Bartłomiej Nowak

Equal Access to the Energy Market for Energy Suppliers – Benefits for the Customers

INTRODUCTION

A reliable and continuous supply of both electricity and gas at reasonable prices is an essential public service. In the past, in almost all member states, electricity and natural gas have been supplied by one or a small number of vertically integrated companies with control over the entire gas and electricity industry, from generation to supply. This has influenced large control over the industry by few national champions – vertically integrated undertakings. These conglomerates with cross subsidization of their activities as well as with state subsidies, could offer artificially lower prices, thus blocking competition and entrance to the market for new, independent, suppliers. In consequence, consumers had little or no choice of price or quality of service of energy[1]. In fact, energy market remained an economic sector dependent on and under the control of the different national governments (responsible for national champions) for many years. It did so for two reasons. First, because these nations attached high importance to energy matters, which they perceived as strategic to their national economies, they wanted to exercise close control of energy. Second, the very high cost of the energy infrastructure kept the national energy markets dependent on their respective national governments. Not surprisingly, it is only recently that the segmented European energy markets are being integrated together throughout the liberalization process which has started in the middle of 90s. Although Europe is

[1] M. Roggenkamp, F. Boisseleau, *The Regulation of Power Exchanges in Europe*, Intersentia 2005, pp. 3–6.

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on the right track, the process of liberalization is still far from being completed. One has to bear in mind that vertical integration in energy sector is lucrative for the dominant monopolies. Vertical integration enables the incumbents to favor their own corporate divisions, since there is both clear incentive to do so and the means to discriminate against competitors by blocking access to the infrastructure (networks and gas storage) for independent suppliers, naturally at the cost of the customers[2].

Lack of equal and non-discriminatory access to the infrastructure for all suppliers has a negative consequence for the consumer choice with regard to price of energy and service offered. Artificially lowered prices may lead to discrimination among suppliers and they may prevent market opening, thus causing market segmentation. If the incumbents set the end user prices at a low level in order to create market entry barriers for new suppliers, they may be engaged in discriminatory pricing, which may turn be anticompetitive. Especially if a low level prices are raised by the incumbent after the remaining competition on the market has been eliminated. Consumers, while at first benefiting from low prices, after elimination competition, would be again at a disadvantage. In a highly concentrated market, the dominant firm may shape the price structure of the energy since there is no potential competitor.

Yet regulated prices may be helpful in protecting customers in specific situations – for instance, in the transition period toward effective competition[3], or when customers are vulnerable[4], however this situation should be eliminated at a certain date or when certain preconditions on the market are met. Otherwise while regulated prices are set at lower level compared with what the market would produce, they hinder equal access of all suppliers to customers and prevent the opening of the market.

In order to mitigate the incentives for discriminating against competitors and to open energy market for all suppliers, it is necessary both to separate the transmission and distribution activities of a network business from its activities of production and supply and to ensure non-discriminatory

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[2] For more on discriminatory practices see R. Vaitilingam, *A European Market For Electricity? Monitoring European Deregulation 2*, Center for Economic Policy Research, 1999, UK, pp. 39–41.

[3] In transition periods towards well functioning competition the coexistence of regulated and market prices may be necessary to protect customers from potential abuse of dominant positions. Unfortunately, in practice the co-existence of regulated and a market price is clearly not a transitory measure e.g., France. Such scheme has been valid for many years and there are no clear indications that member states with regulated prices intend to remove them and proceed towards market prices.

[4] Protecting vulnerable customers should not be confused with maintaining regulated energy prices for all or certain categories of customers.

access of all players to the energy infrastructure. Achieving these objectives is the purpose of the unbundling provisions and the third party access protocols set forth in the Electricity[5] and Gas[6] Directives.

Full and non-discriminatory access to the energy market for all suppliers, and not only those who are part of the dominating group should be a paramount goal of any antitrust or regulatory action in the energy market.

2
THIRD PARTY ACCESS

Non-discriminatory access to the electricity and gas transmission and distribution networks (gas storage) is crucial for competition among suppliers to evolve. In many EU countries, the electricity networks and gas pipelines are still the property of the so-called vertically integrated corporations, which are responsible for extraction, generation, transmission, distribution, and supply. Vertical integration raises the possibility that incumbents will favor their own corporate divisions[7].

Vertically integrated companies discriminate against potential competitors in the following ways:[8]

- ☒ By creating technical barriers – for example, expensive procedures for customers who wish to change suppliers, such as the obligation to install new metering devices, to set up complicated balancing timetables, or obligation to collect complex administrative documents;
- ☒ Manipulating access tariffs, for example, the transmission/distribution operator may require customers wishing to switch suppliers to inform the operator about the details of the new contract (information passed on to its own sales department enabling it to selectively offer discounts);

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[5] 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, OJ L 176/37 of 15.07.2003. To be replaced by directive 2009/72/WE. The latter must be implemented by March 3, 2011.

[6] 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, OJ L 176/57 of 15.07.2003. To be replaced by directive 2009/73/WE. The latter must be implemented by March 3, 2011.

[7] R. Vaitilingam, op. cit, p. 39.

[8] For more on this see also Ch.W. Jones, *EU Energy Law. Volume 1 – The Internal Energy Market*, Claeys & Casteels, 2004, p. 61.

- Manipulating the availability of capacity to ensure that lines required by competitors are congested;
- Using various accounting techniques for cross-subsidies between its transmission/distribution activities and other operations (generation or supply).

Vertically integrated undertakings raise questions about the confidentiality of important commercial information. Since those network operators who are part of vertically integrated companies possess the information of considerable importance for market players, they are in a position of using this information on behalf of the parent company and to the detriment of its competitors (other suppliers which are not part of the group).

Effective competition requires that the owners of networks must allow any electricity or gas supplier a non-discriminatory access to these networks. Lack of transparent third party access creates an enormous entry barrier for new players.

Some scholars have argued, however, that "it is unnecessary to require third party access to gas networks to permit competition in the gas sector, as potential competitors to the existing pipeline owner could construct a competing network"[9]. However, if companies are natural monopolies not due to of the "natural" market structure but because the state had created them and then transferred the ownership of the infrastructure to the monopoly, then, by definition, the state has discriminated against companies that are not state-owned. Certainly, the latter would be better off if they constructed their own networks or pipelines, a scenario that would increase competition as well as security of energy supplies. The construction of the Nord Stream (formerly the North European Gas Pipeline) by the consortium Nord Stream AG, composed of several major European and Russian gas companies the illustrates the complexities of this alternative to the third party access[10]. The cost of the project, estimated at around E 10 Billion, was far too high for a single company. Even though such

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[9] Ch.W. Jones, op. cit., p. 31.

[10] Nord Stream AG (NEGP Company) was incorporated on 30 November 2005 and is a consortium in which 51% is owned by Gazprom, 24,5% shares currently owned by the German partners BASF and E.ON Ruhrgas. On 5 October 2006 Gazprom and N.V Nederlandse Gasunie signed the Memorandum of Understanding on co-operation towards joint participation of both companies in the Nord Stream and BBL projects (Balgzand Bacton Line connecting the Netherlands and the UK) as well as towards the use of transport capacity of the Gasunie system. In accordance with the memorandum, Gazprom will receive a share in BBL Company (whose shareholders are Gasunie-60%, E.ON Ruhrgas – 20% and Fluxys – 20%) whereas Gasunie will receive up to 9% of shares in the capital of Nord Stream AG. Upon completing the deal Gasunie will own 9% of shares and BASF and E.ON will have 20% each. For more on this see *The international Comparative Legal Guide to: Gas Regulation 2007*. A practical insight to cross-border Gas regulation work – Russia. Global Legal Group, p. 197.

projects benefit the nations by securing the supply of energy, their costliness militates against them. New networks, although necessary, are not the only solution to creating an open and competitive market. For this reason the Electricity and Gas Directives provided for a non-discriminatory third party access to the infrastructure.

In principle, there are two access regimes – regulated and negotiated. With respect to electricity, both transmission and distribution are subject to regulated third party access. With respect to the storage of gas and ancillary services related to gas (Article 19 of the G-Directive), Member States may chose between regulated and negotiated third party access.

To secure transparent and non-discriminatory third party access, vertically integrated companies must spin off the functions of network (system) operators – both transmission system operators (TSOs) and distribution system operators (DSOs). Article 2(4) of the G-Directive and Article 2(4) of the E-Directive define the parameters of TSOs. A TSO is:

> "a natural or legal person responsible for operating, ensuring the maintenance of and, if necessary, developing the transmission system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meet reasonable demands for the transmission of electricity".

This definition applies equally to a gas TSO. The transmission of electricity refers to:

> "the transport of electricity on the extra high-voltage and high-voltage interconnected system with a view to its delivery to final customers or to distributors, but not including supply".

The transmission of gas refers to:

> "the transport of natural gas through a high pressure pipeline network other than an upstream pipeline network with a view to its delivery to customers, but not including supply".

Article 2(6) of the E-Directive and Article 2(6) of the G-Directive define distribution system operator as:

> "a natural or legal person responsible for operating, ensuring the maintenance of and, if necessary, developing the distribution system in a given area and, where applicable, its interconnections with other systems and for ensuring the long-term ability of the system to meet reasonable demands for the distribution of electricity".

The above definition applies equally to a gas DSO. The definition of electrical distribution refers to:

> "the transport of electricity on high-voltage, medium voltage and low voltage distribution systems with a view to its delivery to customers, but not including supply".

The definition of gas distribution refers to:

> "the transport of natural gas through local or regional pipeline networks with a view to its delivery to customers, but not including supply".

It is crucial that transmission and distribution of electricity and gas do not involve the supply or retailing; transmission and distribution system operators cannot be involved in selling gas or electricity, what should be guaranteed by the unbundling provisions.

Designating transmission and distribution system operators when they are functionally, if not legally, unbundled is a simple process. A problem occurs with storage[11] and LNG facilities[12] where legal or functional unbundling is not required. Especially when gas storage and LNG facilities are the property of vertically integrated corporations, the result can be interference with third party access (e.g. access for the suppliers outside the group) and competition in the market. It is unclear whether the European legislature was unaware of this problem or was aware but did not have sufficient backing to pass the requirement for legal and functional unbundling. Since Article 17(3) of the G-Directive requires that separate accounts for storage and LNG should be kept suggests that the problem was in the lack of political will. In any event, Article 17(3) clearly underlines the importance of separate and sovereign operation of storage and LNG. Perhaps member states should require, by way of their domestic legislation, legal or at least managerial unbundling, if they really want third party access to be open and transparent. In fact, having VIU already present in the supply and/or generation chain and directly or indirectly involved in transmission or

[11] Article 4(9) of the G-Directive defines storage facility as a facility used for the stocking of natural gas and owned and/or operated by a natural gas undertaking, including the part of LNG facilities used for storage but excluding the portion used for production operations, and excluding facilities reserved exclusively for transmission system operators in carrying out their functions. For the gas storage Directive also requires the gas storage operator to be established which is: a natural or legal person who carries out the function of storage and is responsible for operating a storage facility.

[12] Article 4(11) of the G-Directive defines LNG facility as a terminal which is used for the liquefaction of natural gas or the importation, offloading, and re-gasification of LNG, and shall include ancillary services and temporary storage necessary for the re-gasification process and subsequent delivery to the transmission system, but shall not include any part of LNG terminals used for storage.

distribution activities raises serious doubts about non-discriminatory behavior, as the following case study demonstrates.

At the end of 2006, the Gaz-System (subsidiary of the PGNiG SA) denied the trading company Emfesz Polska (of Hungarian origin) access to the pipeline, which it needed to fulfill contract obligations for transporting 150 million cubic meters of gas from Polish border to the largest Polish fertilizer producer, ZA Pulawy. The grounds of the denial were vague. Gaz-System claimed in favor of PGNiG SA that Emfesz did not have adequate storage capacity in Poland[13] in order to secure trade (all storage belongs entirely to PGNiG SA). What is more, according to PGNiG SA, it needed the entire Polish storage capacity[14]. As a result, Emfesz lodged a complaint to the Polish antimonopoly authority, which upheld the Gaz-System decision. Emfesz then took the case to the European Commission now pending.

The Emfesz case highlights important legal issues. First, in Poland access to storage is negotiated under Article 19 of the Gas Directive. This Article states at paragraph 2 that access procedures shall operate in accordance with objective, transparent, and non-discriminatory criteria. Moreover, paragraph 3 states:

> "In the case of negotiated access, Member States shall take the necessary measures for natural gas undertakings and eligible customers either inside or outside the territory covered by the interconnected system to be able to negotiate access to storage and linepack, when technically and/or economically necessary for providing efficient access to the system, as well as for the organisation of access to other ancillary services. The parties shall be obliged to negotiate access to storage, linepack and other ancillary services in good faith".

Since there is no need for unbundling storage capacities (only for accounting unbundling), that leaves PGNiG in charge of the storage capacity, not the TSO – that is, not the Gaz-System or other independent body. Due

[13] Every trading company supplying on yearly basis above 50mln cubic meters of gas, imported from outside of Poland should have storage capacity in Poland for uninterrupted supply for 30 days. Whereas companies importing up to 50 mln cubic meter/year to less than 100,000customers are exempt from the necessity to maintain gas reserves in storage on Polish territory. Recently Emfesz has found another solution to the obstacles set forth by the PGNiG: the company had bought underground gas resources (Antonin, Poland) of approximately 120 million cubic meters of which 80 million cubic meters has been already exploited. Emfesz after exploiting the remaining 40 million cubic meters, plans to use the underground resources as the gas storage facilities. For more on this see B. Nowak, *Wewnętrzny rynek energii w Unii Europejskiej*, C.H. Beck, Warsaw 2009, p. 185.

[14] See New Gas Reserve Act gives PGNIG even stronger control over the Polish market. *Gas Matters*, May 2007, p. 18, Platts.

to PGNiG's dominant position, Emfesz has not been able to negotiate access. The development could be in breach of Article 19. PGNiG disagrees. It claims that it needs the entire limited storage capacity in Poland, which is not sufficient for sharing, and which is indispensable for its own operations. In addition, PGNiG argued that it cannot make its storage available to third parties because the Fuel Reserves Act[15] mandates it to store larger quantities of gas in order to secure an adequate reserve in case of national emergencies. The Act requires every trading company that annually supplies above 50 million cubic meters of gas, imported from outside of Poland, to have a storage capacity in Poland and maintain a 30-day reserve of gas supply. Companies that import less than 50 million cubic meters per year and have less than 100,000 customers are exempt from this requirement. PGNiG currently produces around 3.9 billion cubic meters per year and imports from Russia around 7.9 billion cubic meters per year. At present, its storage capacity is only above 2 billion cubic meters. Therefore it is obvious that if arguments submitted by PGNiG is taken under consideration, one could ask why the Polish authorities adopted the Fuel Reserves Act knowing that it will never be implemented, since present storage capacity is already occupied and no additional capacity is available. As a result PGNiG which is already in control of around 95% of the Polish gas market, thanks to the Act will be able to control also its competitors (other suppliers), for instance by denying them access to the storage.

Second, denial of access to the transmission system may constitute a breach of Article 1 paragraph 1 of the Gas-Regulation (Regulation 1775/2005)[16], which states: "This Regulation aims at setting non-discriminatory rules for access conditions to natural gas transmission systems". Gaz-System's denial of system access thus constitute discriminatory behaviour on the part of a TSO acting in favour of its parent company, PGNiG SA, which for its part is the main gas trader in Poland.

Third, it might also be inferred that the behavior of Gaz-System indicates that it has been informally granted preferential capacity for the

[15] The Act of 16 February 2007 on reserves of oil, oil products, natural gas and on procedures in case of emergency in security of fuel supply and disturbance on oil market (Ustawa z dnia 16 lutego 2007 roku o zapasach ropy naftowej, produktów naftowych i gazu ziemnego oraz zasadach postępowania w sytuacjach zagrożenia bezpieczeństwa paliwowego państwa i zakłóceń na rynku naftowym, Journal of Laws of 2007 No. 52, item 343.

[16] Regulation No. 1775/2005 was repealed by Regulation No. 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks O.J. 2009, L 211/36. Article 1 a of the Regulation 715/2009 states:
"setting non-discriminatory rules for access conditions to natural gas transmission systems taking into account the special characteristics of national and regional markets with a view to ensuring the proper functioning of the internal market in gas".

cross-border transmission and storage of gas as the only gas TSO on the market. If this inference is correct, Poland would be in violation of the ECJ judgment of 7 June 2005(C-17/03). That judgment deems preferential access to historical long-term supply contracts and capacity reservations contracts to be discriminatory and thus in violation of Directive 2003/54/EC and Regulation 1228/2003.[17] Although judgement pertained to electricity, it clearly could be applied to any preferential transmission, distribution, and storage capacities in another energy sector – in the case at hand, of natural gas. If so, Poland would be in violation of Directive 2003/55/EC and Regulation 1775/2005. Having its position of market dominance, Gaz-System may argue that it has denied access to Emfesz because it has had to fulfil its public service obligations to Poland by protecting the security of supply or because it has had to be concerned about the economic and financial difficulties with take-or-pay contracts. This, however, is subject to derogation being granted by the competent national regulatory authority and confirmed by the European Commission, which has not taken place. Moreover, it is hard to believe that supplying 150 million cubic meters to one company (under better sales condition, than under PGNiG agreement) would threaten the security of the nation's supply.

Finally, PGNiG – or more precisely, the Treasury as the owner and holder of the state monopoly – might be interpreted to have breached Article 37 of the EU Treaty (former Article 31 of the EC Treaty). Under this Article, Member States are obliged to intervene in the actions of any state monopolies of a commercial character to ensure they do not discriminate between national companies of Member States regarding the conditions under which goods are bought and sold. In a similar case, the Commission issued a formal request under Article 258 of the EU Treaty (former 226 of the EC Treaty) to Malta to intervene in the actions of its monopoly over the importation, storage, and wholesale of petroleum products. Malta, according to Commissioner Kroes, had been maintaining discriminatory measures in favor of the commercial state monopoly that blocked potential new entrants from entering the wholesale petroleum market[18].

[17] Regulation No. 1228/2003 was repealed by Regulation No. 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks O.J. 2009, L 211/15.

[18] For more on this see IP/07/958 of June 2007 concerning Commission requests of Malta to adjust import monopoly for petroleum products, available at: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/958&format=HTML&aged=1&language=EN&guiLanguage=en.

Unfortunately, the fact that suppliers must negotiate with their competitors in order to contract their storage needs is a serious barrier for new entrants and undermines confidence in the market. It takes place at the cost of the customers, who do not have the possibility to chose and negotiate. As a result, even though it is not necessary to separate storage (e.g. combined operators) obligations to separate storage operators would certainly enable competitors and regulators to verify that all available storage capacity is offered to the market on transparent conditions.

One way of determining whether third party access is operational in practice is to ask if a company/customer can switch to a different supplier. If a customer has a high number of suppliers/traders to choose from, the implication is that the suppliers/traders have easy access to the networks and that this access is transparent and based on well-defined access tariffs. If the percentage of customers switching the supplier is low, the inference is that customers are locked into the regulated prices demanded by the incumbents and that the number of new suppliers entering the market is rather low.

Many EU member states have a low switching rate, with the exception of Great Britain and Nordic countries. In Poland as of the end of 2008, only around 20% of large industrial electricity users and less than 0.1% of small and medium industries and businesses changed suppliers[19]. No gas customer switching at all had taken place. In many EU countries, both the lack of information from the energy companies on the availability of changing suppliers and in many cases the administrative difficulty in changing have blocked consumers from switching. Only recently – on 5 July 2007 – has the European Commission explained to energy customers their rights and how to change a supplier. In its proposed Charter of Rights of Energy Consumers, the Commission has identified four key goals[20]:

- More efficient protection of vulnerable citizens;
- More information to consumers;
- Less paper work when changing supplier;
- Protecting consumers from unfair selling practices.

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[19] B. Nowak, *Wewnętrzny*..., p. 220.

[20] See: http://www.agathepower.eu For the European Charter on the Rights of Energy Consumers see also http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1026&format=HTML&aged=0&language=EN&guiLanguage=en.

In sum, third party access remains a significant problem among member states. Preferential access for the companies linked to incumbents occurs in almost every EU country. Moreover, throughout the EU long-term contracts are a significant barrier to the development of an open and competitive common market for the benefit of the customers.

[3] UNBUNDLING

Another aspect of non discriminatory access to the energy market for all suppliers is unbundling – separation of a network's transmission and distribution business from its generation and supply (that is, unbundled) business, such that the former are conducted by independent bodies – system operators. There are three kinds of unbundling:

- ☒ Functional unbundling
- ☒ Accounting unbundling
- ☒ Legal unbundling

The core of functional unbundling is that system operators have effective and independent decision-making rights as well as independent management structures, especially regarding access to the energy infrastructure. In other words, system operators should be independent from other activities not related directly to transmission or distribution. Accounting unbundling involves separation of accounts. If a vertically integrated company separates its accounts, it may operate its various activities as a single business. Legal unbundling, in contrast, requires that a separate legal undertaking be created, a legal entity or personality in which all activities different from generation and supply (namely, transmission or distribution) are conducted. It is reasonable to believe that a legally separated company should act more independently than the one in which only functional unbundling takes place, where informal pressure from the parent company on the dependent party might very well occur.

Articles 10 and 15 of the Electricity Directive and Articles 9 and 13 of the Gas Directive envisaged both legal and functional unbundling. Article 10 of the E-Directive and Article 9 of the G-Directive deal with the unbundling

of transmission system operators (TSOs); Article 15 of the E-Directive and Article 13 of the G-Directive deal with the unbundling of distribution system operators (DSOs). Article 15 (1) of the E-Directive and Article 13(1) of the G-Directive state:

> "Where the distribution system operator is part of a vertically integrated undertaking, it shall be independent at least in terms of its legal form, organisation and decision-making from other activities not relating to distribution. These rules shall not create an obligation to separate the ownership of assets of the distribution system operator from the vertically integrated undertaking".

Under certain conditions exemptions from the requirement of legal and functional unbundling for distribution system operators is possible.

If less than 100,000 customers are connected to the distribution network, or if it operates small isolated systems – an exemption is possible so that the company can continue to operate the network and supply/generation within the same legal entity. What is the *ratio legis*? The most probable answer lies in the cost-effective evaluation. The imposition of unbundling requirements may add significant costs to the operation of very small distribution companies, which in turn might make it impossible for them to compete with much larger distribution companies. The last sentences of Article 15 of the E-Directive and of Article 13 of the G-Directive are identical: "Member States may decide not to apply paragraphs 1 and 2 to integrated electricity/gas undertakings serving less than 100,000 customers, or serving small isolated systems". However, it is possible that a member state might, by virtue of its own law, require smaller DSOs to be legally and functionally unbundled even though directives do not demand such a commitment. Thus, exempting smaller DSOs is left to the member states, according to the principle of subsidiarity, and is by no means obligatory.

In contrast, if the number of customers is above 100,000 unbundling is mandatory. However, member states could postpone the completion of legal unbundling until 1 July 2007. This option did not existed with regard to the full mandatory functional unbundling of management and accounting. On this point Article 30 (2) of the E-Directive states: "Member states may postpone the implementation of Article 15(1) until July 2007. This is

without prejudice to the requirements contained in Article 15(2)". In addition, under Article 32(2) of the G-Directive: "member states may postpone the implementation of Article 13(1) until July 2007. This is without prejudice to the requirements contained in Article 13(2)". If the deadline for legal unbundling has not been met, the Commission may start infringement proceeding pursuant to Article 258 of the EU Treaty.

Research has shown[21] that where a DSO or a TSO is a legal entity within an integrated company without separation of assets, three types of problems arise. First, in many cases system operators treat their affiliated companies better than competing third parties – for instance, by using network assets to make entry to the network more difficult for competitors. Second, non-discriminatory access to information cannot be guaranteed, since there is no effective tool to prevent a TSO or DSO from releasing sensitive market information to the generation or supply branch of the integrated company. Third, investment incentives within integrated undertakings are distorted, since vertically integrated system operators have no incentive for developing the network in the interests of all market players (suppliers), thus competitors as well. Such behaviour leads to market segmentation where access to the networks is reserved only for the member of the group. As a result, ownership unbundling where transmission or distribution companies would own the infrastructural assets and no significant stakes in supply and generation seems to be the best available solution for ending discriminatory practices with regard to non-discriminatory third party access, at the same time increasing competition among suppliers and consumer choice.

Ownership unbundling tends to be the most pro-competitive of the three types of unbundling. It is also the best way to prevent discrimination and to minimize the need for regulation. In the ownership unbundling, a vertically integrated company is required to divest its network assets to other companies, which are not involved in the generation/production and/or supply side of the energy cycle; or it must divest its supply business to companies that are not involved in network activities[22].

Unfortunately, for a number of reasons the directives did not address

[21] B. Nowak, *Wewnętrzny...*, pp. 180–182.

[22] For more on ownership unbundling see: B. Nowak, *Energy Policy of the European Union*, WAiP, Warsaw 2010, pp. 68–72.

ownership unbundling. Only recently the new energy liberalization directives[23] propose ownership unbundling, although not mandatory. One reason is that businesses do not like unbundling, for they fear they will suffer a lowered credit rating and a reduced capital base if they are forced to sell off parts of their operations. This argumentation although true, is not satisfactory, as vertically integrated companies may use their monopoly assets to cross-subsidize the competitive business, thus diminish market opening at the cost of consumers. Therefore, the real obstacle to ownership unbundling has been resistance from some member states – mainly Germany and France, but others as well[24]. Many state-owned companies were afraid that they would lose significant market share if a competitive market were suddenly introduced. Therefore, incumbent players exerted extreme pressure on national governments to oppose ownership unbundling. In response the Commission took the position (during the negotiations over directives) that only if functional, accounting, and legal unbundling failed to achieve non-discriminatory network access would it propose ownership unbundling[25]. In fact, the lack of significant progress in liberalizing the electricity and gas sectors has forced the Commission to include the issue of ownership unbundling (not mandatory) within its third legislative package[26]. In the meantime, the DG Competition of the European Commission recently tried to persuade gas companies that ownership unbundling and the resultaning move towards liberalization and competition in Europe is the right path. Unfortunately, the representatives of the major EU incumbents argued that ownership unbundling would endanger the security of supply and that it would weaken their market positions, especially in the relation to their countries" increasing reliance on large foreign suppliers, most notably Russian[27]. The position

[23] 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 (O.J. 2009, L 211/55) Directive 2009/73/EC of the European Parliament and of the Council of July 13 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC (O.J. 2009, L 211/94). Both directives need to be implemented into domestic law by 11 March 2010.

[24] During the meeting of energy ministers in Luxembourg held in 6 June 2007 a majority of ministers expressed opposition to ownership unbundling. Unfortunately only the UK, Sweden and the Netherlands were in favour of ownership unbundling and even the countries which already introduced ownership unbundling at the transmission level were against it at the distribution level. For more on this see S. Taylor, *Energy unbundling faces switch-off*, European Voice, 14–21 June 2007.

[25] Ch.W. Jones, op. cit., p. 65.

[26] 3rd energy legislative package–proposal for a Directives of the European Parliament and of the Council amending Directive 2003/54/EC and Directive 2003/55/EC; proposal for a Regulations of the European Parliament and of the Council amending Regulation No 1228/2003 and Regulation No. 1775/2005 and proposal for a Regulation establishing an Agency for the Cooperation of Energy Regulators.

[27] For more see *European incumbents display opposition to ownership unbundling at Flame*, available at: http://www.gas-matters.com/news3.shtml

of the incumbents is rational from their point of view. In fact, bilateral negotiations with large corporations outside the EU, such as Gazprom, actually increase their market power inside the EU, which is not necessary advantageous for customers and competition among suppliers.

Another argument often raised by the opponents of ownership unbundling involves the principle of subsidiarity in conjunction with Article 345 of the EU Treaty, which states: "This Treaty shall in no way prejudice the rules in Member States governing the system of property ownership". Some interpret this article as prohibiting the Commission from offering any proposal for ownership unbundling[28]. In this regard Hancher argues that Article II-17 of the new Constitutional Treaty (presently Article 345 of the EU Treaty), which recognizes the right to property, casts doubt on the legality of any proposal for ownership unbundling from the Commission with regard to gas and electricity network industries[29]. Such reasoning is logical, however, it fails to address the context in which it is operational – namely, the context in which natural monopolies use their subsidies of their network operations to diminish competition, and entrance of new suppliers into the gas and electricity market. In other words, by subsidizing those parts of their holdings that are not ownership unbundled – for example, their distribution system operations – national incumbents can influence access to the network system and thus block new entrants.

The above reasoning against unbundling is also inadequate as ownership unbundling does not necessitate nationalization of the properties in question. To the contrary, unbundling would rely on competition law by analogy to the provisions concerning mergers and acquisitions, whereby the transfer of ownership would go through only if certain conditions or remedies are met. Similarly, in ownership unbundling the legislation would demand the selling of transmission or distribution assets to a non-network company, which would entail negotiating a fair-market selling and purchasing price[30]. The idea of ownership unbundling is not to take away properties or harm the affected companies but to foster competition in markets dominated by natural monopolies. In addition, in the present globalized business environment, ownership unbundling might not entail

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28 Ibidem, p. 65.

29 L. Hancher, *The New EC Constitution and the European Energy Market*, in: M. Roggenkamp, U. Hammer (eds.), European Energy Law Report II, Intersentia, 2005, p. 4.

30 See for more on ownership unbundling: B. Nowak, *Energy...*, pp. 68–72.

a pure separation of transmission or distribution assets. Instead, it might involve more sophisticated arrangements such as to permit a company to have a certain non-controlling share (a minority interest of perhaps up to 10% of shares) in both a transmission or distribution system operator and in a supply or generation company. Such a minority shareholder would not have the blocking rights in either company, it could not appoint members of their boards. The key is to prevent conflicts of interest and provide the customers with proper choice regarding the price of energy and conditions on which it is delivered.

4

There are number of tools and methods vertically integrated undertakings can use to diminish competition by discriminating against suppliers from outside of their group. In order to avoid it, it is necessary to ensure non-discriminatory access to the networks (through the regime of third party access) and to separate a network's transmission and distribution business from its generation and supply business, in such a manner that the former are conducted by independent system operators. This process is lengthy and bumpy, though necessary in order to enable customers to take the full advantage of liberalization of the energy industry.

Member states themselves must commit to instituting the provisions of the energy directives. To this end they must foster competition by an aggressive approach to unbundling. Unless ownership is separated, the current unbundling rules will not remove the incentive for a company's cross subsidization of itself or for discriminating against those competitors (suppliers) seeking third party access (by creating unnecessary technical barriers, maintaining artificially small balancing zones, or not making unused capacities available). Member states must prohibit discriminatory practices throughout domestic or Community competition law.