goal. For electricity, the development of market-coupling initiatives creates new regulatory challenges, although prices are increasingly converging. For gas, progress has been slower and efficiently-functioning spot markets have yet to emerge. However, the rapid and fundamental changes brought about in world LNG markets have caused a significant change in this respect and have created favourable conditions for short-term trading. In addition to the significant increase of available volumes and decreases in LNG prices, there is also an important regulatory dimension to this development. The introduction of TPA along with ownership unbundling, driven by both regulatory changes and antitrust enforcement, has combined with elimination of destination clauses (and other historical elements of the market structure) completely to transform the regulatory context in which natural gas companies operate. These fundamental changes have had a significant impact on the markets and spot trading in the EU natural gas markets has taken off.

One issue with respect to TPA is that the access regimes for electricity and gas are very similar, despite significant differences in the ways in which the markets are organized. The sector-specific regulatory regime in the internal market directives creates a market design in both sectors based as much as possible on short-term capacity allocation with liquid secondary trading platforms. The right portfolio of capacity periods is crucial to achieve a functioning energy system. Periods of long duration—far exceeding three years—are needed to facilitate investment in both sectors, but the optimal mix of short- and longer-term contracts is likely to differ greatly between the sectors.[31]

3.3 Unbundling

Due to the natural monopoly character of both electricity and gas networks explained in the introductory section of this chapter, this segment of the energy industry is a non-competitive market and needs to be separated from competitive

[29] These have been examined in detail in A. de Hauteclocque and K. Talus, 'Capacity to Compete: Recent Trends in Access Regimes in Electricity and Natural Gas Networks', in B. Delvaux, M. Hunt, and K. Talus (eds), *EU Energy Law and Policy Issues* (Cambridge: Intersentia 2011).

[30] This issue is discussed in detail in K. Talus, *Vertical Natural Gas Transportation Capacity, Upstream Commodity Contracts and EU Competition Law* (Alphen aan den Rijn: Kluwer Law International 2011).

[31] A. de Hauteclocque and K. Talus, 'Capacity to Compete: Recent Trends in Access Regimes in Electricity and Natural Gas Networks', in B. Delvaux, M. Hunt, and K. Talus (eds), *EU Energy Law and Policy Issues* (Cambridge: Intersentia 2011).

segments such as production and supply. This is the underlying objective of unbundling: to separate the competitive from the non-competitive segment in order to prevent misuse through control of the latter. This objective underpins the current regulation of the energy market: all unbundling obligations concern the separation of network activities from other possible activities. An undertaking may therefore engage in different activities as long as it stays out of the network business.

In the most basic terms, unbundling is necessary because there is an internal conflict of interest within a vertically integrated company: by allowing access to the network, the transmission/distribution branch of the company creates competition for the supply arm, which will have a negative impact on the company's overall return.[32] Logically speaking, a company will strive to maximize group revenue (the management also has this obligation to the shareholders). This idea conflicts with the idea of market liberalization: taken to the extreme, it will eliminate any and all competition and prevent market entry.

3.3.1 The Status Quo—From Account Unbundling to Legal Unbundling and Ownership

Clearly, if the logic of regulation of a natural monopoly were to be pursued to its conclusion, network (transmission system) operators would have to be divested from integrated energy companies and fulfil the independent public service of transporting natural gas or electricity,[33] their business interest being aligned with the interest of maximizing transport revenues. This end result, achieved for example in the UK, Spain, and the Netherlands,[34] has so far been diluted in EU energy market regulation. Interestingly, this was never done in the US, where liberalization of the gas markets started much earlier than in the EU. In the US, the method of choice has been conduct-related rules coupled with heavy supervision by the Federal Energy Regulation Commission (FERC).

The first internal market directives contained mere 'management unbundling'—i.e. transmission must be organized as a separate division with separate accounts within a corporate system. This mandatory building of 'glass walls' or 'Chinese walls', designed to insulate the transmission business from the same company's business competing with new entrants requiring grid access, could only be of limited practical

[32] DG Competition Report on Energy Sector Inquiry of 10 January 2007 (SEC(2006) 1724) 10.1.2007, p. 14. See also a speech by the Competition Commissioner Neelie Kroes, 'A new European energy policy; reaping the benefits of open and competitive markets' (SPEECH/07/63, Essen, 5 February 2007).

[33] The concept 'third party access' is distinct from the concept 'common carriage' used in connection with oil pipelines. The latter concept cannot be used in connection to natural gas. See J. Stern, 'The Prospects for Third Party Access in European Gas Markets', Chs. 10 and 11 in E. Mestmäcker (ed.), *Natural Gas in the Internal Market—A Review of Energy Policy* (London-Dordrecht-Boston: Graham & Trotman 1993), pp. 184–5.

[34] For a detailed overview of the Dutch situation, see M. Roggenkamp, 'Full Transparency Through Ownership Unbundling: Ownership Unbundling of Transmission and Distribution Grids in the Netherlands', in M. Roggenkamp and U. Hammer, *European Energy Law Report VI* (Antwerp: Intersentia 2009), pp. 61–76.

value. Such artificial structures may, at best, result in a kind of quasi-independence.[35] Admittedly, there were also rules to strengthen it, such as a report on affiliate transactions, but it was naturally unrealistic to expect the management of a corporate division to neglect their own career and collegiality in order to favour competitors threatening the incumbent firm's livelihood.

The 2003 directives marked a significant and necessary improvement over the previous regime.[36] In essence, they provided for both legal and functional unbundling for both transmission system operators and larger distribution system operators.[37] This meant that where the TSO or a DSO was a part of a vertically integrated undertaking, the ownership had to be legally separate from other activities of the group. The TSO or the DSO had to be independent 'at least in terms of its legal form, organisation and decision making from other activities not relating to' transmission or distribution. These provisions were further strengthened by rules relating to the conduct of the network operator, the emphasis being on managerial independence and a compliance programme. These provisions included limitations on the ability to participate in the management of both the network company and other parts of the group, the separation of professional or career interests (reward schemes, salaries, etc.), control and decision-making independence as far as possible, and so on. A compliance programme also had to be set up to prevent discriminatory conduct.

The idea behind the 2003 provisions is that, while it may be argued that if the management and account unbundling, as required by the first regime, is truly operational and implemented in good faith, it is in fact sufficient and the separation of companies to different subsidiaries adds little to the pre-existing situation, the legal unbundling adds to the independence of the network company. It was believed that by creating a separate legal entity, the employees, including the management, would increasingly be able to act independently of the parent company and aim at maximizing the return of the network company.[38]

The idea was therefore to change the corporate identity, from the employee's perspective, through conduct-related rules. It seems, however, that this did not

[35] The Competition Commissioner has made similar remarks concerning the legal unbundling regime. See the speech by Competition Commissioner Neelie Kroes 'A new energy policy for a new era', in a conference: 'European Energy Strategy—the Geopolitical Challenges', Lisbon, 30.10.2006 (SPEECH/06/648), speech by Competition Commissioner Neelie Kroes, 'Improving Europe's energy markets through more competition', Tischgespräch—Industrie-Club e.V. Düsseldorf, 23.3.2007, (SPEECH/07/175), speech of Competition Commissioner Neelie Kroes, 'Improving competition in European energy markets through effective unbundling', Fordham Corporate Law Institute's annual seminar 27.9.2007, (SPEECH/07/574), and Neelie Kroes 'A new European Energy Policy; reaping the benefits of open and competitive markets' in the E-world energy and water conference, Essen, 5.2.2007 (SPEECH/07/63).

[36] For an example of the effects of this new regulatory regime in Member States, see B. Malmendier and J. Schendel, 'Unbundling Germany's Energy Networks', 24(3) *Journal of Energy and Natural Resources Law* (2006) and the country reports in P. Cameron (ed.), *Legal Aspects of Energy Regulation: Implementing the New Directives of Electricity and Gas Across Europe* (Oxford: OUP 2005).

[37] Articles 9 and 13 of the second gas market directive and Articles 10 and 15 of the second electricity market directive.

[38] C. Jones, *EU Energy Law—The Internal Energy Market* (Leuven: Claeys & Casteels 2004), p. 73.

take place. Despite the new rules, significant opportunities for misuse remained. The regime did not appear to achieve the results hoped for. The Commission's Sector Inquiry[39] indicated that severe structural problems were still blocking the path towards an efficiently-functioning internal market for energy. The high degree of vertical integration was specifically identified as a problem, and was also seen as a background factor for many other issues identified by the Commission.[40]

The problem of the existing conduct-related rules—compared to a more drastic corporate restructuring—is that rules, which are not aligned with normal personal and organizational incentives are always a less effective way forward than designing organizational structures which produce the right incentives per se. Despite this, the overall effect of the 2003 directives (once they were properly implemented[41]) was to make discrimination somewhat more difficult for management and to accelerate a probably unavoidable trend towards more complete divestment of ownership and ultimately economic control (ownership or control unbundling), much as is typically required in situations where approval of a merger is accompanied by divestment conditions and more frequently also under Regulation 1/2003.[42]

The 2007 Sector Inquiry threw up numerous examples where the current unbundling regime seemed to fail to achieve its purpose. The various issues uncovered included the top management of a supply company having access to privileged information directly or through board positions, rebates being offered to the supply branch, the favouring of group companies in procurement for network services and balancing, discriminatory behaviour in investment decisions, joint training sessions, shared trading names, the necessity of obtaining approval for major investment decisions, and interpersonal relations.[43] Although it is clear that many of these problems have been rectified since the Sector Inquiry, it is fair to assume that some persist.[44] There is evidence of the existence of persistent problems closely

[39] Preliminary report of the Sector Inquiry under Article 17 Regulation 1/2003 on the gas and electricity markets (16 February 2006) and Communication from the Commission, Inquiry pursuant to Article 17 of Regulation (EC) No. 1/2003 into the European gas and electricity sectors (Final Report) COM(2006) 851 final.

[40] A partial reason for the inefficiency of the past regime can also be a weak regulatory action by the Member State authorities.

[41] See '3rd Legislative Package Input Paper 1: Unbundling' a European Regulators' Group for Electricity and Gas (ERGEG) public document. Ref: C07-SER-13–06–1-PD, 5 June 2007, p. 7, where ERGEG notes that market integration is achieved within countries. This is a further sign of national resistance to market opening. See also Case C-196/07, *Commission of the European Communities v Kingdom of Spain* and Case C-358/05, *Commission v. Spain*, Judgment of 21 June 2007 and K. Talus, 'Role of the European Court of Justice in the Opening of Energy Markets', 8(3) *ERA FORUM* (2007), pp. 435–48.

[42] Commission press releases 'Antitrust: Commission welcomes E.ON proposals for structural remedies to increase competition in German electricity market', (MEMO/08/132), 28.2.2008, 'Antitrust: Commission market tests commitments proposed by E.ON concerning German electricity markets', (MEMO/08/396), 12.6.2008 and 'Antitrust: Commission welcomes RWE proposals for structural remedies to increase competition in German gas market' (MEMO/08/355), 31.5.2008. These cases will be discussed in more detail below in Chapter 4.

[43] DG Competition report on energy Sector Inquiry of 10 January 2007 (SEC(2006) 1724) 10.1.2007, pp. 55–60.

[44] Similarly, see DG Competition report on energy Sector Inquiry of 10 January 2007 (SEC(2006) 1724) 10.1.2007, p. 161.

linked with the vertical integration of energy companies. Recent competition law cases, starting with the 2004 *ENI/Trans Tunisian Pipeline* case[45] and continuing with the *ENI*,[46] *E.ON*,[47] *RWE*,[48] *GDF Suez*,[49] *E.ON*,[50] and *CEZ*[51] cases, all suggest that structural problems related to vertical integration might require radical measures. A similar conclusion can also be drawn from the Commission's energy market progress reports.[52]

Due to these persistent problems, which seemed to stem at least partially from the weak unbundling regime, the Commission proposed the next step: full ownership unbundling.[53] This was to be a clear change to the second energy market directives 2003/54/EC (electricity) and 2003/55/EC (gas), which explicitly excluded the obligation of ownership unbundling.[54] Under the eye-catching heading 'Energising Europe: A *real* market with secure supply',[55] ownership unbundling of the electricity and gas networks was favoured so that 'no supply or production company active anywhere in the EU can own or operate a transmission system in any Member State of the EU'.[56] As a second-best solution, the Commission also proposed the independent system operator model, according to which 'vertically integrated companies [...] retain the ownership of their network assets, but [which] requires that the transmission network itself is managed by an independent system operator—an undertaking or entity entirely separate from the vertically integrated company—that performs all the functions of a network operator'.[57]

However, due to resistance from France and Germany, backed by a number of smaller Member States,[58] and the claims over incompatibility with the right to property and proportionality,[59] the full ownership unbundling option was watered down. Under the new regime, Member States are in effect given a three-way choice. In practice, they may thus decide to opt either for full ownership unbundling,[60]

[45] Case A 358, decision by the Italian Autorità Garante della Concorrenza e del Mercato of 15 February 2004.

[46] Case COMP/39.315—ENI.

[47] Case COMP/39.388—German Electricity Wholesale Market and Case COMP/39.389—German Electricity Balancing Market.

[48] Case COMP/39.402—RWE gas foreclosure.

[49] Case COMP/B-1/39.316—Gaz de France (gas market foreclosure).

[50] Case COMP/39.317—E.ON gas foreclosure.

[51] Case COMP/39.727, CEZ. See also Antitrust: Commission opens formal proceedings against Czech electricity incumbent CEZ (IP/11/891) 15.7.2011.

[52] 'Progress in creating the internal gas and electricity market' (COM/2008/0192 final), Report on progress in creating the internal gas and electricity market (COM/2009/0115 final) and Report on progress in creating the internal gas and electricity market (COM(2010)84 final).

[53] See, in particular, 'Questions and answers', (MEMO/07/362), 10 September 2007.

[54] See Article 15(1), 2nd sentence, Electricity Directive 2003/54/EC and Article 13(2), 1st sentence, Gas Directive 2003/55/EC.

[55] See press release, (IP/07/1361), 19.9.2007; emphasis added.

[56] Explanatory Memorandum of the new proposals, p. 7.

[57] Explanatory Memorandum of the new proposals, p. 5.

[58] See for example: Brussels power proposals opposed, *Financial Times*, 6.6.2007 or France warns on energy 'unbundling' plan, *Financial Times*, 7.2.2007.

[59] See, for example, J.-C. Pielow, G. Brunekreeft, and E. Ehlers, 'Legal and Economic Aspects of Ownership Unbundling in the EU', 2 *Journal of World Energy Law and Business* (2009).

[60] Articles 9 (et seq.) of Directives 2009/73/EC (gas) and 2009/72/EC (electricity).

an independent system operator model (ISO),[61] or an independent transmission operator (ITO) model[62] put forward by the Council.[63] This last model, which did not appear in the Commission's original proposals, allows the ownership of the network to be maintained with the supply companies, but attempts to ensure the neutrality and independence of the transmission operator through a set of detailed conditions, including independent management, a supervisory board, a compliance officer, and the possibility of substantial fines in cases of mismanagement. A pessimist might describe this as the 'business as usual' option.

Although both ownership unbundling and the ISO/ITO alternatives require that one company cannot be involved both in transmission and supply/generation, one apparent downside of the new directives is that they yet again contribute to the long list of exemptions and derogations from generally applicable rules.[64] While some vertically integrated companies are forced to sell their network assets, others are not. The Member States where energy companies have close relationships with the political powers are presumably those that will use the opportunity to derogate from full ownership unbundling (provided, of course, that this is what the national energy company wants).[65]

However, despite this defeat at the level of sector specific-regulation, the Commission's strategy to force private companies (so far E.ON[66] for electricity, and RWE[67] and ENI[68] for gas) to sell their network assets and achieve ownership unbundling through the use of general EU competition law is one recent development in the

[61] Article 13 (et seq.) of Directive 2009/72/EC (electricity) and Articles 14 (et seq.) of Directive 2009/73/EC (gas).

[62] Articles 17 (et seq.) Directives 2009/73/EC (gas) and 2009/72/EC (electricity).

[63] For an overview of the Third Legislative Package and the unbundling provisions, see J. G. Westerhof, 'The Third Internal Market Package', in M. Roggenkamp and U. Hammer, *European Energy Law Report VI* (Antwerp: Intersentia 2009), pp. 19–35.

[64] On the logic behind exemptions and derogations in the energy sector see K. Talus, 'First Interpretation of Energy Market Directives by European Court of Justice—Case C-17/03, Vereniging voor Energie', 24 *Journal of Energy & Natural Resources Law* (2006), p. 39.

[65] Also the different cultures, traditions, and approaches to energy as a good will undoubtedly have an effect. In France, for example, supply of energy for the population is a central public service function. For France, the national energy company is an element of national independence. Thus energy companies in France have a more central role than, for example, in the Nordic countries. For this see A. Guimaraes-Purokoski, 'Vertikaalinen toimivallanjako EU-oikeudessa. Tutkimus Yhteisön Toimivallan Kehittymisestä Energia-alalla Sekä Julkisen Palvelun Velvoitteen ja Yleispalvelun Sääntelystä Sähkön Sisämarkkinoilla', *Suomalainen Lakimiesyhdistys* (2009), pp. 319–29.

[66] Case COMP/39.388—German Electricity Wholesale Market and Case COMP/39.389—German Electricity Balancing Market. Press release, 'Antitrust: Commission welcomes E.ON proposals for structural remedies to increase competition in German electricity market' (MEMO/08/132), 28.2.2008. See also Summary of Commission Decision of 26 November 2008 relating to a proceeding under Article 82 of the EC Treaty and Article 54 of the EEA Agreement, 8.

[67] Case COMP/39.402—RWE gas foreclosure. Press release, 'Antitrust: Commission welcomes RWE proposals for structural remedies to increase competition in German gas market', (MEMO/08/355), 31.5.2008. For another divestiture (Vattenfall), see Commission press release, 'Energy Commissioner, Andris Piebalgs, welcomes Vattenfall's decision to sell their transmission grids' (MEMO/08/527), 25.7.2008. The Vattenfall case does not seem to be related to a threat of competition law enforcement.

[68] Case COMP/39.315—ENI. 'Antitrust: Commission welcomes ENI's structural remedies proposal to increase competition in the Italian gas market' (MEMO/10/29), 4.2.2010.

enforcement of competition law obligations in the energy sector. By means of this strategy, the Commission seeks to curb the impact of sector-specific regulation regardless of the choice left to the Member States. The Commission's press release indicates that all three companies involved in the above-mentioned cases were behind the proposed structural remedies[69] (ownership unbundling) to settle the ongoing antitrust investigations against them. On the basis of this development, one might say that, while the Commission may have lost the battle on the regulatory front, it is winning the war through the use of general competition law.

3.3.2 The Third Country Clause or '*Lex* Gazprom'

The third country clause, popularly known as the 'Gazprom clause' or '*Lex* Gazprom', is a related issue.[70] This provision will subject operations and investments in the EU market by vertically integrated companies from third countries to the requirement of prior EU consent. The objective of the provision is to ensure that EU interests are secured. In practice, this means avoidance of situations where an external non-EU undertaking has control over EU networks. The decision-making power in this respect will be divided between the Commission and the Member States. Article 11 of Directive 2009/73/EC provides that each Member State retains the competence to decide whether or not to allow a vertically integrated third country company to invest, or whether such investment would be detrimental to its energy security. Here, in addition to the unbundling regime, the general effect on energy security will have to be taken into consideration. The role of the Commission is consultative. Each Member State retains the ultimate power of veto where its energy security is at stake.

Although Article 11 makes a reference to international law and notes that the Commission must take into account the possible agreements 'concluded with one or more third countries to which the Community is a party and which addresses the issues of security of supply', it has been suggested that this provision is at odds

[69] While the Commission press release suggests that the initiative came from the companies involved in the investigations, the timing and the Commission activities suggest that the initiative could have come from the Commission. Why would a company that has fiercely opposed ownership unbundling (e.g., see *Financial Times*, E.ON defiant on break-up plan, 4.10.2007) suddenly make a complete change in its opinion, unless it was pressured to do so? The developments under the general competition law regime could also have wider implications, given that Article 52 of third gas market directive provides for a review procedure and requires the Commission to propose further measures in the event that the unbundling regime of the third package proves to be insufficient. If this were to prove the case, would Germany, with two of its main energy companies already being forced to unbundle ownership, still have an incentive to oppose ownership unbundling? While this is, to some extent, a criticism of the Commission approach, it is only partially so. The current situation is also a result of the institutional arrangements chosen by the Member States and the Commission's dual role in the EU. It has an obligation to initiate legislative action where this is necessary and an obligation to enforce EU competition rules. In this case, the Commission is addressing the same issue on both fronts.

[70] A first analysis of this provision is offered in S.S. Haghighi, 'Establishing an External Policy to Guarantee Energy Security in Europe? A Legal Analysis', in M. Roggenkamp and U. Hammer (eds), *European Energy Law Report VI* (Antwerp: Intersentia 2009), pp. 155–88. Haghighi raises certain concerns over some economic and legal effects of this clause.

with the ECT[71] and other instruments of public international law.[72] One practical problem with this provision is the supervision of unbundling in third countries.

Clearly, the 'Gazprom clause' is an extremely political provision. However, given the significance of this clause, the political issues should be separated from more tangible commercial and security-related factors. For example, given that a strong presence in the EU markets means strong commercial interest in maintaining supplies (that generate revenue) and that the penetration of a new company into downstream markets would create new competition, the effects of this clause are somewhat obscure. In this area, company-level linkages can also be seen as strengthening security of supply.

The 'Gazprom clause' may also affect future cooperation between the EU and Russia.[73] The EU emphasizes its need for greater reciprocity in terms of investment and access to the Russian market. However, it is very unlikely that this move will help to achieve the goal of opening up the Russian energy sector to EU companies, or facilitating negotiations relating to a 'new ECT'.

The final issue raised in the context of ownership unbundling is the compatibility of ownership unbundling with general EU law. Even if the ownership unbundling discussion in the context of the third energy law package is now over, it is very likely that the same discussion will re-emerge at some point.[74]

3.3.3 Ownership Unbundling and EU Law

Various authors have suggested that there are considerable concerns regarding the legal enforceability of the introduction of ownership unbundling.[75] Issues raised in this context usually relate to: (i) Article 345 TFEU; (ii) the EU's competences, and the limits of Article 114 TFEU in particular; and (iii) the right to property under the ECHR and the EU legal order.

In essence, the claim is that certain EU and ECHR legal provisions are obstacles to the EU-level adoption of mandated ownership unbundling and that the European

[71] A. Willems, J. Sul, and Y. Benizri, 'Unbundling As a Defence Mechanism Against Russia: Is the EU Missing the Point?' 2 *OGEL* (2009).

[72] V. Van Hoorn, '"Unbundling", "Reciprocity" and the European Internal Energy Markets: WTO Consistency and Broader Implications for Europe,' 18 *European Energy and Environmental Law Review* (2009), pp. 51–76.

[73] This concern was also raised, among others, by V. Van Hoorn, '"Unbundling", "Reciprocity" and the European Internal Energy Markets: WTO Consistency and Broader Implications for Europe,' 18 *European Energy and Environmental Law Review* (2009), pp. 51–76. The author notes that the 'EU is building a fence around its garden'. The same concern is noted in S.S. Haghighi, 'Establishing an External Policy to Guarantee Energy Security in Europe? A Legal Analysis', in M. Roggenkamp and U. Hammer (eds), *European Energy Law Report VI* (Antwerp: Intersentia 2009), pp. 155–88.

[74] It is also worth repeating that the same discussion took place in the context of the introduction of TPA.

[75] A. Willems, J. Sul, and Y. Benizri, 'Unbundling As a Defence Mechanism Against Russia: Is the EU Missing the Point?' 2 *OGEL* (2009), M. Hunt, 'Ownership Unbundling: the Main Legal Issues in a Controversial Debate', in B. Delvaux, M. Hunt, and K. Talus (eds), *EU Energy Law and Policy Issues* (Brussels: Euroconfidentiel 2008), and J.-C. Pielow, G. Brunekreeft, and E. Ehlers, 'Legal and Economic Aspects of Ownership Unbundling in the EU', 2(2) *Journal of World Energy Law and Business* (2009).

courts would annul the provisions transposing this idea into law. First, there is Article 345 TFEU. The objective of this provision is to regulate the division of competence between the EU and the Member States, without conferring absolute immunity on property rights from the application of EU law. A certain degree of unification of property law is unavoidable in view of the process of economic integration.[76] Moreover, the purpose of Article 345 TFEU is not to evade the enforceability of the fundamental rules of the Treaty with regard to national systems of property ownership.[77] This means that to some extent the EU has competence to deal with issues involving property rights, and also that national legislators must take into account the EU's general principles and interest in regulating the means of acquisition and enjoyment of property. Article 345 TFEU is not an obstacle to ownership unbundling if we take the view that it will lead to more efficient competition, considered as a matter of public interest. Neither does ownership unbundling exclude Member States' freedom to choose the property ownership regime under which they wish to place the transmission system (e.g. domestic implementation of EU-mandated ownership unbundling could stipulate that the transmission network must remain in public ownership).

Secondly, the focus moves to the legal basis for EU action: Article 114 TFEU. Again, if we agree with the view that ownership unbundling is the best way to achieve a level playing field and agree with the assessment of both national and EU-level regulators that, despite the legislative action taken thus far, a level playing field has not yet been established, then it is clear that further action is necessary. Clearly, ownership unbundling alone is not the 'silver bullet' for securing perfectly-functioning EU energy markets. It is, however, one element of a legislative set up that can deliver efficiently-functioning markets.[78] Therefore, ownership unbundling would eliminate obstacles to the functioning of the internal market.

Thirdly, there is the question of proportionality: in essence, this general principle of EU law requires that there must be a reasonable (proportional) relationship between the means used and the objective desired.[79] While certain tests of proportionality have been developed through the case law of the ECJ,[80] the proportionality test is not always applied in an identical way in every case. In particular, the degree of judicial scrutiny varies according to the background and aims of the provision in question. For example, the Court has ruled that, in matters concerning the common agricultural policy, the EU legislature has a discretionary power, which corresponds to the

[76] F. Campbell-White, 'Property Rights: A Forgotten Issue under the Union', in N.A. Neuwhal and A. Rosas (eds), *The European Union and Human Rights* (The Hague: M. Nijhoff 1995), p. 249.

[77] Case C-302/97, *Konle* [1999] ECR I-3099, para. 38; Case C-300/01, *Salzmann* [2003] ECR I-4899, para. 39; Case C-452/01, *Ospelt* [2003] ECR I-9743, para. 24.

[78] While it may be argued that in this case the applicability of Article 95 is rather clear, it may also be noted that the harmonizing effect that is required is not always clear: see, e.g., Case C-217/04, *UK v Parliament and the Council* [2006] ECR I-3771.

[79] See Case 66/82, *Fromançais* [1983] ECR 395, para. 8; Case 181/84, *Man (Sugar)* [1985] ECR 2889, para. 20; Case C-118/89, *Lingenfelser* [1990] ECR 2637, para. 12.

[80] T. Tridimas, 'Proportionality in Community Law: Searching for the Appropriate Standard of Scrutiny', in E. Ellis (ed.), *The Principle of Proportionality in the Laws of Europe* (Oxford: Hart Publishing 1999), p. 68.

political responsibilities imposed on it by the Treaty. Consequently, the legality of a measure adopted in that sphere can be affected only if the measure is manifestly inappropriate having regard to the objective which the competent institution intends to pursue.[81] The Court takes the same approach in cases concerning measures adopted in the sphere of the common commercial policy.[82] Finally, and for present purposes, most significantly, the Court has repeatedly stated that the European legislator has broad discretionary power in situations which require the evaluation of a complex economic situation.[83] Again, the key question comes back to whether ownership unbundling is the appropriate way to bring about competitive energy markets (an objective considered to be in the general interest of the EU). To quote the late Thomas Wälde: 'Save recourse to God, there is no definite method of precisely predicting the future result of economic policies in the interplay with market, institutional, political and other economic and social forces. Accordingly, one cannot require more than a reasonable and plausible relation of the method chosen to the accepted objective within the overall framework of the Treaty.'[84]

The fourth main question raised is whether ownership unbundling is contrary to the case law of the European Court of Human Rights (ECtHR) or the principles developed by the ECJ to protect the right to property and the freedom to pursue an economic activity. These two rights are regularly referred to in tandem, largely following the reasoning and approach taken in the *Nold* case.[85] In *Nold*, the Court expressly denied that these rights were absolute, affirming that they 'must be viewed in the light of the social function of the property and activities protected thereunder'.[86] In others words, prima facie restrictions on property rights and the freedom to pursue an economic activity can justifiably be set aside in the public interest. What counts as being in 'the public interest' must be interpreted in the light of the values and aims of the EU's legal order.[87] Similarly, the Court noted in *Hauer*[88] that the European legislator can establish the basis for restrictive regulation of the use of property within the terms of the pursuit of the general EU interest.

[81] Case 265/87, *Schräder* [1989] ECR 2237; Joined Cases C-296 and 307/93, *French Republic and Ireland v Commission of the European Communities* [1996] ECR 795; Case C-120/99, *Italian Republic v EU Council* [2001] ECR 7997; Case T-125/01, *José Martí Peix* [2003] ECR II-865.

[82] Case T-162/94, *NMB and others* [1996] ECR II-427; Case C-150/94, *United Kingdom of Great Britain and Northern Ireland v Council of the European Union* [1998] ECR I-7235; Case T-340/99, *Arne Mathisen* [2002] ECR II-2905.

[83] Case 138/79, *Roquette* [1980] ECR 3333; Case C-4/96, *Northern Ireland Fish Producers' Organisation Ltd* [1998] ECR I-681; Case C-179/95, *Kingdom of Spain v EU Council* [1999] ECR I-6475.

[84] T. Wälde, 'Comment on Einar Hope's Chapter with a Critical Review of Legal and Policy Arguments Driving the Discussion on Third Party Access', in E. Mestmäcker (ed.), *Natural Gas in the Internal Market—A Review of Energy Policy* (London-Dordrecht-Boston: Graham & Trotman 1993), p. 240. Thomas Wälde's opinion relates to the introduction of TPA but given that the arguments of those opposing TPA are the same as those today opposing ownership unbundling, we can extend the argument to cover ownership unbundling.

[85] Case C-4/73, *Nold* [1974] ECR 491. This is the first case in which the applicant maintained an infringement of a right 'akin to proprietary right' and the 'right to the free pursuit of business activity' (para. 12).

[86] *Nold*, para. 14.

[87] *Nold.*

[88] Case C-44/79, *Hauer* [1979] ECR, I-3727.

As for the freedom to pursue trade or professional activities, the Court has ruled that if the applicant can continue to pursue its previous economic activity, the substance of that right is protected.[89] Thus, measures, which interfere with the way in which the companies operate are permitted unless they are manifestly inappropriate in relation to the objective pursued. Furthermore, according to the Court's case law, the substance of the right to property is protected if the compensation provided takes the value of the investments made into consideration.[90]

To date, the Court has settled disputes concerning measures that regulate the use of property (how and how much to produce), whereas in the present case it is a matter of regulating access to property and excluding the energy producers from ownership of network assets. Because of this difference and because of the duality of the human rights regimes in Europe, it is necessary to examine the case law of the ECtHR.[91] Here, one particularly interesting case is *James v UK*,[92] where the ECtHR characterized a compulsory transfer of property as deprivation of property.[93]

Given that the ECtHR has established that there is interference with the right to property, the principle of proportionality is again the key issue in the reasoning of the Strasbourg Court. The ECtHR uses the proportionality principle as a counter weight to the margin of appreciation doctrine.[94] In cases dealing with deprivation of property, the provision and amount of any compensation given is one of the elements of proportionality.[95] As regards the amount of compensation in the *James* case, the ECtHR ruled that 'legitimate objectives of "public interest", such as pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of the full market value'.[96]

As regards the freedom to pursue an economic activity, ownership unbundling affects the possibility of energy producers pursuing network activities. However, companies active in both production and transmission are not forced to give up all their previous economic activities. If one considers the production of energy to be a company's main commercial activity, interference with the freedom to pursue an economic activity can be considered as proportionate to the objective sought by the interference, since affected companies will be able to continue with their

[89] Joined Cases C-184 and 223/02, *Kingdom of Spain and Republic of Finland v European Parliament and Council of the European Union* [2004] ECR I-7789; T-216/05, *Mebrom NV* [2007] ECR 0000, para. 88.

[90] Case C-5/88, *Wachauf* [1989] ECR 2609, para. 19.

[91] The ECJ recognises that the ECtHR plays the role of a guide in the development of the fundamental rights protection: see G. R. Iglesias, 'The Court of Justice, Principles of EC Law, Court Reform and Constitutional Adjudication', 15 *European Business Law Review* (2004), p. 1120.

[92] *James v United Kingdom* [1986] 8 EHRR 123 (ECtHR).

[93] *James v United Kingdom*, para. 40.

[94] See, Y. Arai-Takahashi, *The Margin of Appreciation Doctrine and the Principle of Proportionality in the jurisprudence of the ECHR* (Antwerp: Intersentia 2002).

[95] See, e.g., the discussion in A. Johnston, 'Take-or-Pay Contracts for Renewables: An Analysis of European Legal Issues', in B. Delvaux, M. Hunt, and K. Talus (eds), *EU Energy Law and Policy Issues—ELRF Collection* (1st edition) (Rixensaert: Euroconfidentiel 2008), p. 269, at pp. 277–84; and see also S. Praduroux and K. Talus, 'The Third Legislative Package and Ownership Unbundling in the Light of the European Fundamental Rights Discourse', 9(3) *CNRI* (2009).

[96] *James v United Kingdom*, para. 54.

primary activity. The same argument can of course be used where the main activity of an undertaking is transmission. This conclusion is in line with the case law of the ECtHR.[97] In the *Van Marle* case, where the applicants complained about new legislation which precluded them from continuing to exercise the profession of 'accountants', the Strasbourg Court found no breach of Article 1 of the First Protocol to the ECHR.[98]

In essence, it may be argued that there are no insurmountable legal obstacles if the EU legislature were to decide to adopt ownership unbundling as the only model. This option would guarantee a level playing field without the regulatory intervention coupled with oversight that the current regime requires. However, although this policy choice does not face serious legal obstacles, it must clear daunting political hurdles. These hurdles seem to have posed enough of a difficulty to block full ownership unbundling as far as the third legislative package is concerned. Instead, more exemptions and derogations were added to the EU energy *acquis*, some of which are examined in detail in section 3.4.

3.4 Exemptions and Derogations

As hinted at in sections 3.1–3.3, the number of exemptions and derogations provided from otherwise applicable rules are a notable feature of EU energy law. These exemptions have been seen as a necessary component in the process of transformation from national and monopolistic markets into a competitive and EU-wide market. The pros and cons of the exemptions have been discussed in various commentaries, and they have been seen as either positive[99] or negative factors in EU energy law.[100] While it is clear that such exemptions are a necessary component of the transitional legal regime which will modify the nature of EU

[97] The European Convention on Human Rights does not provide for the protection of the freedom to pursue an economic activity, but the Strasbourg court protects the economic enterprise by means of Article 1 of the First Protocol to the ECHR.

[98] *Van Marle v The Netherlands* [1986] 8 EHRR 483.

[99] C. Jones, *EU Energy Law—The Internal Energy Market* (Leuven: Claeys & Casteels 2004), p. 155 and C. Jones, *EU Energy Law—The Internal Energy Market: The Third Liberalisation Package* (Leuven: Claeys & Casteels 2010), p. 443. In the opinion of Jones (et al.), it is not surprising that such exemptions exist but that they are both limited in numbers and strictly controlled. While not disputing the first point, it could also be claimed that the number of different options to derogate is not, in fact, limited. Ultimately this is a question of how one wants to see the issue. Clearly, some exemptions are necessary, but not all.

[100] T. Van Der Vijver, 'Exemptions to Third Party Access for New Infrastructures in European Community Gas Sector—The Exception that Defies the Rule?', 29 *European Competition Law Review* (2008), pp. 229–37. The author notes that while this approach has certain positive elements, the relaxed application of Article 22 might 'harm TPA's status as a legal principle when it comes to new infrastructures' (at p. 137). Similar, but more positive, views are presented by the same author in T. Van Der Vijver, 'Commission Policy on Third-Party Access Exemption Requests for New Gas Infrastructure', in M. Roggenkamp and U. Hammer (eds), *European Energy Law Report VI* (Antwerp: Intersentia 2009), pp. 115–30. Also, based on my own understanding that derives from various presentations of the Commission officials in various conferences and seminars and some subsequent discussions, the Commission seems to be internally divided on this question.

energy markets in a very profound way, it may also be noted that, over the shorter term, each new exemption or derogation is an obstacle on the path towards a level playing field. Therefore, their number should be kept to a minimum.

This section examines some of the most significant exemptions and derogations: the exemption allowing the imposition of a public services obligation; unbundling of small companies; the derogation for emergent or isolated markets; and finally the exemption for major new infrastructure.

3.4.1 Public Service Obligations (PSOs)

Clearly, it is not always possible to offer public services based on pure market mechanisms alone.[101] This is particularly the case where remote and sparsely populated areas are concerned. Full geographical coverage is often difficult to achieve through market-based mechanisms. To remedy this, and other shortcomings (universal service and security of supply, among others), the internal energy market directives offer the possibility to grant exclusive rights.

Article 3(2) of both the third electricity and gas market directives provide that Member States may impose on undertakings operating in either of these two sectors 'public service obligations which may relate to security, including security of supply, regularity, quality and price of supplies [...]. Such obligations must be well defined, transparent and cannot discriminate between companies. It is furthermore added that in relation to security of supply [...] Member States may introduce the implementation of long-term planning, taking into account the possibility of third parties seeking access to the system'.[102] In addition, the Member States should implement appropriate measures to achieve the objectives of social and economic cohesion, environmental protection—which may include means to combat climate change—and to ensure security of supply.

In the name of the PSO, Member States may decide not to apply a number of provisions of the directives where their application would obstruct the performance, in law or in fact, of the obligations imposed on undertakings in the general economic interest.[103] According to the ECJ, the public-service requirements are to be interpreted on a national basis.[104] Where a Member State decides to have recourse to these provisions, it is required that the measure taken does not restrict competition and trade between the Member States more than necessary in order

[101] D. Helm, J. Kay, and D. Thompson, 'Energy Policy and the Role of the State in the Market for Energy', in Paul Stevens, *The Economics of Energy Vol. II* (Cheltenham: Edward Elgar Publishing House 2000), p. 415. See also L. Hancher and S. Janssen, 'Shared Competences and Multi-Faceted Concepts—European Legal Framework for Security of Supply', in B. Barton, C. Redgwell, A. Ronne, and D. N. Zillman, *Energy Security—Managing Risk in a Dynamic Legal and Regulatory Environment* (Oxford: OUP 2004), pp. 87–8.

[102] For an overview and an in-depth assessment of various provisions relating to public service objectives in electricity and gas market directives, see C. Jones, *EU Energy Law Vol. 1—The Internal Energy Market* (Leuven: Claeys & Casteels 2004), pp. 113–48.

[103] Article 3(5) of the Gas Market Directive.

[104] Case C-439/06, *Citiworks AG Flughafen Leipzig v Halle GmbH, Bundesnetzagentur* [2008] ECR I-3913, para. 59.

to fulfil the legitimate general interest objectives.[105] The payment of compensation relating to the accomplishment of a public service obligation is not, in principle, considered state aid.[106] However, when examining the question of compensation, the Commission applies the state aid test laid down by the Court[107] in the *Altmark* case.[108]

In discussing the early PSO regime, Hancher and Janssen have noted how the wording of that directive left much scope for subsidiarity.[109] The same can be noted here. The measures adopted by various Member States therefore vary considerably, but must, however, be reported to the Commission.[110] Based on these measures, the Commission will prepare a report and may issue recommendations on appropriate measures to be taken at national level to achieve high public service standards, or measures intended to prevent market foreclosure.[111] The degree of development from the first energy market directives is noticeable. Where the first directives only imposed an obligation to inform the Commission of PSOs that necessitated derogation from these directives, the wording used in the second and third directives requires Member States to inform the Commission of all PSOs, regardless of whether they call for derogations from the directives. This development allows the Commission to acquire information about measures that might distort competition even if they do not require derogation from the directives.[112] It also provides the Commission with information on the overall picture, thus giving it

[105] Case C-439/06, *Citiworks AG Flughafen Leipzig v Halle GmbH, Bundesnetzagentur* [2008] ECR I-3913, para. 60. 'However, in order to do so, the Member States must, on the one hand, ascertain whether an unrestricted right of access to the systems would obstruct the performance by the system operators of their public-service obligations and, on the other, determine whether that performance cannot be achieved by other means which do not impact adversely on the right of access to the systems, which is one of the rights enshrined in [the EC energy *acquis*].'

[106] Implementing Note by the Commission concerning the public service obligation. Available at: <http://ec.europa.eu./comm/energy/electricity/legislation/doc/notes_for_implementation_2004/public_service_obligations_En.pdf>. The Commission has been very careful to highlight that these guidelines do not bind the Commission. The issue however is not as simple as it might seem. These guidelines are part of a wider category of 'soft law' comprising a number of non-binding Community instruments such as declarations, resolutions, recommendations, notes of implementation, notices, and codes of conduct. These guidelines are issued by the Commission and further to the principle of legal certainty and the principle of *patere legem quam ipse fecisti*, the Commission should generally be bound by its guidelines. (See, among others, Case T-105/95, *WWF UK v Commission* [1997] ECR II-313.) Therefore it could be suggested that these guidelines should have some effect on the future decision-making of the Commission. On the other hand, the Commission can of course always claim that the guidelines did affect its decision-making but that the particularities of a given case nevertheless dictated a certain outcome.

[107] Note of DG Energy and Transport on Directives 2003/54/EC and 2003/55/EC on the internal market in electricity and natural gas—public service obligations—16.1.2004. Available at:<http://ec.europa.eu/energy/electricity/legislation/doc/notes_for_implementation_2004/public_service_obligations_en.pdf>.

[108] Case C-280/00, *Altmark* [2003] ECR I-7747. This case is discussed in Chapter 4, Section 4.7 on State aids.

[109] L. Hancher and S. Janssen, 'Shared Competences and Multi-Faceted Concepts—European Legal Framework for Security of Supply', in B. Barton, C. Redgwell, A. Ronne, and D. N. Zillman (eds), *Energy Security—Managing Risk in a Dynamic Legal and Regulatory Environment* (Oxford: OUP 2004), p. 97.

[110] Article 3(11) gas directive and Article 3(15) electricity directive.

[111] Article 52(2) gas directive and Article 47(2) electricity directive.

[112] C. Jones, *EU Energy Law—The Internal Energy Market* (Leuven: Claeys & Casteels 2004), p. 130.

the ability to examine the potential effect of a web of PSOs. It may be that granting a single special or exclusive right or other kind of PSO has no significant harmful effect, but that a web of similar grants of rights does have such an effect. This translates into a need to consider the overall effects of various measures and choices at the EU level.

At a more individual level, Article 3(3) of the Electricity Market Directive obliges Member States to take appropriate measures to protect final customers and ensure that there are adequate safeguards to protect vulnerable customers, including measures to help them avoid disconnection. In this regard, the European Parliament pushed the introduction of a new provision in the third electricity market directive (Article 3(7)) which prohibits the disconnection of electricity from 'vulnerable customers' at critical times—i.e. it is intended to prevent pensioners and disabled people being cut off during the winter[113] (although on the basis of subsidiarity the meaning of 'vulnerable customer' is left for Member States to define). The appointment of a supplier of last resort is another new and related concept, which emerged largely because of liberalization and relates to security of supply from a final-customer perspective. Further to Article 3(3) of both electricity and gas market directives, Member States may appoint a supplier of last resort for customers connected to the energy networks. Prior to liberalization of the market, the state monopoly guaranteed the energy supply. This has changed with market liberalization. Market players are now exposed to a number of risks which are inherent in the market-based mechanism. In the worst-case scenario, this may result in a supplier becoming bankrupt as has in fact happened in a large number of cases in, for instance, the UK, the Netherlands, and California. Because of this, Member States may appoint a supplier of last resort which must step in and provide the affected customers with energy until a new supplier has been identified.[114]

The issues of PSOs and security of supply were also debated before the ECJ in 2010. In response to a request for a preliminary ruling from Italy, the Court had the opportunity to pronounce on price security as part of the PSO under Article 3 of the second gas market directive.[115] The case concerned an Italian decree that allowed the national energy market authority (Autorità per l'energia elettrica e il gas (AEEG)) to set 'reference prices' permitting the determination of price levels for supply of natural gas. The decree in question stipulated as follows:

'To comply with the Community law provisions on universal service, [the AEEG] shall set standard terms for the supply of the service and establish, on a transitory basis and based on the actual costs of the service, reference prices ... for supplies of natural gas to domestic customers, which distributors or suppliers shall, within the scope of their public service obligations, incorporate into their commercial offerings (providing also the possibility of a choice between differentiated tariff packages and time tariffs). Article 1, paragraph 375,

[113] See EP proceedings of 18 June 2008, amendment 155. (Ref. P6_TA(2008)0294).

[114] U. Hammer, 'Introduction' in M. Roggenkamp and U. Hammer (eds), *European Energy Law Report I* (Cambridge: Intersentia 2004), p. 178. See also T. Vermeir, 'Electricity Market Liberalisation and Supplier of Last Resort in Belgium', in M. Roggenkamp and U. Hammer (eds), *European Energy Law Report I* (Cambridge: Intersentia 2004), pp. 221–33.

[115] Case C-265/08, *Federutility and others* [2010] ECR, p. I-03377.

of Law No 266 of 23 December 2005 ... authorises, within sixty days of the date of entry into force of the law converting this decree, of measures for the protection of consumers in particular circumstances of health or economic disadvantage. The powers of supervision and intervention of the Authority to protect the rights of consumers are also maintained, including in cases of established and unjustified price increases and variations in the terms of service to customers who have not yet exercised their right of choice.'

The applicants in the main proceedings had argued that, as from the date of the full liberalization of the EU natural gas markets, 1 July 2007, the prices should be defined only through the supply/demand mechanism and, as such, the setting of references prices after that date was contrary to EU law.

After noting that in principle price security can arguably be part of the PSO the Member States may decide to impose on private undertakings, the Court's examination of the matter focused essentially on the proportionality test as applied to the PSO and the use of reference prices. The Court concluded that the second gas market directive did not preclude national regulation permitting determination of the price level for the supply of natural gas by the definition of 'reference prices', such as those at issue in the main proceedings, after 1 July 2007, *provided* that such intervention:

- pursues a general economic interest consisting in maintaining the price of the supply of natural gas to final consumers at a reasonable level having regard to the reconciliation which Member States must make, taking account of the situation in the natural gas sector, between the objective of liberalization and that of the necessary protection of final consumers pursued by Directive 2003/55;
- compromises the free determination of prices for the supply of natural gas after 1 July 2007 only insofar as is necessary to achieve such an objective in the general economic interest and, consequently, for a period that is necessarily limited in time; and
- is clearly defined, transparent, non-discriminatory and verifiable, and guarantees equal access for EU gas companies to consumers.

By leaving the proportionality test to the national court, the ECJ in effect also left the price security issue to the national court. The question raised by this judgment is that of whether the national court was adequately equipped to carry out such a balancing exercise. This is particularly the case since it requires taking into consideration the various stages of progress in the national natural gas markets and the balancing of market liberalization and competition with the need to provide for security of supply. Conducting this balancing exercise, which is also required by the Security of Supply Regulation,[116] calls for advanced understanding of the EU and national energy markets and their regulation.

[116] The security of supply regulation requires that the measures taken to safeguard the security of gas supply do not unduly distort competition and/or the effective functioning of the internal gas market (Articles 3(6), 10(4), and 10(7)).

3.4.2 Unbundling of Small Companies

Both of the current energy market directives provide an exemption for small distribution companies. Further to Article 26 of both the electricity and gas directives, Member States may decide not to apply the unbundling requirements contained in the energy market directive to an integrated electricity or natural gas undertaking serving fewer than 100,000 connected customers. On this point, it should be noted that even in these cases the exemption does not cover the obligation for account unbundling. The underlying reason for this derogation is the need to consider the particular situation of smaller distribution companies. In these cases, it may be assumed that the added value of the implementation of the unbundling regime is not significant enough to outweigh the cost of restructuring the company.

While the Commission has explained that the 100,000 customers threshold was considered an appropriate figure for the EU as a whole,[117] it seems rather arbitrary. The logic behind the exemption is clear and certainly not disputed, but the specific threshold decided upon is nevertheless questionable. However, this potential problem is mitigated by the fact that Member States are not obliged to adopt this approach and are free to apply lower thresholds or require unbundling from all distribution companies. However, the choice should reflect national circumstances[118] rather than constituting a method of protectionism. The Commission's suggestion was to take a gradual approach in which the larger DSOs, which are still eligible for the exemption from legal unbundling, would be required to adopt functional unbundling, or at least some elements of functional unbundling; and only the smaller DSOs—in terms of the national context—would be exempted from all unbundling requirements.[119]

However, where a company controls several separate network companies, it is the aggregate number of customers that counts. Otherwise it would be easy to circumvent the rule and take advantage of the exemption regime (through the creation of several small and separate distribution companies owned and controlled by a single entity).[120]

Finland is a good example of the use of this exemption. Finland has adopted a two-stage threshold: 50,000 and 100,000 customers for certain unbundling requirements in electricity markets. As distinct from the situation with respect to electricity markets, this exemption does not apply in gas markets, because in this area Finland has the benefit of another exemption: that of isolated markets.

[117] Note of DG Energy & Transport on Directives 2003/54/EC and 2003/55/EC on the internal market in electricity and natural gas, 16 January 2004, 'The unbundling regime', p. 17.
[118] Note of DG Energy & Transport on Directives 2003/54/EC and 2003/55/EC on the internal market in electricity and natural gas, 16 January 2004, 'The unbundling regime'.
[119] Note of DG Energy & Transport on Directives 2003/54/EC and 2003/55/EC on the internal market in electricity and natural gas, 16 January 2004, 'The unbundling regime'.
[120] Note of DG Energy & Transport on Directives 2003/54/EC and 2003/55/EC on the internal market in electricity and natural gas, 16 January 2004, 'The unbundling regime', p. 16.

3.4.3 Emergent and Isolated Gas Markets

Article 49 of the gas market directive offers another possibility to derogate from the unbundling requirements and certain other provisions. Where a Member State is not directly connected to the interconnected system of any other Member State and has only one main external supplier (meaning that one supplier has more than 75 per cent of the market), it may derogate from certain requirements of the gas market directive, including the unbundling requirements, the market opening requirement, and the authorization procedure for new gas facilities. The conditions for the derogation for an isolated market cease to exist if one of the above conditions is eliminated. Finland is an example of such an area. The Finnish natural gas markets are not connected to any other Member State markets. The only pipeline into or out of the country is the supply pipeline from Russia.

Article 49 also contains an interesting section which states: 'Articles 4, 9, 37 and/or 38 shall not apply to Estonia, Latvia and/or Finland until any of those Member States is directly connected to the interconnected system of any Member State other than Estonia, Latvia, Lithuania and Finland.' This section became crucial (and political) when the Lithuanian government announced that 'Lithuania is not able to use an exemption provided by the EU Energy Directive, therefore the Baltic country must separate its gas supply from gas transmission through its gas pipelines'.[121] To understand why this would be controversial, it is sufficient to explain that Gazprom holds a 37.1 per cent shareholding in the Lithuanian gas company.

Under a strict interpretation, Lithuania's approach seems correct. The wording of Article 49 does not directly state that it applies to Lithuania, but only to Estonia, Latvia, and Finland. However, if instead one looks at the rationale of the provision and the fact that the same provision goes on to say that the 'subparagraph [referring to Estonia, Latvia, and Finland] is without prejudice to derogations under the first subparagraph of this paragraph' the issue becomes much more complicated. It is most likely (though this is not clear) that the correct interpretation is that as this is an exemption from the rule, it must be interpreted strictly. This approach would be in line with the Court's case law in the third party access cases.[122] However, one could arguably also look at the question in terms of the rationale of the provision.

The provision states:

> 'Member States not directly connected to the interconnected system of any other Member State and having only one main external supplier may derogate from Articles 4, 9, 37 and/or 38. A supply undertaking having a market share of more than 75% shall be considered to be a main supplier.'

In other words, two criteria must be fulfilled: no connection and only one supplier. Lithuania clearly meets the second one: Gazprom has over 75 per cent market share in supplies. The no-connection criterion is less clear. However, the rationale

[121] 'Lithuania must implement 3rd EU Energy Directive despite Russian protests' (29 November 2010) <http://www.lithuaniatribune.com/2010/11/29/ec-lithuania-must-implement-3-rd-energy-directive-despite-russian-protests/>.

[122] Case C-17/03, *VEMW and others* [2005] ECR I-4983 and Case C-439/06, *Citiworks AG Flughafen Leipzig v Halle GmbH, Bundesnetzagentur* [2008] ECR I-3913.

of the exemption for Finland and the Baltic States would suggest that this area is considered to be an 'isolated market' as a whole. Following this interpretation, Lithuania would be able to apply the first paragraph of Article 49 by simply notifying the European Commission that it will do so. Accordingly, internal Baltic connections would not be taken into account.

Similarly, an emergent market may benefit from a similar, but wider, derogation if it would, because of the implementation of the Gas Market Directive, experience substantial problems.[123] An 'emergent market' is defined in Article 2 of the Gas Market Directive as a Member State where the first commercial supply of its first long-term natural gas supply contract was made fewer than ten years earlier. This derogation can also be applied to a certain region within a Member State. A Member State may apply to the Commission for a derogation for an emergent region from the same provisions. When examining the application for an emergent region, the Commission has to take into account the following criteria: the need for infrastructure investment, which might not be economic to operate in a competitive market environment; the level of pay-back prospects for such investment; the size and maturity of the gas system in the area concerned; the prospects for the gas market concerned; the geographical size and characteristics of the area; and socio-economic and demographic factors. The Commission may not grant an exemption unless no gas transmission system has been established in the area or it has been in operation for less than ten years (or 20 years in the case of a distribution system). The temporary exemption may not exceed ten years from the date of the first gas supply in the area (or 20 years in the case of a distribution system). The 20-year exemption for a distribution network is based on the practice of Member States. Greece, at least, has granted 20-year concessions for regional distribution networks.[124] However, the conditions for derogation are examined on a case-by-case basis and the duration of the exemption cannot exceed the period objectively necessary in each case.[125]

The idea behind the derogation is that where the preconditions for free competition do not exist—either because the Member State markets have not been connected to other markets or because the emergence of a market per se is still a very recent phenomenon—the effects of certain provisions of the Directive are likely to be ineffective or even harmful.[126] It is, for example, important to understand that

[123] Thomas Wälde discussed the concerns of the Mediterranean countries (Spain, Portugal, Greece, and Italy) that liberalization of energy markets may impede the emergence of their national gas industries. See T. Wälde, 'Comment on Einar Hope's Chapter with a Critical Review of Legal and Policy Arguments Driving the Discussion on Third Party Access', in E. Mestmäcker (ed.), *Natural Gas in the Internal Market—A Review of Energy Policy* (London: Graham & Trotman 1993), p. 231. These concerns seem to have been covered by the exemption regimes included in the directives.

[124] C. Jones, *EU Energy Law—The Internal Energy Market* (Leuven: Claeys & Casteels 2004), p. 166.

[125] C. Jones, *EU Energy Law—The Internal Energy Market* (Leuven: Claeys & Casteels 2004), p. 167. Jones also suggests that the difference in the exemption period for the distribution and other gas infrastructure investments is due to the fact that, for example, when the initial investments in the transmission pipelines are made, they are backed by already concluded gas purchase agreements with large industrial users.

[126] Similarly, C. Jones, *EU Energy Law—The Internal Energy Market* (Leuven: Claeys & Casteels 2004), p. 159.

where capital-intensive infrastructure investment is concerned—which is required in particular in the early stages of the market—there is a need for predictable cash-flow to secure the amortization. That usually involves long-term contractual commitment, with take-or-pay elements or at least some assured quasi-monopoly involving at least temporary preferences for the sponsors to make it economically viable. The significance of the investment costs is in proportion to the risks involved and, mirroring this, the extent of the required special arrangements. Here, this predictability requirement has been translated into an exemption for new emergent markets. However, if it may be concluded that the investment would be made even in the absence of an exemption, such exemption should not be granted.[127]

Article 49(3) provides that the derogation can be partially extended beyond the 10-year period, thus facilitating gradual market opening (with a negotiated access regime for ancillary services and temporary storage).

Article 49 was the key to the Court of First Instance (CFI) judgment in the Portuguese EDP merger judgement, Case T-87/2005.[128] Since Portugal qualified as an emergent market and benefited from a derogation until 2007, the market opening calendar for the Portuguese energy markets became operative only at the end of 2007. There was no real competition on the Portuguese gas markets prior to that date, as the national gas undertaking, Gas de Portugal, dominated all levels of the gas supply chain. In this scenario, the CFI concluded that the absence of competition under the derogation precluded the application of Article 2(3) of the Merger Regulation[129] because 'the creation or strengthening of a dominant position' requirement[130] could not apply in circumstances where GDP already had a monopoly on the gas supply market. As a monopoly by definition represents the ultimate dominant position, it cannot be strengthened. As to the second criterion of Article 2(3)—significant impediment to competition—the CFI noted that, in the absence of any competition, there was no competition that could be impeded.[131]

3.4.4 New Infrastructure

As discussed in detail above, the EU energy *acquis* provides for TPA to all transmission and distribution grids and for LNG facilities. The operator must grant third parties non-discriminatory access to their facilities and in return they earn a regulated return on their investment. However, under Article 17 of the Electricity Regulation

[127] C. Jones, *EU Energy Law—The Internal Energy Market* (Leuven: Claeys & Casteels 2004), p. 166.
[128] Case T-87/2005, *EDP v Commission* [2005] ECR II-03745. See also G. Conte, G. Loriot, F. Rouxel, W. Tretton, 'EDP/ENI/GDP: The Commission Prohibits a Merger Between Gas and Electricity National Incumbents', 1 *Competition Policy Newsletter* (2005), pp. 84–7.
[129] Case T-87/2005, *EDP v Commission*, para. 126.
[130] While the previous version of the EC Merger Regulation (4064/89) prohibited 'the creation or strengthening of a dominant position which would have the consequence of significantly impeding effective competition' the current version prohibits 'a concentration which would significantly impede effective competition, in particular as a result of the creation or strengthening of a dominant position.'
[131] Case T-87/2005, paras. 117–8.

(EC) 714/2009 and Article 36 of the third Gas Market Directive 09/73/EC, a major new piece of gas infrastructure such as interconnectors and LNG storage facilities can be exempted for a defined period of time from the mandatory TPA, tariff systems, and unbundling obligations provided that certain conditions are fulfilled.

This exemption represents a compromise between two interrelated aims: the promotion of the internal energy market and network investments, and the need to ensure free competition and TPA to the necessary infrastructure. The logic behind such an exemption is to favour long-term efficiency gains over short-term advantage. If capacity reservations and priority rights are necessary for the construction of electricity or gas infrastructure, then they must be accepted, but only for a limited period. To date, the majority of the projects exempted under this scheme have been LNG regasification terminals, but a number of pipelines and electricity interconnectors have also been exempted.[132] Given that this exemption has been discussed in much detail in many previous studies, both by myself (for gas and electricity[133]) and de Hauteclocque (for electricity[134]), this section does not go into detail about the conditions for the exemption. A short comment on the security of supply aspect of the exemption will suffice.

The security of supply aspects largely explain why both the national regulatory authorities and the Commission have been ready to apply the Article 36 exemption to a number of LNG regasification terminals.[135] In addition to enhancing internal energy security by promoting cross-border connections between Member States, this instrument has also become very significant for external energy security. Largely because LNG provides an alternative source of natural gas, with origins such as Qatar, Nigeria, or Trinidad, the EU has so far taken a very favourable attitude towards applications concerning exemption regimes for new LNG terminals. The only situation in which such an exemption would perhaps not be granted is where the owner of the facility is an incumbent and the new facility would further increase its market dominance and/or where this investment would have a negative impact on the investment conditions for other new LNG regasification plants.[136] The logic here is that the anti-competitive effects might outweigh the positive security benefits. Without disputing this logic, it may be noted that a temporary right to supra-normal profits and extended monopoly in exchange for new facilities is not necessarily a scenario that should easily be dismissed. The same logic also lies

[132] See the Commission website at <http://ec.europa.eu>.
[133] For gas: K. Talus, *Vertical Natural Gas Transportation Capacity, Upstream Commodity Contracts and EU Competition Law* (Alphen aan den Rijn: Kluwer Law International 2011). For electricity: K. Talus, 'First Experience under the Exemption Regime of EC Regulation 1228/2003 on Conditions for Access to the Network of Cross-Border Exchanges in Electricity', 23 *Journal of Energy and Natural Resources Law* (2005).
[134] A. de Hauteclocque, *Market Building Through Antitrust: Long-term Contract Regulation in EU Electricity Markets* (Cheltenham: Edward Elgar 2012).
[135] For the reasons behind this, see Commission staff working document on Article 22 of Directive 2003/55/EC concerning common rules for the internal market in natural gas and Article 7 of Regulation (EC) No. 1228/2003 on conditions for access to the network for cross-border exchanges in electricity (SEC(2009)642 final), 6 May 2009, p. 9.
[136] See, for example: <http://ec.europa.eu/energy/electricity/legislation/doc/notes_ for_ implementation _2004/security_of_gas_supply_en.pdf>.

behind *Estlink*[137] and *BritNed,*[138] the two decisions on electricity interconnections in which all or some of the investors were transmission system operators with a *de facto* natural monopoly status.[139]

The security of supply discussion in the *Poseidon*[140] pipeline decision is also of interest, though from a different perspective. On this matter, the Commission first noted that the new supply route would increase security of supply. It then noted that the precise effect of the project would also depend on whether it would provide access for new producer countries which had not previously supplied Italy. If this were the case, the positive effect of security of supply, both at national and EU level, would be substantially stronger.[141] The Commission thus appeared to consider the different elements and threats to security of supply.[142] In this regard, the source-related discussion also took into consideration another condition for the exemption, related to the level of risk that the investor must demonstrate. In the *Poseidon* pipeline decision, the Commission first noted that the risks involved in the case of traditional and non-traditional sources of gas supply were different. It then required that this difference in the risks involved be reflected in the final decision and that the national authorities should explicitly determine whether and to what extent different derogation periods should be granted depending on the actual origin of the gas eventually contracted for with respect to the pipeline, and amend the decision based on these factors.[143]

While security and internal market conditions speak in favour of granting these merchant exemptions, the EU competition objective of the liberalization process and the need to balance long-term (dynamic) and short-term (allocative) efficiencies, mean that proportionality constraints are increasingly rigid.

3.5 Security of Supply

The organization of the European energy markets in the pre-liberalization era provided for security of supply. The old government-centred system with monopolies guaranteed security of supply, usually successfully, although often through over-investment with costs passed on to the end-user. This way of organizing the

[137] <http://ec.europa.eu/energy/infrastructure/exemptions/doc/doc/electricity/ 2005_ estlink_ decision_ en.pdf>.

[138] <http://ec.europa.eu/energy/infrastructure/exemptions/doc/doc/electricity/ 2007_britned_decision_ en.pdf>.

[139] See the two OGEL special issues on electricity interconnectors edited by K. Talus and C. Zimmermann, 'Electricity Interconnectors' 2 *OGEL* (2006) and 'Electricity Interconnections' 1 *OGEL* (2007) <http://www.ogel.org>.

[140] <http://ec.europa.eu/energy/gas/infrastructure/doc/2007_05_22_poseidon_en.pdf>.

[141] <http://ec.europa.eu/energy/gas/infrastructure/doc/2007_05_22_poseidon_en.pdf>.

[142] For security of supply and its different notions, see K. Talus, 'Security of Supply—An Increasingly Political Notion', in B. Delvaux, M. Hunt, and K. Talus (eds), *EU Energy Law and Policy Issues* (Brussels: Euroconfidentiel 2008).

[143] <http://ec.europa.eu/energy/gas/infrastructure/doc/2007_05_22_poseidon_en.pdf>.