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ISSN : 1875-418X  
Issue : Vol. 9 - issue 5  
Published : October 2011

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# Oil, Gas & Energy Law Intelligence

## New EU Rules on the Internal Energy Market and Energy Policy by A. Stanic

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## The Europeanisation of EU energy policy and the EU internal energy market

Based on the “business as usual” scenario in 2030 fossil fuels will still represent 70% of EU’s energy mix and EU’s dependency on imports for oil and gas is expected to rise to 94% and 83% respectively<sup>1</sup>. Although EU’s energy demand is expected to remain at present levels until at least 2030, the world’s demand for energy is expected to rise considerably with demand in China and India doubling by then<sup>2</sup>. Since ensuring safe, secure, sustainable and affordable energy is regarded as key to EU’s continuing prosperity, the European Council at its summit on 4 February 2011 signalled a new and more robust EU energy policy going forward<sup>3</sup>. This paper examines four energy policy priorities announced at the summit, together with the main provisions of the EU package of energy laws which entered into force on 3 March 2011.

### 1. Building a Truly Pan-European Energy Market

The Council declared the completion of the internal market for gas and electricity by 2014 as its foremost priority. This is the first time that a deadline for the creation of the internal market has been set by the Council. The Third Energy Package (“TEP”)<sup>4</sup> is seen as key to meeting this deadline. Before discussing the further actions the Council has foreshadowed it will take to ensure this deadline is achieved, the key provisions of TEP will be briefly presented.

#### 1.1 TEP

The TEP represents the third bundle of legislation adopted at the EU level since 1986 with the aim of creating fully integrated European gas and electricity markets. The key novelties of TEP are (i) the effective unbundling of energy generation and supply from transmission network ownership and operation, (ii) the strengthening of the powers and duties of national energy regulators, (iii) the establishment of an EU agency for energy and (iv) the introduction of a separate certification procedure for transmission system operators (“TSO”) controlled by non-EU legal entities. EU

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<sup>1</sup> European Commission, Background to Energy in Europe, available at [http://ec.europa.eu/commission\\_2010-2014/president/news/documents/pdf/energy\\_background\\_en.pdf](http://ec.europa.eu/commission_2010-2014/president/news/documents/pdf/energy_background_en.pdf).

<sup>2</sup> IEA, *World Energy Outlook 2010*.

<sup>3</sup> European Council, *Conclusions on Energy European Council*, 4.2.2011, available at [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ec/119141.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/119141.pdf).

<sup>4</sup> The TEP consists of (i) a directive concerning the common rules for the internal market in electricity (2009/72/EC) (the “Electricity Directive”); (ii) a directive concerning the common rules for the internal market in gas (2009/73/EC) (the “Gas Directive”); (iii) a regulation on the conditions for access to the natural gas transmission networks ((EC) No 715/2009); (iv) a regulation on the conditions for access to the network for cross-border exchange of electricity ((EC) No 714/2009); and (v) a regulation establishing the Agency for the Cooperation of Energy Regulators ((EC) No 713/2009). The TEP was adopted in July 2009.

Member States (“MS”) had until 3 March 2011 to transpose the Gas and Electricity Directives into national law<sup>5</sup>.

### 1.1.1. Effective unbundling

The rules on effective unbundling aim to prevent companies involved both in the transmission of energy and in production and/or supply of energy from using their privileged position as a TSO to prevent or obstruct access of their competitors to the transmission network. The Sector Inquiry undertaken by the EU Commission (“Commission”) in the period from 2005 until 2007 found that the legal and functional unbundling of energy supply and production from transmission networks introduced as part of the second energy package (“SEP”) in 2003 were not sufficient to ensure a well functioning energy market<sup>6</sup>. Ownership unbundling (“OU”) of energy generation and/or supply from transmission network ownership and operation was, therefore, introduced by the Commission an essential pillar of the initial draft of TEP. However, the requirement of OU was replaced by “effective unbundling” in the final version of TEP after extensive lobbying from vertically integrated energy companies.

Under the Gas Directive and Electricity Directives MS must choose between the following three models of effective unbundling by 3 March 2012: OU, the Independent System Operator (“ISO”) and the Independent Transmission Operator (“ITO”). Each model is described below.

#### (a) Ownership Unbundling

If a MS decides to impose full OU, vertically integrated energy undertakings<sup>7</sup> (“VIU”) will have to dispose of their gas networks and electricity grids. Under this model, no supply or production company is allowed to hold a majority share in a TSO, nor exercise voting rights or appoint board members. Even before TEP entered into force, E.ON and Vattenfall Europe divested their high voltage electricity grids in Germany, Endesa divested its electricity and gas transmission assets in Spain and RWE and E.ON sold gas transmission assets in Germany. However, it would seem that most MS will not prescribe this model.

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<sup>5</sup> The English version of the complete text of the TEP is available on <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0094:01:EN:HTML>.

<sup>6</sup> EU Commission, *The Sector Inquiry pursuant to Article 17 of Regulation (EC) 1/2003 in to the European gas and electricity sectors*, 10 January 2007, available at [http://ec.europa.eu/competition/sectors/energy/inquiry/communication\\_en.pdf](http://ec.europa.eu/competition/sectors/energy/inquiry/communication_en.pdf).

<sup>7</sup> A VIU is defined in Article 2(19) of the Gas Directive as a “natural gas undertaking or a group of natural gas undertakings where the same person or the same persons are entitled, directly or indirectly, to exercise control, and where the undertaking or group of undertakings perform at least one of the functions of transmission, distribution, LNG or storage, and at least one of the functions of production or supply of natural gas. A similar definition can be found in the Electricity Directive.

(b) ISO

Under this model, the VIU can remain the owner of the physical transmission network, but it has to transfer the operation, maintenance and management of the network to an independent company. This separate legal entity is to be designated an ISO by the MS in which it is located subject to EC's approval<sup>8</sup>.

(c) ITO

Under this model the TSO can remain part of the VIU provided requirements ensuring the effective independence of the TSO set out in Chapter IV of both directives are complied with. The following are the key requirements: (i) the ITO is required to be set up as a separate legal entity<sup>9</sup>, (ii) the ITO must own the transmission network assets<sup>10</sup>, (iii) the ITO cannot share the premises with the VIU and must have a separate corporate identity<sup>11</sup>, (iv) the ITO must not share the same IT or security access systems or use the same consultants or legal advisers or auditors<sup>12</sup>, (v) VIU's subsidiaries which generates or sells energy must not have any direct or indirect shareholding in the TSO<sup>13</sup>, (vi) all commercial agreements and arrangements between the ITO and VIU must be at arm's-length and subject to the prior approval of the national regulatory authority<sup>14</sup>, (vii) the management of the ITO must be appointed by the supervisory body instead of the VIU<sup>15</sup> and the majority of the ITO's management and/or members of other administrative bodies must not have advised or had any business relations with VIU or the shareholder who has a controlling interest therein for three years before their appointment<sup>16</sup>, (viii) no member of management or employee of ITO may have any interest, business relationship or hold any position in any part of the VIU or in its controlling shareholder or receive any remuneration therefrom<sup>17</sup>, and (ix) the ITO must appoint a compliance officer whose responsibility is to ensure that discriminatory conduct is excluded and a compliance procedure, previously approved by the national regulatory authority (the "NRA"), is complied with<sup>18</sup>.

### 1.1.2. Strengthening the powers and duties of national regulators

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<sup>8</sup> See paragraph 1 of the Articles 14 and 13 of the Gas and Electricity Directives respectively.

<sup>9</sup> See Article 17(3) of the Gas Directive and the Electricity Directive.

<sup>10</sup> See Article 17(1)(a) of the Gas Directive and the Electricity Directive.

<sup>11</sup> See Article 17(4) of the Gas Directive and the Electricity Directive.

<sup>12</sup> See Article 17(5) of the Gas Directive and the Electricity Directive.

<sup>13</sup> See Article 18(3) of the Gas Directive and the Electricity Directive.

<sup>14</sup> See Articles 18(6) and 18(7) of the Gas Directive and the Electricity Directive.

<sup>15</sup> See Article 19(1) of the Gas Directive and the Electricity Directive.

<sup>16</sup> See Article 19(3) and 19(8) of the Gas Directive and the Electricity Directive.

<sup>17</sup> See Article 19(4) and 19(5) of the Gas Directive and the Electricity Directive.

<sup>18</sup> See Article 21 of the Gas Directive and the Electricity Directive.

The role and independence of NRA have been strengthened under TEP in order to address the failing of some NRA to exercise their powers robustly to ensure the creation of the EU single market and minimise political interference which was affecting their operation<sup>19</sup>. The key duties of NRA under TEP include to (i) promote the internal EU energy market (instead of the national energy market)<sup>20</sup>, (ii) co-operate at one or more regional levels<sup>21</sup>, (iii) develop appropriate cross-border transmission capacities to meet demand and enhance integration of national markets<sup>22</sup> and (iv) impose penalties of up to 10 per cent of the annual turnover against energy companies which breach EU law.

### 1.1.3 Establishment of ACER

Another novelty of TEP is the establishment of the Agency for Cooperation of Energy Regulators (“ACER”) to ensure effective cooperation between national regulatory authorities. Importantly, ACER is tasked with (i) drafting framework guidelines for the operation of cross-border gas pipelines and electricity networks based on which binding network codes will then be adopted, (ii) ensuring that the network codes adopted are in accordance with the framework guidelines, (iii) reviewing the implementation of the EU-wide ten-year network development plans and national network development plans, (iv) deciding cross-border issues, if NRA cannot agree or ask ACER to intervene, and (v) monitoring the functioning of the EU internal market, including retail prices, available network access for electricity produced from renewables and the respect of consumer rights.

## 1.2 Council’s possible actions

Acknowledging the concerns expressed by many in the sector that TEP will not lead to the creation of an internal energy market by 2014, the Council emphasised in the Summit conclusions that it will not shy away from using the new powers granted to EU institutions in respect of energy policy under the Lisbon Treaty (see Article 194 of the Consolidated version of the Treaty on the Functioning of the European Union) to adopt further legislative measure should this prove necessary for the 2014 deadline to be met.

The Council further called on ACER to, together with TSOs, step up the work on market coupling, framework guidelines and network codes. On 3 March 2011, the very day on which it officially started working, ACER published the Draft Framework

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<sup>19</sup> Datamonitor, *End Game: What Now for Europe’s Energy Markets?* April 2009, at 5 and 6, available at

[http://www.europeanenergyreview.eu/data/docs/Viewpoints/datamonitor\\_en090430.pdf](http://www.europeanenergyreview.eu/data/docs/Viewpoints/datamonitor_en090430.pdf).

<sup>20</sup> See Article 40(a) of the Gas Directive and Article 36(a) of the Electricity Directive.

<sup>21</sup> See Article 7 of the Gas Directive and Article 6 of the Electricity Directive.

<sup>22</sup> See Article 40(c) of the Gas Directive and Article 36(c) of the Electricity Directive.

Guidelines on Capacity Allocation Mechanisms for the European Gas Transmission Network for the purposes of public consultation. The European Networks for Transmission System Operators for Gas and Electricity (known as “ENTSOS”) set up under TEP are already working on other draft framework guidelines including on capacity allocation and congestion management for electricity. Based on these framework guidelines the drafting of binding network codes is expected to start later this year. Many in the sector believe that these binding network codes will significantly contribute to the removal of barriers to competition in the energy sector and to the achievement of the 2014 goal of a single internal market for gas and electricity.

Finally, the Council made clear that it expects the Commission to ensure that MS comply with the provisions of TEP. As at the time of the publication of this article no MS has transposed TEP into national law despite the fact that 3 March 2011 was the deadline set for transposition. The Commission is empowered to commence infringement proceedings against MS which fail to transpose EU law on time pursuant to Article 258 of the Treaty on the Functioning of the European Union (the “Treaty”). No proceedings have been commenced yet. The Commission has, however, made clear that it expects MS to transpose the directives before the end of 2011.

The forty infringement proceedings presently pending against twenty MS for failing to implement EU energy law do not bode well for the achievement of the 2014 deadline. The Commission issued thirty five reasoned opinions to twenty MS in June 2010 for alleged breaches of the SEP, six years after it should have transposed into national law. MS had until the end of August 2010 to respond to the reasoned opinions. It is expected that the Commission will shortly commence legal proceedings before the European Court of Justice (“ECJ”) against certain MS for breaches of the SEP.

## **2. Infrastructure Priorities by 2020**

At the Summit the Council declared that no MS should remain isolated from the European gas and electricity networks after 2015 or see its energy security jeopardised by the lack of the appropriate connections. Investments of over € 1 trillion are needed by 2020 to modernise and expand Europe's energy infrastructure, provide for increasing and changing demand, interconnect networks across borders and integrate electricity from renewable sources. In the shorter term, the Commission estimates that for the completion of priority projects the EU needs at least € 19bn for gas pipelines and € 6bn for electricity transmission before 2013.

The TEP package brings important changes in respect of the evaluation of new infrastructure projects going forward by requiring national regulators to evaluate new investments by reference to the EU-wide benefits rather than narrow benefits to the

MS granting the authorisation. However, recognising that a far more ambitious policy framework must be put in place to ensure that the infrastructure priorities are achieved by 2020, the Council proposed on 4 February that the following actions be taken.

First, the Council called for the streamlining of the authorisation procedures and asked the Commission to prepare a proposal in this regard in the coming months. While respecting national competences and procedures, the Commission is expected to propose a one-stop shop for authorising projects of "European interest", with a single national authority coordinating the entire permitting process. It is understood that the Commission is also considering setting time limits by which competent authorities must issue decisions in respect of each stage of the permitting process. Presumably careful considerations will be given by the Commission to circumscribing the ability of companies to "country shop" between MS to try to take advantage of the fact that some MS have more lax environmental and planning laws than others.

Second, since the bulk of the investment in infrastructure will need to be made by private companies and thus financed through tariffs, the Council emphasised the need for tariffs to be set in a transparent and non-discriminatory manner at levels consistent with the financing needs, the appropriate cost allocation for cross-border investments as well as taking account of their impact on consumers.

Third, recognising that infrastructure projects which are justified from a security of supply/solidarity perspective will require some public finance to leverage private funding, the Council invited the Commission to devise a new method for defining European priority projects by June of this year. Projects declared of "European interest" will be eligible for financial support from the EU in the form of grants, equity participations, guarantees, public-private partnership loans or EU project bonds. Why the existing guidelines for trans-European energy networks as set out in Decision No 1364/2006/EC need replacing is not clear from the Summit's background papers.

Finally, given the long lead-in time for changes to be achieved in the energy sector, the Council called for the adoption of a low carbon 2050 strategy. This strategy is to provide a complete roadmap of measures to be adopted between 2020 and 2050 to ensure that EU's goal of reducing greenhouse gas emissions by 80-95% compared to the levels in 1990 is achieved by 2050 as recommended by the Intergovernmental Panel on Climate Change.

### **3. Achieving the Energy Efficiency Target**

Both the Commission and the Council have expressed concern that the 20% energy efficiency target is presently unlikely to be realised by 2020. The Commission has

made clear in the Summit's background documents that the quality of MS' National Energy Efficiency Action Plans is disappointing.

In view of this, the Council proclaimed energy efficiency as a key priority action going forward. Referring again to the new powers granted to EU institutions under the Lisbon Treaty in respect of energy policy, the Council called for a new pan-European approach to be taken on energy efficiency. In response to the Council's calls the Commission published its Energy Efficiency Plan on 8 March setting further policies and measures to be adopted across the full energy supply chain to achieve the target. In the plan the Commission also foreshadowed the legislative measures it expects to table in 2011 including (i) the revision of the existing Energy Services Directive 2006/32/EC and Combined Heat and Power Directive 2004/8/EC; (ii) the adoption of new eco design and energy labelling measures; (iii) the launch of the Smart Cities and Smart Communities Initiative; and (iv) the proposal on financing tools to incentivise energy-efficiency investments, as well as to clarify the role of EU funding, including existing structural funds, in promoting energy efficient investments<sup>23</sup>.

In addition, the Council called MS to prescribe energy efficiency standards based on the EU headline target in respect of public procurement contracts for public buildings and services by 1 January 2012. What, therefore, is clear is that this year will bring lots of new regulation at the EU level regarding energy efficiency.

#### **4. Europeanising EU's External Energy Policy**

In a further step in europeanising energy policy, the Council called for greater coordination and coherence in the EU's external energy policy and relations. In the Summit's background documents, the Commission called for the EU to formalise the principle whereby MS must act for the benefit of the EU as a whole in their bilateral energy relations with key EU partners as well as during multilateral negotiations concerning energy matters. The fact that in the same paragraph reference is again made to the new power granted to EU institutions in respect of energy policy under the Lisbon Treaty reveals the Commission's ambitions concerning its role in devising EU's external energy policy. These statements are likely to ring alarm bells in many capitals across the EU.

Although these statements have not expressly been endorsed by the Council in its conclusions, the Council has invited the Commission to submit by June 2011a communication on the security of supply and international cooperation which will improve the consistency and coherence of the EU's external action in the field of

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<sup>23</sup>EU Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Energy Efficiency Plan 2011*, at 15, available at [http://ec.europa.eu/energy/efficiency/action\\_plan/doc/20110308\\_efficiency\\_plan\\_act\\_en.pdf](http://ec.europa.eu/energy/efficiency/action_plan/doc/20110308_efficiency_plan_act_en.pdf).



energy. According to the Commission, this document will propose mechanisms to align existing international agreements (notably in the gas sector) with the internal market rules and to strengthen cooperation between MS before the conclusion of new ones. What effect this may have on the South Stream project and other Gazprom related projects in the EU is unclear.

As a further step in coordinating EU's external energy policy, the Council invited MS to inform the Commission of all their new and existing bilateral energy agreements with third countries from 1 January 2012 onwards. Pursuant to the current proposal it is envisaged that the Commission, having due regard to the need to protect commercially sensitive information, will then forward this information to other MS. This is likely to be another matter which will be strongly resisted by MS.

The Council also endorsed the Commission's proposal to extend and deepen the Energy Community Treaty ("ECT") by integrating neighbouring countries, in particular transit and Mediterranean countries (Ukraine joined in February 2011) and extending new *acquis communautaire* to the existing signatories to the ECT. Without specifically referring to Gazprom and Russia, but clearly with them in mind, the Council called for the Commission to develop additional measures it deems necessary to ensure a level playing field between power producers within the EU and those outside the European Economic Area. It would, therefore, seem that the special certification procedure for TSO owned by non-EU nationals prescribed under TEP and discussed above (dubbed the "Gazprom clause") is seen as insufficient to address the perceived imbalance in the level playing field.

It is not clear how the Council envisages that these measures, as well as the Council's call to diversify routes and sources of supply of oil and gas to the EU and its emphasis on the Southern Corridor, can be pursued in conjunction with its other declared priority of developing an energy partnership with Russia. Given Russia's and Gazprom's strong objection to the "Gazprom clause", it is likely that any further measures adopted by the Commission in this regard will make the conclusion of any energy agreement with Russia very difficult, if not impossible.

The proposed europeanisation of EU external energy policy is arguably the most important change to EU's energy policy going forward and one which will probably raise the most controversy. There is no doubt that the Commission expects to play a much greater role in devising EU foreign policy in the field of energy. The infringement proceedings it brought against Poland in July last year in respect of the Gazprom territorial clause contained in the gas supply agreements is likely to be a taste of what is to come.

## **Conclusion**

The EU Summit on 4 February seems to mark a watershed in EU energy policy. The Commission and the Council have emphasised that the time has come for a truly European energy policy. There is little doubt that both consider the new powers granted to EU institutions concerning energy policy by the Lisbon Treaty as key to the new approach to EU energy policy. Whether or not the MS intended for broad powers to be granted to EU institutions under the Lisbon Treaty, it is clear that the Commission and Council believe that they have such powers.

Should TEP not lead to the creation of the single energy market by 2014, both the Council and the Commission have made clear that a new package of legislative measures will be adopted at the EU level. This may well mean that energy companies and MS who fought hard and successfully resisted OU during TEP negotiations and who plan to adopt the ITO or ISO models of effective unbundling under TEP have simply delayed OUs adoption rather than precluded it. In this case, they may need to start preparing for OU much sooner than anyone would have anticipated at the time TEP was being negotiated.

For all these reasons, it seems very likely that the europeanisation of EU's energy policy will bring significant changes to the way the EU energy sector operates and is to be regulated much sooner than many in the industry had anticipated and, perhaps, would wish. Energy companies and states which are ahead of the EU legislative curve may at last find this to be a competitive advantage.