

# Energy Policy of the European Union

*To my parents (Alek and Jola),  
my wife (Beata) and daughter (Julka)  
for their great support*



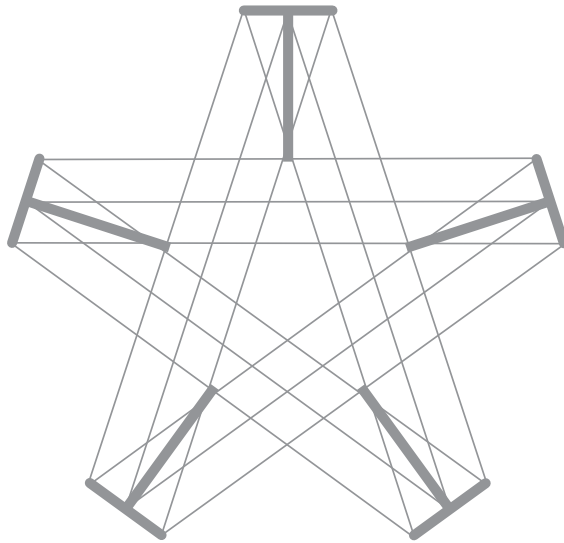
Bartłomiej Nowak

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# Energy Policy of the European Union

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Chosen legal and political aspects  
and their implications for Poland



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Cover, title pages and typographical design  
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Warsaw 2009

ISBN 978-83-61408-43-7  
ISBN 978-83-89437-3-27

Academic and Professional Press  
WSiP S.A. Group  
00-696 Warsaw, 3 J. Pankiewicza St.  
[www.waip.com.pl](http://www.waip.com.pl)

Kozminski University  
03-301 Warsaw, 57/59 Jagiellońska St.  
[www.kozminski.edu.pl](http://www.kozminski.edu.pl)

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# List of abbreviations

<b>ACER</b>	Agency for the Cooperation of Energy Regulators
<b>AP</b>	Accession Partnership
<b>BNA</b>	Bundesnetzagentur (German Regulator)
<b>CEE</b>	Central and Eastern Europe
<b>CRE</b>	Commission de régulation de l'énergie (French Regulator)
<b>DG COMP</b>	Directorate General Competition
<b>DG TREN</b>	Directorate General Energy and Transport
<b>DSO</b>	Distribution System Operator
<b>EA</b>	Europe Agreement
<b>ECTreaty</b>	European Community Treaty
<b>EC</b>	European Commission
<b>ECJ</b>	European Court of Justice
<b>ECR</b>	European Court Report
<b>ECSC Treaty</b>	European Coal and Steel Community Treaty
<b>EEC Treaty</b>	European Economic Community Treaty
<b>EP</b>	European Parliament
<b>Euratom Treaty</b>	European Atomic Energy Community Treaty
<b>EU</b>	European Union
<b>ERGEG</b>	European Regulators' Group for Electricity and Gas
<b>IEM</b>	Internal Energy Market
<b>ISO</b>	Independent System Operator
<b>MS</b>	Member State
<b>NPAA</b>	National Programs for the Adoption of the <i>Acquis</i>
<b>NRA</b>	National Regulatory Authority
<b>OJ</b>	Official Journal of the European Communities
<b>PSO</b>	Public Service Obligations
<b>SEA</b>	Single European Act
<b>SGEI</b>	Service of General Economic Interest

<b>SOEC</b>	Statistical Office of the European Communities
<b>SSO</b>	Storage System Operator
<b>TA</b>	Treaty of Amsterdam
<b>TEN</b>	Trans-European Networks
<b>TN</b>	Treaty of Nice
<b>TPA</b>	Third Party Access
<b>TSO</b>	Transmission System Operator
<b>TUE</b>	Treaty on the European Union
<b>URE</b>	Urząd Regulacji Energetyki (Polish Regulator)
<b>VIU</b>	Vertically Integrated Undertaking
<b>QMV</b>	Qualified Majority Voting



# List of the legal acts quoted in the book

Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity (OJ L 027 of 30.01.1997).

Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 concerning common rules for the internal market in natural gas (OJ L 204/1 of 21.07.1998).

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).

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).

Directive 2004/67/EC of the Council of 26 April 2004 concerning measures to safeguard security of natural gas supply (OJ L 127 of 29.04.2004).

Directive 2005/89/EC of the European Parliament and of the Council of 18 January 2006 concerning measures to safeguard security of electricity supply and infrastructure investment (OJ L 33/22 of 04.02.2006).

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 211/55 from 14.08.2009).

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 (OJ L 211/94 from 14.08.2009).

Regulation No. 1228/2003 of the European Parliament and Council of 26 June 2003 on conditions for access to the network for cross-border exchanges in electricity (OJ L 176/1 of 15.07.2003).

Regulation No. 1775/2005 of the European Parliament and Council of 28 September 2005 on conditions for access to the natural gas transmission networks (OJ L 289 of 03.11.2005).

Regulation No. 139/2004 of the Council of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation) (OJ L 24 of 29.1.2004).

Regulation No. 714/2009 of the European Parliament and of the Council of July 13 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing regulation No 1228/2003 (OJ 211/15 from 14.08.2009).

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 and repealing Regulation No 1775/2005 (OJ L 211/36 from 14.08.2009).

Treaty of Paris, 1951, establishing the European Coal and Steel Community (ECSC Treaty).

Treaty of Rome, 1957, establishing the European Economic Community (EEC Treaty).

Treaty of Rome, 1957, establishing the European Atomic Energy Community (Euratom Treaty).

Energy Charter Treaty, 1994.

**After ratification of the Lisbon Treaty by all Member States Article 95 of the EC Treaty will be enumerated as Article 114 of the Lisbon Treaty, Article 81 of the EC Treaty as Article 101 of the Lisbon Treaty, Article 82 of the EC Treaty as Article 102 of the Lisbon Treaty, and Article 86 of the EC Treaty as Article 106 of the Lisbon Treaty.**

# Introduction

The energy policy of the European Union (EU) is a concept that is rather difficult to pin down. In general, it encompasses legal, political, business as well as environmental considerations. Although the Community has legislated in the area of energy policy for many years, and evolved out of the founding Treaties, the concept of introducing a comprehensive European energy policy for all Member States is fairly new. The possible principles of EU energy policy were elaborated at the Commission's green paper entitled *A European Strategy for Sustainable, Competitive and Secure Energy*<sup>1</sup> and in *An Energy Policy for Europe*<sup>2</sup>. Both documents identify six key areas where action is necessary to address the challenges the EU presently faces. The key areas include:

- Competitiveness and the internal energy market.
- Security of supply (mainly diversification of the energy mix).
- Solidarity.
- External Policy (especially energy relations with third countries).
- Sustainable development.
- Innovation and technology.

The variety of issues relevant for the EU energy policy makes it almost impossible to discuss every concept in detail. Therefore, for the purpose of this publication some restrictions have to be introduced. The fundamental question that this book is trying to answer, is whether an agreement can be reached regarding the need to develop a common European energy policy and whether internal (competitiveness and internal energy market) as well as external issues (security of supply, external policy) should be the core principles to underpin this policy? The answer is: yes, although

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<sup>1</sup> A European Strategy for Sustainable, Competitive and Secure Energy Commission's green paper COM (2006) 105 final.

<sup>2</sup> Communication from the Commission to the European Council and the European Parliament – An Energy Policy for Europe COM (2007) 1 final.

such a process is a difficult and lengthy one. In fact, this book reviews the developments that have created the current state of the EU energy policy and discusses the prospects for further progress in the light of the challenges that still remain. These challenges include the slow process of creating an internal energy market and the lack of a common external energy policy, especially regarding the security of supply and relations with third countries. Although sustainable development together with the protection of the environment and climate change are equally important in the EU energy policy, they will not be discussed in this volume.

This book is divided into three chapters preceded by an introduction and concluded with general conclusions: chapter one – the legal basis for the EU energy policy; chapter two – the internal dimension of the EU energy policy; chapter three – the external dimension of the EU energy policy. Chapter one examines a number of legal acts and treaties, which constitute the legal basis for the EU energy policy as well as the internal energy market. Chapter two – the internal dimension of the EU energy policy mostly refers to the creation of an internal/common energy market where secure and reliable supplies of energy (mainly electricity and gas) at competitive prices can be safeguarded. However, the creation of an internal energy market that is based on the open and competitive markets of the 27 Member States represents great challenges for the European Union, if it is to have the kind of direct impact on the European industry and economic activity as well as on the welfare of many European citizens that has been envisioned. For decades, a unified European energy market with a common energy policy existed solely in theory. It remained an economic sector dependent on and under the control of the different national governments. It did so for two reasons. Firstly, because these nations attached very high importance to energy matters, which they perceived as strategic to their national economies, and they wanted to exercise close control of energy. Secondly, 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 combined together under the name of the internal energy market as a large part of the EU energy policy. Although Europe is on the right track, the process of unification is still far from being complete. One has to bear in mind that the creation of a solid energy policy and a common energy market (one that would take into consideration all the different views of the Member States) cannot occur all at once but will occur only over time. This is because it involves a complicated process of political negotiations, decision-making, the passage of specific legislation and massive market adaptations. Moreover, it should be clear that the necessary political

involvement will not end with the decision to establish a common energy policy or with the completion of the legislative work required to establish a market framework as part of this policy. Continued political involvement will be required to create a competitive European internal energy market as well as to monitor and regulate the exercise of monopoly powers by independent national regulators.

In fact, well functioning energy markets, which ensure secure energy supplies at competitive prices, are fundamental to economic growth as well as consumer benefit in the EU. To achieve this double objective the Community institutions must foster the observance of the EU competition law and harmonize the domestic energy markets through directives and regulations. For the purpose of harmonization, the Community has introduced legislation at three different times. The first occurred in the 1990s and included laws to end legal monopolies in the electricity and gas sectors. Unfortunately, the legislative framework established by the first electricity and gas directives<sup>3</sup> – which aimed to allow large industrial users to freely choose their supplier, to grant access to independent third parties, and to separate the operations of the vertically integrated companies – did not prove as beneficial as imagined. In response, the Community adopted a second legislative package<sup>4</sup>. It looked towards further liberalizing the energy sector by unbundling vertically integrated activities of the electricity and gas conglomerates and reducing their horizontal concentration, by introducing competition in the wholesale generation market and retail supply, by monitoring transmission and distribution networks by mandating regulated third party access to the energy infrastructure, by introducing fixed access tariffs, which were to be established and approved by national regulators that Member States were also obliged to set up. The third wave of energy legislation came just recently (August 2009) and Member States will bring the necessary provisions into force to comply with the third package of directives<sup>5</sup> by

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<sup>3</sup> Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity (OJ L 027 of 30.01.1997). Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 concerning common rules for the internal market in natural gas (OJ L 204/1 of 21.07.1998).

<sup>4</sup> 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). 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).

<sup>5</sup> 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 211/55 from 14.08.2009). 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 (OJ L 211/94 from 14.08.2009).

the 3rd of March 2011. Consequently, it is difficult to judge what the final result of the expected objective will be. Nevertheless, the third package looks to ensure that all European citizens can derive advantage from the numerous benefits provided by a truly competitive energy market. Consumer choice, fairer prices, cleaner energy and security of supply are the focus of the third legislative package.

Additionally, two other legislative acts provide for structural changes in the regulatory framework of the electricity and gas sectors. Regulation 1228/2003 of the European Parliament and Council as amended by regulation No. 714/2009<sup>6</sup>, which stipulates the conditions for access to the network for cross-border exchanges in electricity (hereinafter electricity regulation), and regulation 1775/2005 of the European Parliament and Council as amended by regulation No. 715/2009<sup>7</sup>, which lays out the conditions for access to the natural gas transmission networks (hereinafter gas regulation) aim to set non-discriminatory rules for cross-border trade of electricity and gas. These regulations aim to establish harmonized principles and methodologies for calculating tariffs and for setting both non-discriminatory rules (for access to transmission systems, capacity allocation and congestion management) and balancing rules.

In conjunction with the secondary laws that the Community has passed, the Commission's powers concerning antitrust action (Articles 81, 82 and 86 TEC), market concentration (regulation No. 139/2004/EC), and the regulation of State aid (Articles 87–89 TEC) are needed to maximize the impact of the Community's efforts to enforce the liberalization and cross-national harmonization of the internal energy market. The Commission needs to apply the full force of its powers to prevent abuse when vertical integration between supply and infrastructure businesses takes place and when insufficient unbundling leads to the infringement of competition. Depending on their circumstances, these cases may be addressed by applying the essential facility doctrine under the Merger Regulation and Article 82 EC. The Community must guard against the vertical entanglement of markets by long term downstream contracts on the part of dominant firms, for such action tends to close, not open, the

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<sup>6</sup> Regulation No. 1228/2003 of the European Parliament and Council of 26 June 2003 on conditions for access to the network for cross-border exchanges in electricity (OJ L 176/1 of 15.07.2003). Regulation 1228/2003 has been amended by regulation No. 714/2009 of the European Parliament and of the Council of July 13 2009 on conditions for access to the network for cross-border exchanges in electricity (OJ 211/15 from 14.08.2009).

<sup>7</sup> Regulation No. 1775/2005 of the European Parliament and Council of 28 September 2005 on conditions for access to the natural gas transmission networks (OJ L 289 of 03.11.2005). Regulation No. 1775/2005 has been amended 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 (OJ L 211/36 from 14.08.2009).

market and may violate Articles 81 and/or 82. The Community must be alert to the ways that the forces of market foreclosure hinder access to the infrastructure within a country (transmission and distribution networks as well as storage) and the particularly severe consequences where cross-border access is concerned. Finally, if the Community is to succeed in preventing the partitioning of the common energy market, it must fight against collusion among incumbents, take aggressive antitrust enforcement action and prevent companies from seeking monopolistic or near-monopolistic control of the market, rather than entering into free and open competition. After all, the growth of certain industries in the EU, as well as of the EU economy in general, depends largely on competition, in relation to which the internal energy market is essential. Although competition can expose market players to the risk of losing market share if they are not sufficiently efficient and innovative, it is also a force that benefits customers in the form of lower prices, lower costs, and better service. As a result, competition in the internal energy market should be seen as an essential apparatus to enhance Europe's competitiveness, especially since energy is an essential input for the European industry competing in the global market. In this regard, only competitive markets generate the right investment signals, offer fair network access for all potential investors, and thus provide effective incentives for both system operators and generators to invest billions of Euros in infrastructure. After all, a competitive and efficient energy market is a precondition for tackling climate change. With a well-functioning market it is possible to develop an effective emission trading mechanism and a renewable energy industry.

With regard to the external dimension of the EU energy policy (chapter three), one may ask: does Europe really need a common external energy policy? Yes, the EU's dependence on external primary energy sources, such as gas or oil, has been constantly growing and will continue to do so. In 2001, 31% of the EU's natural gas supply was imported from outside; by 2025 it is estimated that the Community will have to import around 70% of its natural gas consumption<sup>8</sup>. Currently, Russia is the biggest player on the EU market, with approximately 48 trillion cubic meters of proven gas reserves<sup>9</sup>. In contrast, the EU currently holds

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<sup>8</sup> Cornwall N. (2006) International trade in gas and prospects for UK gas supplies, in: Robins C. (ed.) *Regulating Utilities and Promoting Competition. Lessons for the Future*. Edward Elgar Publishing, p. 45.

<sup>9</sup> 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.

less than 4% of the world's proven gas reserves<sup>10</sup>. Therefore, it is obvious that if the present situation is not tackled within the framework of a coherent external dimension of EU energy policy, this external dependence will have profoundly negative economic and social consequences for the whole of the European Union.

The heavy dependence on imports on the part of certain Member States and the lack of a coherent European strategy towards the security of supply and diversification of the energy mix significantly affect the bargaining position of the Community as such. In fact, the EU is not speaking with one voice regarding gas supplies. As a result, the Community goals are shifted to a second plan, giving priority to domestic aims, often creating tensions between Members. For example, the construction of a Baltic pipe between Germany and Russia, one that provides no access for Poland and the Baltic States, is perceived by the excluded nations as a selfish response to a problem that concerns all EU Member States.

In addition, the mechanisms to ensure solidarity between Member States in the event of an energy crisis are not in place and several Member States are largely or completely dependent on a single gas supplier.

Moreover, Poland and the other new Member States, even though they are dependent on energy supplies similarly to the old Member States, face different challenges as a result of their proximity to and relationship with Russia, which is the main gas partner of the EU. Important differences can be seen in four areas: the structure of energy use, energy dependence, infrastructure, and the politization of the issue<sup>11</sup>. The first important difference between the energy situation of Poland and that of Western European countries has to do with the fact that Central and Eastern European countries (CEE) in general have a much higher level of energy dependence on a single source – namely Russia – than other European countries. While in Western European countries the level of dependence on a single source hardly exceeds 30%, the level of energy dependence of the CEE countries on Russian gas oscillates between 50–100%<sup>12</sup>, and for Poland it is 65%. The difference between Eastern and Western Europe is further marked with disparities in the effectiveness

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<sup>10</sup> Cornwall N. (2006) *International trade in gas and prospects for UK gas supplies*, in: Robins C. (ed.) *Regulating Utilities and Promoting Competition. Lessons for the Future*. Edward Elgar Publishing, p. 46.

<sup>11</sup> For more on this see Rulska A. (2006) *The European Union Energy Policy: An Initiative in Progress*. Paper presented at the Conference in April 2006 at the Central and East European International Studies Association – University of Tartu, Estonia.

<sup>12</sup> Balmaceda M. (2003) EU energy policy and future European energy markets: consequences for the central and east European states. *Oil, Gas and Energy Law Intelligence* 1:2 (March 2003). Available at: [http://www.gasandoil.com/ogel/samples/freearticles/article\\_40.htm](http://www.gasandoil.com/ogel/samples/freearticles/article_40.htm)



and quality of infrastructure and facilities and the role energy plays in politics. The legacy of difficult relations with the Soviet Union makes it very difficult for trade with Russia to be conducted as if it was trade with any other country. For Poland and the other CEE states mistrust and fear spoil the perception of the relationship with their main gas supplier – an element that is not present in the relationship of other European states and their suppliers, be it Norway or Algeria.

Additionally, the role energy plays in politics and the disparities in the relationship with Russia among EU countries make the entire process of creating an external energy policy even more demanding. For example, the relations between the UK and Russia are more complicated than those of Germany, Italy or France. This was particularly obvious when the British government was completely against the entrance of Gazprom into the British market through the purchase of assets in Centrica. A similar model of relations can be observed between Russia and Poland, which for the preservation of its energy safety repeatedly blocked the attempts of Gazprom to acquire assets in Polish energy companies.

Finally, at present, the gas and electricity market dynamics and levels of competitiveness vary enormously across the EU 27 due to the diverse patterns of energy consumption, fuel mixes, sources of supply and the natural resources among them. This variation, which is both historical and structural, among the respective energy sectors of the EU 27 has created the current variation in openness to competition and most probably will continue to hamper the emergence of a truly coherent EU energy policy for a number of years.



## Chapter 1

# The legal basis for the EU energy policy and internal energy market

Over the past decades, in most EU countries the structure of the electricity and gas industries, being stagnant for decades, has been transformed significantly by far-reaching programs of institutional and legal reform at both Community and domestic level. This transformation did not proceed smoothly, with its periods of stagnation and conflict, until the implementation some radical transformations during the 1990s. This chapter investigates the legal basis, both in terms of treaties and secondary legislation, of the uneven path the Community traveled in order to achieve the transformation of the EU energy policy and the internal energy market.

## 1.1. The development of the treaties and energy policy framework

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After World War II, the energy sectors within Europe have undergone significant changes. Because of Europe's immense need for energy in order to rebuild and modernize in the post-War era, European policy makers focused on the energy sector to develop common policies and

co-ordination actions<sup>1</sup>. The recognition of how important energy is for the economic development and political integration of Europe is reflected by the fact that two out of three European treaties were specifically directed to the energy sector<sup>2</sup>. The Treaty establishing the European Coal and Steel Community (ECSC) and the Treaty establishing the European Atomic Energy Community (Euratom) constituted the legal framework for the first six Member States in undertaking common activities to manage and administer energy resources, such as coal and nuclear energy. The Treaty of Paris that was signed in 1951<sup>3</sup> established a supranational coal and steel regime for a period of 50 years, while the Euratom Treaty, signed in 1957, created the European Atomic Energy Community<sup>4</sup>. Both Treaties were responsible for a common coal and nuclear policy as a part of the sectoral approach to energy market integration<sup>5</sup>. At the early stage, the integration was political rather than market-based<sup>6</sup>.

The political aim of the ECSC was to transfer the control of coal and steel industries from national authorities, in particular those of Germany and France, to supranational authority, the High Authority,

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<sup>1</sup> See Armand L. (1955) *Some aspects of the European energy problem: suggestions for collective action* (OEEC 1955); OEEC, *Europe's growing needs of energy – How can they be met?* (OEEC 1956).

<sup>2</sup> Although both Treaties also had other political objectives. This will be discussed later on in the text.

<sup>3</sup> The ECSC Treaty (Treaty of Paris), signed in Paris on 18 April 1951. Entered into force on 25 July 1952. The Treaty term was 50 years, and it has expired in 2002. The Contracting Parties were the 6 original Member States: Belgium, France, Germany, Italy, Luxembourg and the Netherlands.

<sup>4</sup> The Euratom Treaty was signed in Rome on 25 March 1957. Entered into force on 1 January 1958. The Contracting Parties were the 6 Member States of the ECSC. The treaty was concluded for a unlimited period.

<sup>5</sup> On the other hand, the EEC Treaty (now EC Treaty) is a framework treaty, an instrument of general economic integration. Its rules are mainly expressed as general principles, which may be supplemented by the secondary legislation, see for instance: Artis M., Nixon F. (2001) *The Economics of the European Union. Policy and Analysis*, Oxford University Press, New York, p. 11. Whereas the two other treaties provide for detailed rules governing sectors, and such matters as research, investment, health and safety. Here further secondary (implementing) legislation is not always required. For instance, in Case 188/80 France, Italy and the United Kingdom v Commission [1982] ECR 2545 the Court held that the Commission Directive 80/723/EEC on financial transparency could not be applied to the entities in the coal sector, since the ECSC already contains rules governing this matter. On the other hand, the Euratom Treaty does not have special provisions for competition or state aids, so these matters fall within the domain of the relevant articles of the EC Treaty or secondary legislation.

<sup>6</sup> Market integration is also called economic integration in the literature on European integration.

now the European Commission. The ECSC's main economic or market integration aims were to ensure security of supplies and a unified market for the coal and steel products, and to do so by lifting restrictions on imports and exports (removing quotas and custom duties among the six members) over a five-year transitional period; the rational expansion and modernization of the domestic industries; and the creation of a unified labor market. Additionally, the ECSC required restricting the use of discriminatory state subsidies by the Member States and it provided a common external commercial policy relating to the two sectors<sup>7</sup>.

Article 1 of the ECSC explicitly states:

*By this Treaty, the High Contracting Parties establish among themselves a European Coal and Steel Community, founded upon a common market, common objectives and common institutions.*

Furthermore, Article 4<sup>8</sup> highlights the importance of a common market in energy, at least in theory, and European integration, which was understood in terms of a common market for coal and steel:

*The following are recognized as incompatible with the common market for coal and steel and shall accordingly be abolished and prohibited within the Community, as provided in this Treaty:*

- (a) import and export duties, or charges having equivalent effect, and quantitative restrictions on the movement of products;*
- (b) measures or practices which discriminate between producers, between purchasers or between consumers, especially in prices and delivery terms or transport or transport rates and conditions, and measures or practices which interfere with the purchaser's free choice of supplier;*
- (c) subsidies or aids granted by States, or special charges imposed by States, in any form whatever;*
- (d) restrictive practices, which tend towards the sharing or exploiting of markets.*

In practice, the focus of the ECSC was on how to manage coal and steel production in Europe in both its political and economic implications,

<sup>7</sup> Artis M., Nixon F. (2001) op. cit., p. 11.

<sup>8</sup> Article 4 of the ECSC Treaty served 7 years later as a legal base for the regulation of competition matters on the common market by the EEC Treaty. Consequently, import and export duties (...), Art. 4 a) of the ECSC Treaty, found its destination in Article 28 and 29 of the EEC Treaty. Articles 28–29 claim to guarantee free movement of goods by prohibiting quantitative restrictions on imports and exports (and all measures having equivalent effect). The other parts of Article 4 b), c), d) were set forth accordingly in Articles 81–90 of the EEC Treaty.

and not on creating a comprehensive energy policy<sup>9</sup>. In economic terms, the Coal and Steel Community achieved success at an early stage. Between 1952 and 1960, iron and steel production rose by 75% in ECSC Countries, and industrial production rose by 58%. In 1957, OECD members in Europe were producing about 500 million tons of coal, while net crude oil imports amounted to 100 million tons. When overproduction of coal became a problem in 1959, mainly in Belgium, the ECSC adapted by reducing Belgium's coal production capacity by 30%, and by creating funds for aid to retrain miners and to develop new industries. By 1970, the ECSC had granted about 150 million dollars in aid to retrain over 400,000 coalminers<sup>10</sup>. In fact, the ECSC Treaty is the only one of the founding treaties that dealt with the social aspects of the energy sector. In Article 2 and Article 3<sup>11</sup>, the Treaty included social provisions on employment, cost of living and supply. Article 2 states:

*The European Coal and Steel Community shall have as its task to contribute, in harmony with the general economy of Member States and through the establishment of a common market as provided in Article 4, to economic expansion, growth of employment and a rising standard of living in the Member States (...).*

Furthermore, Article 3.e states:

*The institutions of the Community shall, within the limits of their respective powers, in the common interest:*

*(e) promote improved working conditions and an improved standard of living for the workers in each of the industries for which it is responsible, so as to make possible their harmonization while the improvement is being maintained (...).*

The Treaty provided far reaching competencies on market organization and some horizontal policies, such as research and development (R&D). It also provided for the restructuring of the coal and steel industries. However, the Treaty did not establish full competition in the EC coal industry. However, it created a system of regulated competition under which the High Authority could intervene in the market in specific circumstances. For instance, if demand went beyond supply, the High Authority, by virtue of the complex legislation of the ECSC

<sup>9</sup> Matlary J.H. (1997) *Energy Policy in the European Union*. The European Union Series, Macmillan Press, p. 16.

<sup>10</sup> <http://www.infoplease.com/ce6/history/A0817880.html>

<sup>11</sup> The text of the ECSC Treaty is available at: [http://www.eurofer.org/legislation/entr30a.htm#I\\_\\_Text\\_of\\_the\\_Treaty](http://www.eurofer.org/legislation/entr30a.htm#I__Text_of_the_Treaty)

Treaty, would be allowed to intervene in matters of pricing, competition, and commercial policy as well as in matters of financial and social concern<sup>12</sup>.

The quasi market-regulations of the ECSC Treaty were significant when nearly all of the former EU-6 nations were engaged in extracting coal and did so at low cost. Coal soon became the main source of energy, accounting for about 90% of all energy consumption in the countries concerned. In 1960, coal production in Europe was approximately 450 million tons, almost 3 times the tonnage of oil imports, which grew to 170 million tons from 100 million tons in 1957. In 1959, the Eisenhower administration adopted quotas on oil imported from the Middle East to the U.S., thus making Western Europe the largest recipient of Middle East petroleum. Among the original six EU Members States, along with England, Ireland, and Denmark, oil imports in 1960 amounted to 32.5% of all primary fuel requirements. By 1973 that figure had increased to 63%<sup>13</sup>. The increase in cheap oil imports to Europe in the 1970s decreased the prices of coal, which led to a decrease in its extraction and the decline of its dominant role in the energy sector. A significant number of Community coal mines were closed due to steadily increasing costs. In addition, nuclear energy development slowed down significantly. Consequently, the quasi-market regulation that had been set up by the ECSC Treaty lost its economic justification.

The second instrument of integration that was planned for the energy sector was the European Atomic Energy Community Treaty (Euratom), which was signed in 1957. The task of Euratom was to create the conditions essential for a fast establishment and growth of nuclear industries among the Member States. The main advocate of the Euratom Treaty at that time was France. France had begun a civilian nuclear energy program and perceived Eurotom as a way of obtaining financial support for developing a market for its nuclear technology<sup>14</sup>. The aim of the Euratom Treaty is clearly defined in Article 1 of the Treaty, which states:

*It shall be the task of the Community to contribute to the raising of the standard of living in the Member States and to the development*

<sup>12</sup> Cameron P. (2002) *Competition in Energy Markets: Law and Regulation in the European Union*, Oxford University Press, New York, p. 41.

<sup>13</sup> Marquis M. (2001) *Introducing Free Markets & Competition to the Electricity Sector in Europe*, Wisdom House Publications Ltd, p. 19. See also *Econometrica* (1960), Vol. 28, No. 1, available in JSTOR at: <http://www.jstor.org/view/00129682/di952544/95p0412y/0?frame=noframe&userID=53672895@iue.it/01cc99331600501b2f308&dpi=3&config=jstor>

<sup>14</sup> For more on this see Artis M., Nixon F. (2001) op. cit., p. 13.

*of relations with the other countries by creating the conditions necessary for the speedy establishment and growth of nuclear industries.*

To carry out its nuclear energy tasks the Community was required to establish a nuclear common market, as specified in Article 2.g:

*In order to perform its task, the Community shall:*

*(g) ensure wide commercial outlets and access to the best technical facilities by the creation of a common market in specialized materials and equipment, by the free movement of capital for investment in the field of nuclear energy and by freedom of employment for specialized within the Community (...).*

Though France had its interests in Euratom, in reality the driving force for establishing the Euratom Treaty was the Community's sense of urgency in reducing the nuclear power dominance of the United States and the USSR after World War II<sup>15</sup> and in responding to the Suez Oil Crisis of 1956 in the Middle East<sup>16</sup>.

The biggest success of the Treaty turned out to be the willingness of the key Member States to give up some control over their national nuclear programs and shift resources to civilian use of nuclear technology. The greatest impediment to the operationalization of the Treaty arose from the nuclear industry itself. Their costs of constructing the nuclear power plants were greater than anticipated. Moreover, they encountered a European public hostility towards further developments within the nuclear industry, especially following the Chernobyl accident in 1988.<sup>17</sup> It is only recently that attitudes towards nuclear energy are changing, France being the greatest supporter and enthusiast in Europe. However, what should be stressed is the fact that France began to invest heavily in

<sup>15</sup> Cameron P. (2002) *op. cit.*, p. 42. See also Summaries of the Union's legislation (SCADPlus) at: [http://europa.eu/scadplus/treaties/euratom\\_en.htm](http://europa.eu/scadplus/treaties/euratom_en.htm) for more on the Euratom Treaty.

<sup>16</sup> The Suez Canal was an extremely important international passage at the time of the crisis. About 1.5 million barrels of oil a day passed through the canal, of which about 1.2 million was destined for Western Europe. This was around two-thirds of the total oil supplies of Western Europe. As a result, in the circumstances when Western Europe was shifting from coal to oil for its energy needs, the vision of severe oil shortages, especially for the countries that were very dependent on foreign oil reserves, of Western Europe (mainly Great Britain and France), became a driving force for research on alternative energy sources, such as atomic energy. For more on this see the University of Michigan press publications at: <http://www.press.umich.edu/pdf/0472108670-06.pdf>

<sup>17</sup> For more on this, see Gruenwald J. (1988) *The Role of Euratom*, in: Cameron P., Hancher L., Kuhne W. (eds.) *Nuclear Energy Law After Chernobyl*, Graham & Trotman, London-International Bar Association.



nuclear energy after the oil crisis of 1973 and well before the Chernobyl crash. This way, France established an initial competitive advantage in the nuclear industry. Not surprisingly, it is presently the leading country in the world in nuclear technology.

An additional restriction for the Euratom Treaty was the lack of jurisdiction with respect to the use of nuclear fuels and/or installations for military purposes. In this regard, the Treaty also did not confer powers over the construction or operation of the nuclear facilities of the Member States. It actually gave the EU institutions power only over a narrow sector of activity – mainly research and development in nuclear matters. Although the Treaty also tried to create a centralized monopoly agency, charged with the exclusive rights to import nuclear materials into the Community and exclusive rights of purchase from producers, this agency never came into existence. According to Cameron<sup>18</sup>, the driving force to create such a body was not the idea of a common market, but rather the idea that users could only receive a regular supply of ores and nuclear fuels through the establishment of a centralized monopoly supply agency.

In practice, the Euratom Treaty has had rather limited impact on developing a common energy policy and market. Recently, a number of opinions and proposals have been released, which envisaged the abolition of the Euratom Treaty and the consolidation of its specific provisions into the new Constitution for Europe<sup>19</sup>. Despite its limitations, the Euratom sparked the development of EC nuclear research centers and the start of works for European nuclear plants, such as Ispra in Italy, Petten in the Netherlands, Geel in Belgium or Cadarache in France. These research centers were later used for research into safety – for testing new components and fuels for the European civil nuclear power programs.

With more or less success, all three founding Treaties of the European Communities aimed at creating a common market, at least in theory, in which a free flow of goods, services, labor, and capital among the Member States would be established. However, the greatest input into the creation of a common market is the European Economic Community Treaty (EEC Treaty), subsequently renamed the European Community Treaty (EC Treaty). The EEC Treaty, which came together with the Euratom Treaty on 1 January 1958, was more of an instrument for economic

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<sup>18</sup> Cameron P. (2002) op. cit., p. 43.

<sup>19</sup> See for instance proposals submitted to the European Convention Secretariat, entitled *The Future of the Euratom Treaty in the framework of the European Constitution*, CONV 563/03. See also Protocol No. 2 annexed to the Treaty of Lisbon, amending the Treaty and establishing the European Atomic Energy Community.

integration<sup>20</sup> compared to the ECSC Treaty or Euratom Treaty, because it was more market-oriented. It was designed to create a market within Europe based on the free market principles, fair competition and an external commercial policy. The scope of the EEC Treaty was much wider than the two other treaties. Article 2 describes the aim of the Community:

*It shall be the aim of the Community, by establishing a Common Market and progressively approximating the economic policies of Member States to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increased stability, an accelerated raising of the standard of living and closer relations between its Member States.*

To carry out its tasks the EEC Treaty, according to Article 3 f) and h), is required to:

*For the purposes set out in the preceding Article, the activities of the Community shall include, under the conditions and with the timing provided for in this Treaty:*

- (f) the establishment of a system ensuring that competition shall not be distorted in the Common Market;*
- (h) the approximation of their respective municipal law to the extent necessary for the functioning of the Common Market;*

Although it contained specific provisions dealing with the establishment of a common market, and in a few areas it mentioned policies for agriculture and transport, the EEC Treaty remained silent with regard to a

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<sup>20</sup> *Economic integration can take several forms that represent varying degrees of integration. These are a free-trade area, customs union, common market, economic union and complete economic integration. In a free trade area, tariffs (and quantitative restrictions) between the participating countries are abolished, but each country retains its own tariffs against non-members. Establishing a customs union involves, besides the suppression of discrimination in the field of commodity movements within the union, the equalization of tariffs in trade with non-member countries. A higher form of economic integration is attained in a common market, where not only trade restrictions but also restrictions on factor movements are abolished. An economic union, as distinct from a common market, combines the suppression of restrictions on commodity and factor movements with some degree of harmonization of national economic policies, in order to remove discrimination that was due to disparities in these policies. Finally, total economic integration presupposes the unification of monetary, fiscal, social, and countercyclical policies and requires the setting-up of a supranational authority whose decisions are binding for the Member States. See Balassa B. (1962) *The Theory of Economic Integration*. Available at: <http://www.spartacus.schoolnet.co.uk/2WWeec.htm>*

common energy policy<sup>21</sup>. Nevertheless, some provisions of the EEC Treaty and later on the EC Treaty are highly relevant to energy activities. The rules falling under Articles 28–31 and 81–90 are of particular relevance.

According to Lucas<sup>22</sup>, the EEC Treaty did not include provisions for a common energy policy, since it was thought that the task had been largely covered with respect to coal, viewed as the principal object of a common energy policy in the present, and with respect to nuclear power, the principal concern for a common energy policy in the future. Unfortunately, the most important sources of energy in the EU today – oil, natural gas, and electricity – received little or no attention in the EEC Treaty. Green<sup>23</sup> characterized this neglect as *a failure of vision* on the part of the forefathers of the Community. Another commentator described the handling of the energy policy in the EC Treaty as *astonishing*<sup>24</sup>. Consequently, for many years the regulation of energy matters depended on powers conferred for other purposes, such as competition matters, the environment, or external relations. Thus, it is no exaggeration to say that for several years the application of the EC Treaty provisions relevant to the network-bound energy industry was almost non-existent. Consequently, national legislation became dominant in the energy sector, shifting Community legislation to a second plan. Another key factor behind this state of affairs was the fact of close cooperation between governments of the Member States on one hand, and public undertakings, such as energy monopolies, on the other<sup>25</sup>. One has to remember that the energy sector is economically and strategically very important for national policy makers. Not surprisingly, especially the electricity and gas industries have been subject to high degrees of government ownership and control. Because Member States have been very reluctant to give up control over the energy policy

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<sup>21</sup> See also *Rapport des Chefs de Délégations aux ministres des Affaires Étrangères* (Secretariat of the Intergovernmental Conference, Brussels, 21 April 1956 – the Spaak Report). The report identified energy and especially oil as an area for urgent attention but this was not taken any further. A widely held view at the time, which led to non-action in this area, was that the oil companies were well equipped to deal with issues in this sector.

<sup>22</sup> Lucas N. (1977) *Energy and the European Communities*, London, Europa for the David Davies Memorial Institute of International Studies, pp. 14–16. Although there have been attempts to enlarge Community competencies during crises in the oil supply in the 1970s and during the Gulf War, for more on this see *Security of Supply, the Internal Market and Energy Policy*, Working Paper of the Commission of the EC, 1990: SEC (90) 1248; and later in the definition of common energy objectives.

<sup>23</sup> Green N. (1983) *The implementation of Treaty Policies: the energy dilemma*, 8 ELR 186–189.

<sup>24</sup> Schwarze J. (1992) *European Energy Policy In Community Law*, in: Mestmäcker E.J. (ed.) *Natural Gas in the Internal Market. A Review of Energy Policy*. Graham & Trotman, London, pp. 153–182.

<sup>25</sup> Matlary J.H. (1997) *op. cit.*, pp. 79–103.

to European institutions, a majority of the Member States wish to retain maximum control over their national energy policies<sup>26</sup>. Furthermore, given the fact that coal, to which all the first 6 Members of the EEC had access, was the dominant energy source until the 1970s, and given the diversity of aims of the different national energy policies, the resistance to a centralized Community approach was to be expected.

Generally speaking, although the idea of establishing an integrated energy market could be derived from the Treaties, especially the ECC Treaty, the period between the 1960s and early 1970s lacked any effective common policy and binding legislation in this regard<sup>27</sup>. However, what should be clearly emphasized is the fact that the European energy policy was one of the most widely discussed subjects in the mid 1960s. Moreover, energy experts at that time were aware of Europe's increasing dependence on future gas and oil imports and the potential market power of the Middle East oil suppliers<sup>28</sup>. In 1964, Member States approved a set of basic principles for developing a Community energy policy in the future<sup>29</sup>. They emphasized the necessity for greater integration of Member State energy markets and free trade of energy products, leading to the creation of a secure internal energy market (IEM). Unfortunately, although this ambitious goal received enthusiastic support from the European Commission, it remained vague for many years<sup>30</sup>. In 1968, the Commission in its Communication to the Council<sup>31</sup> underlined the importance of the energy policy:

<sup>26</sup> For more on the issue of the close connection between energy policies and national interests as a limit to integration in the EU energy sector at that time see Daintith T., Williams S. (1987) *The legal Integration of Energy Markets; Integration through Law – Europe and American Federal Experience*, Walter de Gruyter, Berlin.

<sup>27</sup> For more on the Community policy from 1957 to the 1980s see Daintith T., Hancher L. (1986) *Energy Strategy in Europe: The legal Framework*, Berlin, Walter de Gruyter. For statements of early Community energy policy see also, European Commission, *Première orientation pour une politique énergétique communautaire* (1968); *Necessary Progress in Community Energy Policy*, COM (72) 1200 (Oct 1972); *Guidelines and Priority Actions under the Community Energy Policy*, SEC (73) 1481 (Apr 1973) – the above statements are also in the Bulletin of the European Communities: Supplements 12/68, 11/72 and 6/73.

<sup>28</sup> See e.g., Schumacher E. (1964) *The Struggle for a European Energy Policy*, *Journal of Common Market Studies*, Vol. 2, Vol. 3, pp. 199, 203, 205.

<sup>29</sup> These principles originally surfaced in an agreement signed by the Member States on 21 April 1964, a document called *The Initial Guidelines for a Community Energy Policy*. It was presented to the European Parliament in 1968. For more on this see Cardoso e Cunha A. (1991) *The Internal Energy Market*. *Journal of Energy and Natural Resources Law*, No. 290.

<sup>30</sup> In 1998, the basic principles served as the basis for the Commission's working document on the Internal Energy Market, discussed later on in the text. See also COM (88) 238 at p. 2.

<sup>31</sup> *First guidelines for a Community energy policy*, Communication from the Commission to the Council, 18 December 1968, p. 5 paragraph 4. Available at: [http://aei.pitt.edu/5134/01/001612\\_1.pdf](http://aei.pitt.edu/5134/01/001612_1.pdf)

*(...) there are still serious obstacles to trade within the Community as regards energy products. If this situation does not improve, and if a common energy market is not achieved in the near future, the level of integration already attained in this field will be endangered (...).*

Moreover, according to the Commission the Member States themselves are to be blamed for the lack of progress in creating a common energy market:

*(...) disparities between the costs of use of energy, resulting primarily from divergences between the energy policies of the individual Member States, are increasingly distorting competition in industries with high-energy consumption, and penalize certain regions of the Community when important investment decisions are to be taken. The attempts made to remedy this state of things by measures at national level are leading to a gradual disintegration of the Community's energy economy; uneconomic systems of aid, consumption taxes varying from country to country, and increasingly nationalist supply and marketing policies are the result. This dangerous trend can only be changed by a Community energy policy, which fully integrates the energy sector into the common market (...)<sup>32</sup>.*

Further, in paragraph 5 of the Communication, the Commission pointed out that a Community energy policy is also necessary in order to counterbalance the risks within the Community, which arise from the great dependence of the Member States on imports and from insufficient diversification of the sources of supply. In response to this threat, in 1968 the Community created a regime for compulsory oil stocks by issuing directive 68/414/EEC<sup>33</sup>. Unfortunately, this directive mentioned only crude oil (which in fact was perceived as vital to the European economy – gas playing a rather minor role) and remained silent as to the other fossil fuels, such as gas. Consequently, the gas market was left outside the scope of Community interest at the early stage.

The period between 1958 and 1972 was an era during which Member States were focused on the availability of low-cost oil supplies from

<sup>32</sup> Ibidem.

<sup>33</sup> Council Directive 68/414/EEC, OJ L 308 (1968), as amended by Council Directive 72/425/EEC of 19 December 1972 amending the Council Directive of 20 December 1968 imposing a requirement on ECC Member States to maintain minimum stocks of crude oil and/or petroleum products, OJ L 291/154 (1972) (raising the minimum national requirements for compulsory oil stockholdings from 65 days to 90 days of inland consumption. This 1972 Oil Stock Directive was repealed as of 31 December 1999, pursuant to Council Directive 98/93/EC of 14 December 1998 amending Directive 68/414/EEC and imposing an obligation on EEC Member States to maintain minimum stocks of crude oil and/or petroleum products, OJ L 358/2 (1998).

outside of Europe and on different strategies regarding nuclear research and development, rather than on close market integration of the domestic energy sectors<sup>34</sup>. The Community action at that time was very well described by Hassan and Duncan:

*Emphasis... had been placed upon the need to harmonize national policies, and to establish a competitive, integrated energy sector. Even with respect to these aims, however, all available evidence... suggests the period as a whole witnessed a retreat away from rather than progress towards the goal of market integration in the Community's energy policy*<sup>35</sup>.

Meanwhile, in the early 1970s the OPEC countries began to charge European oil companies in the Middle East higher prices, in order to levy new taxes, and to exert increased pressure and control on the part of the national governments<sup>36</sup>. In 1973, the OPEC states imposed embargoes on crude oil together with serious restrictions on oil production by foreign companies in the OPEC states. The prices of imports quadrupled almost immediately, setting off the first oil crisis. The oil shortages in 1973–1974 and again in 1978 caused the European economies, dependent on oil for up to 50% of their petroleum needs, to slow down and face the fact of their energy dependence. In consequence, European countries began, although only in a very limited way, to reconsider the urgent need for a common energy policy<sup>37</sup>. As a first step, in 1974 the OECD countries, apart from France, established the International Energy Agency (IEA) and adopted an International Energy Program, which included supply-sharing measures in cases where demand exceeded supply<sup>38</sup>.

<sup>34</sup> Roggenkamp M., Ronne A., Redgwell C., Del Guayo I. (2001) *Energy Law in Europe. National, EU and International Law and Institutions*, Oxford University Press, New York, p. 251.

<sup>35</sup> Hassan J., Duncan A. (1994) Integrating Energy: the Problems of Developing an Energy Policy in the European Communities. *Journal of European Economic History*, Vol. 23, p. 159, 166.

<sup>36</sup> For more on prices see Oil Price History and Analysis (2007) WTRG Economics, available at: [www.wtrg.com/prices.htm](http://www.wtrg.com/prices.htm)

<sup>37</sup> It is important to notice that just after the oil crisis, in general, Member States were interested in protecting national interests in this regard rather than creating a common policy.

<sup>38</sup> A quite negative influence on the cooperation between Member States was conflict between UK and France on the one hand, and the Netherlands on the other. France and UK benefitted from special treatment that they received from the OPEC countries, because of their so-called *positive attitude*, which blocked an emergency of the oil-sharing program in the framework of the OECD. Netherlands, responding to efforts to prevent diversion of supplies into the Netherlands, threatened to cut off gas supplies to France and UK. For more on this see Evans A.C. (1981) The International Energy Agency. *Journal of World Trade Law*, No. 440, as well as Marquis M. (2001) op. cit., p. 21.

Alternatively, the main concern of the Community actions was mainly the security of oil supplies and to some extent also of gas supplies. In 1974, the Community also launched a program on the rational use of energy<sup>39</sup>. In addition, the Council adopted resolutions that aimed to decrease the already high dependence on solid fuels, natural gas and nuclear energy, and at reducing dependence on imports to a maximum of 50% by 1985<sup>40</sup>. Furthermore, the oil crises resulted in a series of EC directives and recommendations, which were mainly focused on security of supply, on reducing energy demand by means of conservation and on use of alternative energy techniques, such as combined heat and power<sup>41</sup>. Three relevant Council directives obliged Member States to maintain minimum levels of fuel reserves as well as to limit the use of natural gas and petroleum products as fuel-sources for electricity generation. The first of the three mentioned directives, directive 75/339/EEC<sup>42</sup>, concerned the safety of oil supply to the Community. It required Community energy suppliers, such as electricity producers, to possess and maintain a minimum level of stocks of “fossil fuels” for at least 30 days of uninterrupted supply of electricity. Directive 75/405/EEC<sup>43</sup> dealt with the construction of new power stations. It predetermined that the construction of new power stations – those that would use fuel oils, either exclusively or to a significant degree – as well as the conversion of existing power stations to run on such fuels must be subject to approval by the competent Community authorities. The last of the directives, directive 75/404/EEC<sup>44</sup>, required that new contracts for the supply of natural gas to power stations, the extension or renewal of existing contracts and the construction of new

<sup>39</sup> See European Commission, *Rational Utilization of Energy*, OJ 1975 C 152/5.

<sup>40</sup> See Council resolution of 17 December 1974 , OJ 1975 C153/2; Council resolution of 13 February 1975 OJ C153/6, 1975 .

<sup>41</sup> Council recommendation 76/492/EEC of 4 May 1976 on the rational use of energy by prompting the thermal insulation of buildings, OJ L 140/11,1976; Council recommendation 76/493/EEC of 4 May 1976 on the rational use of energy in the heating systems of existing buildings, OJ L 140/12,1976; Council recommendation 77/712/EEC of 25 October 1977 on the regulating of space heating, the production of domestic hot water, and the metering of heat in new buildings, OJ L 295/1,1977; Council recommendation 77/713/EEC of 25 October 1977 on the rational use of energy in industrial undertakings, OJ L 295/3,1977; Council recommendation 77/714/EEC of 25 October 1977 on the creation in the Member States of advisory bodies or committees to promote combined heat and power production and the exploitation of residual heat, OJ L 295/5,1977; Council recommendation 80/823/EEC of 29 July 1980 on the rational use of energy in industrial enterprises.

<sup>42</sup> Council directive 75/339/EEC of 20 May 1975 obliging the Member States to maintain minimum stocks of fossil fuel at the thermal power stations, OJ L153/35, 1975.

<sup>43</sup> Directive 75/405/EEC, OJ L178/26, 1975.

<sup>44</sup> Directive 75/404/EEC, OJ L178/24, 1975. This directive was repealed by Council directive 91/148/EEC, OJ L 75/52, 1991.

power stations using natural gas all required prior authorization by the Member States that were responsible for the power plant concerned. Consequently, by the late 1970s the EC was able to implement its own emergency system.<sup>45</sup> In the case of fuel shortages, the Commission, based on directive 75/339/EEC, was responsible for imposing restrictions on consumption and for mandating how Member States would redistribute oil held in reserves. In addition to these crisis management powers, the Commission would take various steps to ease the trade obligations of the Member States when they experienced a shortage of supplies<sup>46</sup>.

Unfortunately, the oil crisis and the steps taken by the Community institutions through secondary legislation did not entirely succeed in creating a common energy policy. Member States were still not very eager to give up their influence over domestic energy sectors. They were interested in strengthening national industries rather than in transferring their authority to a centralized decision-making process at Community level. In reality, a common policy was possible only in areas where the Community had specific or exclusive powers. In a Communication to the Council in 1981, the Commission expressed its frustration due to the lack of progress that was being made:

*In the course of recent years, the European Council has repeatedly declared the need for the Community to face up to the energy challenge. This has led to two Council Resolutions – in 1974 and in 1980 – setting Community energy objectives whose main features are a reduction in oil dependence through the more rational use of energy and a broader diversification of energy supply. However, it has not led to the implementation of any overall strategy comprising action by the Community, Member States and producers and consumers. The inadequacy and inconsistency of the action taken in the wake of these expressions of political will can only be deplored.*

Furthermore, in paragraph 6 the Commission stated:

*Equivalence of effort does not require any substantial centralization of energy policy instruments, nor does it require the pursuit of uniformity in the diversification of energy supply, which must vary according to national circumstances. Nevertheless, it does call for collective discipline going beyond mere expressions of*

<sup>45</sup> See Council decision 706/77, OJ L292/9, 1977 and Commission decision 639/79, OJ L183/1, 1979.

<sup>46</sup> See Council decision 186/77, OJ L61/23 1977, as amended by the Council decision 879/79, OJ L270/58, 1979.



*common agreement. The policies of each Member State must reflect a willingness to pursue common goals*<sup>47</sup>.

However, a number of commentators of this period questioned whether the *flood of paper resolutions* produced any genuine economic results, and whether these resolutions are the appropriate response to the oil crisis and whether they are the proper instruments for a common energy policy and for the energy market integration<sup>48</sup>. In a defense of the legislation and the Community steps taken to foster a common energy policy, energy experts within the Commission argued that the lack of cooperation among Member States was the key problem:

*Even when the broad lines of community energy policy are approved... they are, for the most part, exhortatory rather than binding on the Member States... and are achieved not by Community fiat but by requesting the co-operation of the Member States*<sup>49</sup>.

In order to calm down the tense atmosphere between the Community and the Member States, the Commission identified and promulgated five energy related objectives<sup>50</sup>. Because each objective could potentially entail both Community and state action, each risked aggravating or even creating additional tensions between the Commission and Member States. The Commission tried to mitigate this risk. With respect to its first two objectives, its role would be to coordinate state actions rather than to initiate action; with respect to the three other objectives, the Community would undertake concrete interventions.

The first objective was to encourage the Member States to increase investments in the rational use of energy and to promote the use of alternatives to oil. The second objective was to accelerate the development of a common approach to energy pricing and taxation. In relation to the consequences of the oil crisis, the third objective was to ease the instability of the oil markets. The fourth involved common action in research and development in energy matters. Finally, the fifth objective called for a fully coordinated approach with respect to external energy relations and security of supply. The last objective was established most probably on account of the conflict between the UK and France on the one hand, and the Netherlands on the other, which arose during the first oil crisis (see

<sup>47</sup> Commission of the European Communities, *The Development of an Energy Strategy for the Community*, COM (81) 540 final p. 9 paragraph 1 also p. 10 paragraph 6. Available at: [http://aei.pitt.edu/1508/01/energy\\_30\\_May\\_COM\\_81\\_540.pdf](http://aei.pitt.edu/1508/01/energy_30_May_COM_81_540.pdf)

<sup>48</sup> Hassan J., Duncan A. (1994) *op. cit.*, p. 164.

<sup>49</sup> Brondel G., Mormon N. (1977) *The European Community – An Energy Perspective. Annual Review of Energy*, Vol. 2, pp. 343–344.

<sup>50</sup> Marquis M. (2001) *op. cit.*, p. 23.

footnote 44). The idea of the “five principles” was to diminish European dependence on Middle Eastern oil and to foster the energy market within the Community. A White Paper published in 1985<sup>51</sup> underscored the importance of these objectives. In 1986, a Council resolution identified various energy policy aims to be achieved by 1995. The main aim was security of supply and price stability; a secondary aim was the convergence of the energy policies of the Member States<sup>52</sup>. Nevertheless, in practice, the White Paper and the 1986 Council Resolution did not bring about the expected results concerning a common policy in the energy market.

## 1.2. The Single European Act of 1986 and the Commission’s Working Document of 1988 – an important step forward

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Until the late 1980s, the energy sector had proven to be especially resistant to the integration process. Energy was not an exceptional case; the progress towards the removal of barriers to trade in other sectors of the European industry was also slow. In their legislation and practices the Member States took a temperate approach to the four freedoms of the common market<sup>53</sup>. As a result, in order to make more visible and efficient progress in integration, both secondary legislation and modifications to the treaties to increase the power of the Community institutions in the decision-making process were seen as essential steps. The first was the treaty called the Single European Act (SEA)<sup>54</sup>.

The Single European Act entailed an important step forward in creating and integrating the internal market in general and the energy market in particular. The president of the Commission, Jacques Delors (1985–1995), was the main proponent of the SEA. President Delors sum-

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<sup>51</sup> European Commission (1985) *Completing the Internal Market: White Paper from the Commission to the European Council*, COM (85) 310 final. Available at: [http://europa.eu.int/comm/off/pdf/1985\\_0310\\_f\\_en.pdf](http://europa.eu.int/comm/off/pdf/1985_0310_f_en.pdf)

<sup>52</sup> Cameron P. (2002) op. cit., p. 47.

<sup>53</sup> Ibidem, p. 48.

<sup>54</sup> The Single European Act was signed by the 12 Member States in Luxembourg on 17 February 1986 and the Hague on 28 February, and entered into force on 1 July 1987. OJ L 169 June 1987. Also available at: [http://europa.eu.int/comm/economy\\_finance/emu\\_history/documents/treaties/singleeuropeanact.pdf](http://europa.eu.int/comm/economy_finance/emu_history/documents/treaties/singleeuropeanact.pdf) It was the first major modification of the foundational treaties of the European Communities, although the most important changes for the future liberalization of the electricity and gas sectors were introduced in the EEC Treaty.

marized the main objectives of the Single European Act in the following way:

*The Single Act means, in a few words, the commitment of implementing simultaneously the great market without frontiers, more economic and social cohesion, an European research and technology policy, the strengthening of the European Monetary System, the beginning of an European social area and significant actions in environment<sup>55</sup>.*

Commentators agree that the most significant changes brought about by the SEA were those introduced in the EEC Treaty, which enabled the internal market to be completed by removing the remaining barriers to trade in the European Community by December 1992. Other reforms took place at Community level and affected the energy sector in particular. These involved changes made in the law-making process in line with the EEC Treaty, including the introduction of qualified majority voting to the Council and a greater involvement of the European Parliament in the law-making process.

## The establishment of an internal market by the end of 1992

The main compromise promulgated by the SEA was the adoption of measures geared towards a progressive establishment of a common market by 31 December 1992. The SEA also defined the concept of the internal market as an area without obstacles for the free movement of goods, people, services and capital. In consequence, a new Article, Article 8a, was added to the EEC Treaty.

Article 13 of the Single European Act, subsection I (Internal Market), stated:

*The EEC Treaty shall be supplemented by the following provisions:*

### *Article 8a*

*The Community shall adopt measures with the aim of progressively establishing the internal market over a period expiring on 31 December 1992, in accordance with the provisions of this Article and of Articles 8b, 8c, 28, 57(20), 59, 709(1), 84, 100a, and 100b and without prejudice to the other provisions of this Treaty.*

*The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services*

<sup>55</sup> Jacques Delors' statement is available at: <http://www.historiasiglo20.org/europe/acta.htm>

*and capital is ensured in accordance with the provisions of this Treaty*<sup>56</sup>.

In order to supervise the process of creating an internal market, in Article 14 (article 8b of the amended EEC Treaty) the SEA obliged the Commission to report to the Council before 31 December 1988 and again before 31 December 1990 on the progress made in achieving an internal market in accordance with Article 8a.

Particular attention should be placed not on the requirement to establish a common market, since this prerequisite has been already mentioned in a number of documents and legislative acts of the Community prior to the SEA<sup>57</sup>, but on the novelty of establishing within the framework of the treaty a fixed date by which an internal (common) market was supposed to be created. This fixed date, together with the improvement in harmonization procedures and the development of laws required for the proper functioning of the common market, in particular the move towards an approximation of indirect taxation<sup>58</sup>, later on proved to be a very useful development for the energy sector.

## The new decision-making procedure in the Council of Ministers

The second change brought by the Single European Act modified the voting procedure within the Council of Ministers. Specifically, the SEA introduced a qualified majority voting system, instead of the requirement for unanimity, which was to be applied in matters relating to the internal market within the time limit fixed in Article 8a of the ECC Treaty.

Article 14 of the Single European Act stated:

*The ECC Treaty should be supplemented by the following provisions:*

*Article 8b*

*The Commission shall report to the Council before 31 December 1988 and again before 31 December 1990 on the progress made towards achieving the internal market within the time limit fixed in Article 8a.*

<sup>56</sup> The full text of the Single European Act is available at: [http://europa.eu.int/comm/economy\\_finance/emu\\_history/documents/treaties/singleeuropeanact.pdf](http://europa.eu.int/comm/economy_finance/emu_history/documents/treaties/singleeuropeanact.pdf)

<sup>57</sup> The White Paper from 1985 [Com (85) final 310], has already declared the creation of an internal market by 1992, however it did not have a binding force for Member States.

<sup>58</sup> White Paper, Com (85) final 310 p. 6 paragraph 4. Although energy as such was omitted in the White Paper.

*The Council, acting by a qualified majority on a proposal from the Commission, shall determine the guidelines and conditions necessary to ensure balanced progress in all sectors concerned*<sup>59</sup>.

As a result, Article 14 of the SEA (in conjunction with Article 13) supplemented Article 100a of the EEC Treaty:

*Article 100a*

*1. By way of derogation from Article 100 and save where otherwise provided in this Treaty, the following provisions shall apply for the achievement of the objectives set out in Article 8a. The Council shall, acting by a qualified majority on a proposal from the Commission in co-operation with the European Parliament and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market.*

Apart from the provisions set out in article 8a of the EEC Treaty, the existing system of voting based on unanimity remained in place with respect to many other decisions of the Council. For instance:

*Article 100a*

*2. Paragraph 1 shall not apply to fiscal provisions, to those relating to the free movement of persons nor to those relating to the rights and interests of employed persons.*

The new decision-making procedure in the Council of Ministers based on qualified majority voting with respect to the common market and its objectives set forth in Article 8a also indirectly influenced the energy market. The new procedure increased the power of the Commission, which from then on had to convince the qualified majority of the MS, and not all of them. Consequently, this facilitated their efforts to reach consensus in such a delicate matter as energy. In this regard, the accession of Spain and Portugal in 1986 changed the weighting votes. Before 1986, only one large Member State could be outvoted; after 1986, two Member States could be outvoted. This is important for the common energy market, since the diversity of energy policies and practices of the Member States has increased with the accession of the new Members<sup>60</sup>.

<sup>59</sup> The Single European Act available at: [http://europa.eu.int/comm/economy\\_finance/emu\\_history/documents/treaties/singleeuropeanact.pdf](http://europa.eu.int/comm/economy_finance/emu_history/documents/treaties/singleeuropeanact.pdf)

<sup>60</sup> The first enlargement involved the UK, Denmark, Ireland and it took place on 1 January 1973. Then Greece joined the EEC on January 1981, and Spain and Portugal on 1 January 1986.

In sum, if the changes had not been made, it would have been extremely difficult to achieve and sustain consensus among the Member States in energy matters as well as to reach an agreement on the status of the forthcoming Electricity and Gas Directives, in which the Commission played a crucial role.

## The new cooperation procedure in the European Parliament

The third and final important change brought about by the SEA (Article 7) was to increase the role of the European Parliament in the legislative process by virtue of a new procedure for cooperation. This article amended Article 149 of the EEC Treaty, which stated:

*2. Where in pursuance of this Treaty, the Council acts in co-operation with the European Parliament (...)*

The “new” cooperation procedure simplified the process by which the initiatives and legislative proposals of the European Commission initiatives were sent to the European Parliament as well as to the Council. On account of the fact that, based on the cooperation procedure, these two institutions were supposed to reach consensus, the procedure increased the importance of the European Parliament in the overall legislative process. Not only was the Commission required to consult and cooperate with the Parliament regarding a wide range of issues, but it also had an interest in acquiring the support of the Parliament for its proposals in dialogue with the Member States. In this regard, the Maastricht Treaty from 1992 further enhanced the role of the European Parliament in the legislative process with respect to internal market legislation. At the second stage of reading, the Parliament and the Council are required (based on the changes made by the Maastricht Treaty) to proceed by way of “co-decision”. To this end, the Council and Parliament must reach a common position within three months. This “co-decision” procedure, in which there has to be a direct dialogue between the two institutions to secure consensus, abolished the SEA regime, under which only those Parliamentary amendments supported by the Commission could be adopted by a majority in the Council. The key point is that legislation introduced under the co-decision procedure cannot be adopted against the will of the Parliament, which retains the right of veto.

In general, the enhanced role of the Parliament, together with the new decision-making procedure in the Council of Ministers, was an important step forward in securing additional legitimacy for the

proposals that would complete the establishment of an internal market in energy. Moreover, the increased role of the Parliament in the legislative process also strengthens the position of the Commission in shaping the scope of the electricity and gas markets, since in almost all cases the Parliament turned out to be the strongest supporter of the Commission proposals (e.g. ownership unbundling). In fact, the changes brought by the SEA greatly increased the possibility of adopting secondary (energy) legislation. Amendments to the decision-making procedures were later underlined in Article 251 of the EC Treaty, which set up procedures under which secondary, sector-specific legislation, such as the first and second set of gas and electricity directives, could be adopted and transposed into national law. The adoption of the gas and electricity directives, in turn, strengthened the Commission's ability to fight against the centralized and highly protected domestic electricity and gas markets.

The Single European Act was a turning point in the creation of the internal energy market as part of the common energy policy. It proved to be an incentive for the Commission to initiate a study on the EU energy sector in the context of the completion of a single market by 1992. The outcome of this study was the Working Document published in May 1988<sup>61</sup>. The European Commission highlighted the creation of the internal energy market as one of the specific goals in the establishment of the larger common market.

The 1988 Commission Working Document encompassed the Commission's commitment to a more competition-oriented approach to energy market integration as well as to a progressive removal of the existing obstacles to the internal energy market. It favored a double approach to the elimination of obstacles: the application of the general principles of the Community law, on the one hand, and on the other hand, the submission of the specific initiatives in the form of directives.

The Working Document had other significant provisions. Prior to this time, there was actually no clear Community policy regarding the electricity and gas sectors. Every state was seeking to acquire as much control over the energy sectors as possible. Electricity and gas featured only indirectly in the Community's various policy documents – for example, directive 66/162/EEC, directive 75/339/EEC, directive 75/404/EEC, directive 75/405/EEC, Commission regulation 3025/77/EEC. The secondary legislation of that period dealt mainly with the security of supply

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<sup>61</sup> The Internal Energy Market (Commission Working Document) COM (88) 238 final, 2 May 1988. Also available at: [http://aei.pitt.edu/4037/01/000179\\_1.pdf](http://aei.pitt.edu/4037/01/000179_1.pdf)

and related matters. Meanwhile, the Working Document contained several annexes, which examined the degree of market integration in each energy sector, listed the potential barriers to the creation of a more open market and outlined the Commission's priorities. Annex III of the Working Document dealt with natural gas and Annex IV with electricity. Throughout the Working Document, for the first time the electricity and gas sectors are treated as part of the Community energy policy.

The creation of an internal market for electricity and gas was a complex matter, both legally and politically. It was also complex economically, since many economic issues, such as the costs of constructing new grids, strongly influenced decisions at that time. In general, due to historically differing degrees of horizontal and vertical integration, natural resources endowments, the electricity and gas sectors differed among the Member States.

Two main features clearly emerged from the Working Document: firstly, the elimination of the obstacles to the creation of a single market in energy; secondly, the opening of the national electricity and gas markets in support of the general objectives of the Community energy policy. These two developments did not involve modifying the objectives of the Community energy policy that were previously set in various documents (both soft and hard law), but they produced a coherent energy policy at Community level.

With regard to the free movement of gas in Europe, the main obstacles were:

- Problems with interconnecting the gas grids in Europe. Spain, Portugal, Greece, the UK and Ireland were not connected to the "European grids" at that time.
- Unclear pricing and lack of price and tariffs transparency.
- Instability of natural gas prices among importers. The idea of a European purchase price was seen as a positive sign of progress being made towards a genuine common market in gas.
- Long-term contracts (20–25 years) between gas transmission undertakings and gas producers.
- Lack of tax harmonization.
- And most importantly, government controls on natural gas imports and exports as well as corporate monopolies and market dominance. Dominant or monopoly transmission entities in each Member State were responsible for the segmentation of the Community market. Since no specific legislation existed (apart from the EEC Treaty regulations in Articles 30 and 37, now 28 and 29), those monopolies were successfully able to control import and export of gas.



With regard to the electricity market the main obstacles were:

- Differences in fiscal and financial treatment of utility companies.
- Unclear pricing, lack of electricity transfer prices<sup>62</sup> and insufficient transparency with respect to tariffs.
- Differences in access to capital markets and state aids among Member States.
- Differential standards and administrative constraints, including, for example, different procedures among Member States for authorizing the installation of new production capacity or for establishing uniform technical requirements for electricity.
- Existence of monopolies and exclusive rights<sup>63</sup>.
- Lack of liberal access to fuel supplies for electricity producers.

In order to bring greater integration in the gas and electricity sectors, Community institutions, mostly through the Commission, were obliged to propose adequate measures. The Commission already had the power to do so, as specified in the chapters of the EEC Treaty on the removal of quantitative restrictions on trade between Member States and on competition. However, it was the secondary, sector-specific legislation (mainly directives and regulations), which was about to bring more effective results of market integration. Here, the telecommunication sector served as a source of inspiration for efforts to liberalize the energy field. The drive to remove obstacles in the creation of an internal telecommunications market by 1992 had yielded some highly significant legal precedents applicable to the energy sector. In 1991, the Court of Justice issued a series of judgments applying the EC competition rules to the public service monopolies in telecommunication<sup>64</sup>. Those judgments resolved the legal debates on monopolies and the opening of the markets to competition. They were later applied to the gas and electricity sectors. The Commission's determination to apply measures to increase the liberalization of the electricity and gas

<sup>62</sup> Prices at which electricity is transferred between systems (or across frontiers).

<sup>63</sup> The Commission noted that the majority of Member States had conferred exclusive import and export rights to entities in the gas and electricity sectors. At that time paragraph 60 of the 1988 Working Document stated: *The Commission should examine in what manner these measures are compatible with the provisions of Article 31 (then – Art. 37) and the actions it may be suitable to take in this respect.* Articles 28 and 31 were also considered relevant to exclusive transmission and distribution rights.

<sup>64</sup> Case C-202/88 *France v Commission* (also referred to as “Telecoms”) [1991] ECR I-1223; Case C-260/89 *ERT v Dimotiki* [1991] ECR I-2925; Joined Cases C-48/90 and C-66/90 *Netherlands and others v. Commission* [1992] ECR I-565.

sector was made clear in a speech given by Leon Brittan in London in April 1991<sup>65</sup>:

*(...) there has to be open competition in electricity and gas within two fundamental constraints: the need to provide security of supply and the related public service obligation of universal, uninterrupted provisions (...)*

Brittan also touched on the delicate issues of the security of supply and public service obligation; the latter proved to be one of the most contentious issues to overcome.

In early 1992, the Commission proposed a set of common rules for the completion of the internal market for gas and electricity<sup>66</sup>. To this end the Commission issued an Explanatory Memorandum that outlined a three-stage plan for the opening of the gas and electricity sectors.

*(...) The internal market for electricity and natural gas should take shape over a period of time sufficiently long to enable the industry to adjust in a flexible and ordered manner to its new environment. This implies a step-by-step approach, with the Commission laying down a minimum level of liberalization to be achieved at each stage while at the same time allowing each Member State discretion to opt for greater liberalization of the domestic market (...)*<sup>67</sup>.

The first stage involved adopting three directives, which focused on establishing transparent pricing for industrial end users in the gas and electricity markets and on determining the parameters for high-pressure and high-voltage transit in the gas and electricity sector. The price transparency directive<sup>68</sup> required Member States to ensure that companies supplying gas or electricity to industrial end users provide all the relevant information to the Statistical Office of the European Communities (SOEC) on a regular basis in order to increase consumers' freedom of choice without creating obstacles to confidentiality. The second set of

<sup>65</sup> *Competition in the European Community's Electricity and Gas Markets*, The Institution of Civil Engineers, London. For more on this see also Hancher L. (1992) *EC Electricity Law*, Chancery Law Publishing, London, pp. 7–17.

<sup>66</sup> See the proposal for a Council directive concerning common rules for the internal market in electricity OJ C65/04 (1992); as well as its counterpart proposal for the gas sector OJ C65/13, 1992.

<sup>67</sup> COM (91) 548 final, 21 February 1992, p. 7.

<sup>68</sup> Council directive 90/377 of 29 June 1990 concerning a Community procedure to improve the transparency of the gas and electricity prices charged to industrial end users (OJ L185/1, 1990) as amended by directive 93/87, OJ L277/32, 1993.

directives, the transit directives<sup>69</sup>, created opportunities for gas and electricity companies to trade more effectively across the Community. These directives obliged those responsible for transition networks to put them at the disposal of other companies that wanted to transport electricity and gas from one country to another across at least one Community border. The aim of the directives was to challenge the exclusive rights still existing in a number of countries – for example those rights that protected the monopoly of the operators of transition networks. However, the challenge was limited by the restriction of the right of access to other electricity and gas operators. Distribution networks were initially excluded from the authority of the directives, which initially limited the scope of the directives.

The second stage involved the introduction of internal energy market directives – respectively 96/92/EC of 19 December 1996 for electricity and 98/30/EC of 22 June 1998 for gas. The main principle was the access of operators, without discrimination among the different activities (production, transmission and distribution) of the sector. This meant the abolition of exclusive rights and the introduction of third party access to the system. As to stage three, very little detail was given. However, the main idea of this stage was both to assess the progress made during stages one and two, and to further open the market.

### 1.3. The amendments of the EEC Treaty by the Treaty on the European Union (Maastricht Treaty)

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Further changes to the treaties in general and to the EEC Treaty, with regard to the common market, were introduced in particular by the Treaty on the European Union (TUE). This Treaty was signed in Maastricht on 7 February 1992 and entered into force on 1 November 1993. The EEC Treaty (as amended) became the EC Treaty.

Regrettably, although certain provisions in the Maastricht Treaty stated that the activities of the Community shall include “measures in the sphere of energy”<sup>70</sup>, there were no provisions explicitly devoted to

<sup>69</sup> Council directive 90/547/EEC of 29 October 1990 for electricity (OJ L313/33,1990) and 91/296/EEC of 31 May 1991 for gas.

<sup>70</sup> Article 3(t) of the Maastricht Treaty.

energy. Nevertheless, various changes made by the Maastricht Treaty deserve attention in the broader context of the internal energy market.

The first of these changes included the contentious concept of *subsidiarity*<sup>71</sup>, which was introduced as a principle of general application that was not limited to environmental matters, as it was in the Single European Act<sup>72</sup>. Article 3B (now Article 5) stated:

*(...) In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.*

The obvious question is: what implication does the principle of subsidiarity have for the energy sector? In fact, the principle has facilitated the ability to take legislative steps in the field of gas and electricity with respect to the distribution of powers between the Community and Member States, by means of framework directives as the main instrument for change. The explanatory memorandum to the proposals for directives on common market rules for electricity and gas interpreted the principle of subsidiarity in the following way:

*The Community must not impose rigid mechanisms, but should rather define a framework enabling Member States to opt for the system best suited to their natural resources, the state of their industry and their energy policies*<sup>73</sup>.

<sup>71</sup> The *Oxford English Dictionary* defines subsidiarity as the idea that a central authority (in this case at European level) should have a subsidiary function, performing only those tasks that cannot be performed effectively at a more immediate or local level (in this case national). It is case-by case evaluation. In areas where the Community does not have exclusive competence, the principle must be applied to decide whether in a given case it is appropriate for the Community institutions to take action. The Commission is obliged to provide a justification for a proposed legislative measure in terms of subsidiarity in the explanatory memorandum. However, its exact scope is somehow unclear and there is a great need for ECJ in each case to provide a detailed explanation of its meaning. For more on this see: *Inter institutional Agreement on Procedures for Implementing the Principle of Subsidiarity, concluded between the European Parliament, Council, and Commission*, 25 October 1993, OJ 1993 C329/135; Toth A. (1994) *A Legal Analysis of Subsidiarity*, in: O’Keeffe D., Twomey P. (eds.) *Legal Issues of the Maastricht Treaty*, Chancery Law Publishing, London–New York.

<sup>72</sup> Article 130r(4) provided that the “Community shall take action relating to the environment to the extent to which the objectives... can be attained better at Community level than at the level of the individual Member states”. Full text of this article is available at: [http://europa.eu.int/comm/economy\\_finance/emu\\_history/documents/treaties/singleeuropeanact.pdf](http://europa.eu.int/comm/economy_finance/emu_history/documents/treaties/singleeuropeanact.pdf)

<sup>73</sup> Amended Proposals for a European Parliament and Council directive on common rules for the internal market in electricity, COM (1993) 643 final, OJ C 123/1.

However, some Commission officials argued that the principle of subsidiarity also gave a wide scope to the national authorities in implementing the provisions of the Directives into national law. In addition, the principle made the relationship between the Community institutions and Member States more complex and extended the time needed for transposition of the directives. Therefore, in practice the principle of subsidiarity has contributed to the development of a common market but at the same time also constrained the Commission in its attempts to promote a single market in energy, mainly in electricity and gas.

Another area of particular interest to energy was the new Title XII on “Trans-European Networks” added to the EC Treaty by the Maastricht Treaty. In general, the principal objective of the TEN program was and still is to integrate and improve the interoperability of separated infrastructure systems to a single market process in order to enable EU citizens, economic players, and entire communities to receive the full benefits of a single market in energy.

The provisions of the new Title XII in Article 129b (now Article 154)<sup>74</sup> provided that the following:

- 1) (...) *to enable citizens of the Union, economic operators and regional and local communities to derive the full benefit from the setting up of an area without internal frontiers, the Community shall contribute to the establishment and development of Trans-European Networks in the areas of transport, telecommunications and energy infrastructures.*
- 2) *Within the framework of a system of open and competitive markets, action by the Community shall aim at promoting the interconnection and inter-operability of national networks as well as access to such networks (...)*

Moreover, in accordance with Article 129c, which provided established guidelines for the objectives in the sphere of Trans-European Networks (TEN) and measures necessary to ensure the inter-operability of those networks, the Commission issued a proposal for a Council Regulation. To facilitate the establishment of Trans-European Networks in the areas mentioned by the Maastricht Treaty, this regulation would introduce a Declaration of European Interest<sup>75</sup>. Such a Declaration of European Interest acted as *an instrument for implementing guidelines established by the Council*; it gave the Community *a powerful instrument*

<sup>74</sup> Maastricht Treaty signed on 7 February 1992. Also available at: <http://europa.eu.int/en/record/mt/title2.html>

<sup>75</sup> COM (92) 15 final, 24 February 1992.

*to plan, coordinate, and implement major investment decisions*<sup>76</sup>. In reality, the new approach to Trans-European Networks underlined the Commission's more active involvement in the utilities sectors. In its report on Electricity and Natural Gas Transmission Infrastructures in the Community in paragraph 3 the Commission stated<sup>77</sup>:

*Attempts at closer integration of the natural gas and electricity transmission infrastructures are essential means of completing the internal energy market while increasing flexibility and security of energy supplies.*

The Commission also once more stressed the importance of removing obstacles to the creation of the internal market:

*(...) Recent proposal from the Commission stressed the importance of changing the legal framework in the energy sector – in particular through elimination of special exclusive rights, the enhancement of competition and the introduction of new market rules. The proposals will only be effective in promoting intra-Community trade in gas and electricity if transmission infrastructure are strengthened and integrated at Community level.*

In addition, in order to correct the legacy of networks that reflected segmented national markets, under the TEN initiative electricity and gas transmissions interconnections have been prioritized and entitled to funding through a variety of Community financing mechanisms<sup>78</sup>. Funding was provided in part by the structural funds as well as by the European Regional Development Fund and European Investment Bank

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<sup>76</sup> Mestmäcker E. (1993) Energy Policy for Natural Gas in the Internal Market – An Overview, in: Mestmäcker E. (ed.) *Natural Gas in the Internal Market: A Review of Energy Policy*, London, Graham & Trotman, p. 5. See also Smeers Y. (1993) Aims and Means of European Energy Policy in the Light of the Completion of the Internal Market, in: Mestmäcker E. (ed.) op. cit., p. 39.

<sup>77</sup> Electricity and Natural Gas Transmission Infrastructures in the Community SEC (92) 533 final SEC (92) 533 final, also available at: [http://aei.pitt.edu/4818/01/000973\\_1.pdf](http://aei.pitt.edu/4818/01/000973_1.pdf)

<sup>78</sup> In the report, Electricity and Natural Gas Transmission Infrastructures in the Community SEC (92) 533 final, the European Commission observed in paragraph 2 that: *The present configuration of the electrical and gas systems is essentially the result of the policies aimed at achieving maximum self-sufficiency in energy followed at the national level. These policies are already accompanied by a certain amount of international cooperation justified on the basis of market supply needs. The transportation networks for electricity and natural gas have nevertheless been designed and developed with a view to the national dimension, a situation which is not compatible with the achievement of the internal market... there is need for greater cohesion within the Community and the increased energy cooperation envisaged with the EFTA countries, central and Eastern Europe and the Mediterranean basin.*

(EIB), which has been active in financing the energy sector for over 40 years. Furthermore, in 1995 the Community issued Council regulation 2236/95/EC<sup>79</sup>, which established the conditions and procedures for granting Community aid to projects of common interest in the field of TEN for transport telecommunications and energy. Community aid was to be granted on a priority basis to projects according to their contribution to the objectives set forth in Article 129b of the Maastricht Treaty and to the other objectives and priorities defined in guidelines referred to in Article 129c (1) of the Treaty. In 1996, in order to create a more encouraging context for the development of Trans-European Networks in the energy sector, and to speed up the realization of projects of common interest already identified in Council regulation 2236/95, the Community issued Council decision 391/96/EC<sup>80</sup> and Council decision 1254/96/EC<sup>81</sup>. The first decision acknowledged actions to be taken for the realization of projects of common interest in connection with Trans-European Energy Networks and for the interoperability of such networks on a Community-wide scale. It proposed a number of measures to be taken, such as:

- the realization of technical cooperation between undertakings in charge of the TEN in energy;
- cooperation between Member States, especially concerning interconnections;
- provisions of financial support as part of the action on TEN in energy.

The second above-mentioned decision set forth a number of priorities related to the TEN – security of supply, the connection of separated systems into an interconnected European system, the improvement of interconnections between the Member States, and the development of interconnections between present and future Member States.

The Maastricht Treaty was the last major revision of the founding Treaties before the Treaty of Lisbon, which looked at the energy policy of the Community. The Treaty of Amsterdam (TA), which amended the Treaty on the European Union, and the Treaties establishing the

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<sup>79</sup> Council regulation 2236/95 of 18 September 1995 laying down general rules for the granting of Community financial aid in the field of trans-European networks, OJ L228, 1995 as amended by the regulation 1655/99 and regulation 807/2004, OJ L143, 2004.

<sup>80</sup> Council decision 391/96 of 28 March 1996 laying down a series of measures aimed at creating a more favorable context for the development of trans-European networks in the energy sector.

<sup>81</sup> Council decision 1254/96 OJ L161/147, 1996, as amended by Council decision 1047/97 OJ L152/12, 1997.

European Communities did not have any essential input into the energy sector. The only relevant issue for the energy field, previously emphasized by the Maastricht Treaty (see section on Maastricht Treaty for more on this), was the Protocol for applying the principle of subsidiarity. This principle affects the allocation of powers between the Community and the Member States in the energy field. The principle of subsidiarity was particularly evident in formulating provisions of the directives that set out common rules for the electricity and gas sector, but left the manner of implementation to the Member States.

The Treaty of Nice (TN) was mainly concerned with issues left over from the previous Inter-Governmental Conference in Amsterdam, especially those issues concerning the impact of EU enlargement, and as such, it had marginal impact on energy matters. However, the TN sustained the system of qualified majority voting, which is a more effective system of decision-making than the system based on unanimity. QMV, which was applied to the internal market measures, encouraged the Commission actively to perform its role as policy initiator in the internal energy market, especially insofar as the power of the Council of Ministers had been weakened by QMV<sup>82</sup>. This was particularly visible in the process of preparing and adopting the second set of electricity and gas directives.

## 1.4. Conclusions – towards energy solidarity in the Lisbon Treaty

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The need to establish a common energy policy and integrated energy market can clearly be derived from the treaties. However, the political will to translate this idea into practice at a Community level was slow to develop. Previous decades up to the mid 1980s show significant domination of the energy sector by the public monopolies that are heavily dependent on national government command and control, thus very resistant to change. Cross-border energy trade was limited to wholesale transactions among incumbent utilities; cross-subsidies between different parties constituting State aids were tolerated. In the case of the transmission and distribution of gas and electricity, all the Member States granted

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<sup>82</sup> For more explanation on this see Section 2.2 The Single European Act and the Commission's Working Document of 1988 – c) *new decision-making procedure in the Council of Ministers*.



undertakings *de jure* or *de facto* exclusive or special rights to sell, to import, to export or to construct infrastructure. Such grants prevented competition among utilities. In consequence, consumers had little or no choice of price or quality of the service of energy<sup>83</sup>. Furthermore, access to networks by third parties was in most Member States not given any special legal protection.

Therefore, it should not be a surprise to learn that the steps that the Commission had taken to facilitate the development of the internal energy market as a large part of the common energy strategy prior to the mid 1980s did not result in much progress. The position of monopolies was too strong to overcome, especially since the Commission had weak institutional measures and procedures at hand and since the Member States evinced a lack of interest. It is no exaggeration to say that for several years the EC Treaty provisions relevant to the network-bound energy industry were ignored. For that reason, national legislation took precedence over Community legislation in the energy sector. Of course, the Commission took some steps to deal with the common energy policy shortcomings at that time, but these steps did not have significant impact on the industry.

Some scholars<sup>84</sup> believe that the lack of a special chapter on energy in the EC Treaty (although there were proposals for including energy policy in the Single European Act or in the Treaty on the European Union) hindered market opening. The introduction of a new energy chapter has had very little support among the Member States; a fact that underlines their strong desire to maintain control over energy. However, within the Commission itself there were different opinions concerning the need for a special chapter on energy in the Treaty. Advocates of the energy chapter have argued that it would give additional powers to the Community to enact required measures within the internal energy market. This view was especially visible at the turn of the 1990s. This was a reaction against the opposition that was for its part directed against the Commission's proposal, in the form of the internal market directives<sup>85</sup>, published at the turn of the 1990s, which the Member States rejected. At the same time, competition law experts argued that the basic principles of the

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<sup>83</sup> Roggenkamp M., Boisseleau F. (2005) *The Regulation of Power Exchanges in Europe*, Intersentia, Antwerp–Oxford, pp. 3–6.

<sup>84</sup> See Swann D. (1988) *The Economics of the Common Market. Integration in the European Union*, London, p. 224.

<sup>85</sup> Proposal for a Council directive concerning common rules for the internal market in electricity (OJ C 65/04) and gas (OJ C 65/13) and the related explanatory memorandum COM (91)548 final.

Treaty are clear enough and that no special energy chapter is needed<sup>86</sup>. Interestingly enough, the European Parliament was a strong supporter and enthusiast of the energy chapter. In various resolutions<sup>87</sup>, the EP insisted on the integration of the ECSC and all other relevant competencies of the EC Treaty into a single energy chapter called “Environment and Security of Supply”.

The Commission’s facilitation of greater integration in the gas and electricity sectors, which it first announced in the late 1980s, has led to significant legal developments in the mid 1990s, both in terms of case law and sector-specific legislation. Prior to the 1980s, by virtue of the EEC Treaty the Commission had implicit power to promote competition and remove quantitative restrictions on trade between the Member States. However, it was the passage of the ECJ case law and secondary, sector-specific legislation (mainly directives and regulations) that brought about the integration of the energy market.

The enhancement to the integration of the internal energy market was first achieved by the Single European Act. Although the SEA amended all three founding treaties of the Community, the most important changes were made to the EEC Treaty. The reforms that took place at Community level and that affected the energy sector in particular involved changes to the law-making process under the EEC Treaty. These changes mandated the introduction of qualified majority voting to the Council and a greater involvement of the European Parliament in the law-making process, initially by cooperation and later by a procedure of co-decision<sup>88</sup>. In all internal market legislation, including internal energy market legislation, the European Parliament acquired greater authority by virtue of co-deciding with the Council in adopting legislation<sup>89</sup>. Additionally, the increased role of the European Parliament in the overall legislative process was beneficial for the Commission. Not only was the Commission required to consult and cooperate with the Parliament on a wide range of issues, but it also had an interest in legitimizing its actions by gaining the support of the Parliament for its proposals in dia-

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<sup>86</sup> See for instance Ehlermann C. (1994) Role of the European Commission as Regards National Energy Policies. *Journal of Energy and Natural Resources Law*, Vol. 12, No. 3, pp. 342, 346–347 (“it is... totally wrong to justify the status quo by the lack of a special chapter on energy in the EC Treaty. Such chapter is neither necessary nor, in my view, desirable”).

<sup>87</sup> Resolution of 17 May 1995; 14 December 1995; 13 March 1996; and 19 June 1996.

<sup>88</sup> Matlary J.H. (1997) op. cit., pp. 19–24.

<sup>89</sup> The key point is that legislation introduced under the co-decision procedure cannot be adopted against the will of the Parliament. In the last resort, the Parliament can veto the proposal. Therefore, this has strengthened the role of the Parliament in the legislative process.

logue with the Member States. Changes made to the decision-making procedures, changes which were later underlined in Article 251<sup>90</sup> of the EC Treaty, greatly enhanced the possibility that secondary legislation, such as a first and second set of gas and electricity directives, could be adopted and implemented into national law.

The Single European Act proved to be a turning point in the creation of an internal energy market. It was an incentive for the Commission acting in conjunction with the European Parliament to initiate new legislative proposals, programs, policy documents and other regulatory instruments, which were and still are designed to develop a legal and policy framework for completing the single energy market. The main policy document was the Commission's Working Document of 1988 (Com (88) 238 final). It highlighted the Commission's commitment to a more competitive approach to energy market integration as well as to the progressive removal of existing obstacles to the gas and electricity sectors. This document approached the elimination of obstacles in two ways. On the one hand, it envisaged applying the general principles of Community law (mainly the provisions of the EC Treaty rules on competition); on the other hand, it looked to the submission of specific initiatives in the form of directives. These efforts and legislative actions to open up the electricity and gas markets were extended over a long period of time. They began with texts of a limited scope before tackling the main problem of the special rights that companies entrusted with producing, transporting and distributing electricity and gas commonly enjoyed.

The first step was to impose "price transparency" for the benefit of large consumers. The Council directive 90/377/EEC of 29 June 1990 obliged electricity and gas suppliers to communicate to the Commission the prices they charged to industrial end users. However, this directive had a limited effect on the electricity and gas markets within the EU. A more ambitious step was provided by the "transit" directives of 1990 (90/547/EEC of 29 October 1990 for electricity and 91/296/EEC of 31 May 1991 for gas). These obliged those companies responsible for the transmission networks to put them at the disposal of other companies that want to transport electricity and/or gas from one country to

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<sup>90</sup> This procedure involves the three institutions with legislative powers – the Commission, the European Parliament and the Council – as well as advisory bodies, such as the Economic and Social Committee. An alternative procedure suitable for the energy sector is also available under Article 86(3), which allows the Commission to issue Directives and Decisions on its own. This was used for instance to introduce the liberalization to the telecommunication sector. In 1991, the Commission threatened to use its powers under Article 86(3) by issuing two Directives on removal of exclusive rights to produce, import, transmit and distribute electricity and gas, however these drafts were withdrawn due to political pressure.

another within the Community (under the circumstance that at least one Community border be crossed). Thus, they challenged the exclusive rights still existing in a number of countries – rights given to monopoly operators of transportation networks.

The actual opening of the electricity and gas markets, which was bumpy, started with the first wave of internal energy market directives – directive 96/92/EC of 19 December 1996 for electricity and directive 98/30/EC of 22 June 1998 for gas. The compromises incorporated into these directives reflected the level of disagreement among Member States expressed during many years of negotiation<sup>91</sup>. The core task was to unbundle the vertically integrated undertakings and to provide access for traders, without discrimination, to the different facets of the sector – generation, transmission, distribution and supply. This meant the abolition of exclusive rights and the introduction of third-party access to the system for eligible end users. Unfortunately, these “eligible” consumers were defined by the Member States themselves, who thereby could get away with some favoritism.

In the meantime, the Treaty on the European Union (Maastricht Treaty) further amended the EEC Treaty on energy issues. However, particular attention needs to be paid to Article 154 of the EC Treaty on Trans-European Networks. This article formed the legal basis for various proposals relating to the Trans-European Networks, especially in gas and electricity markets. Under the TEN, electricity and gas transmission interconnections were prioritized and entitled to funding under various financing mechanisms<sup>92</sup>, including the European Investment Bank (EIB). Subsequent to the Treaty on the European Union, the Commission produced a proposal for the energy chapter, which would either consolidate the energy provisions of the three Treaties or it would introduce a new chapter following the completion of the single market; putting environmental protections into place and securing supply<sup>93</sup> – all per the newly established Article 3t of the Maastricht Treaty. However, no action on

<sup>91</sup> Glachant J.-M. (2003) The making of competitive electricity markets in Europe: no single way and no “single market”, in: Glachant J.-M., Finon D. (eds.) *Competition in European Electricity Markets. A Cross-country Comparison*, Edward Elgar Publishing, pp. 7–11.

<sup>92</sup> For more on this see European Commission (1997) Trans-European energy networks: policy and actions of the European Community; decision 1254/96 of the European Parliament and the Court of Justice of 5 June 1996 laying down a series of guidelines for the Trans-European Networks (OJ 1996 L161/147 as amended by decision 1047/97 (OJ 1997 L 152/12; Regulation 1655/1999 of the European Parliament and the Council of 19 July 1999 amending Regulation 2236/95 laying down general rules for granting of Community financial aid in the field of TEN (OJ 1999 L197/1).

<sup>93</sup> See the Report from the Commission to the Council, SEC(96) 496 final of 3 April 1996. Available also at: [http://aei.pitt.edu/3938/01/000135\\_1.pdf](http://aei.pitt.edu/3938/01/000135_1.pdf)

this was taken. Instead, the Commission adopted an approach based on greater coordination of existing EU competencies<sup>94</sup>. Only recently, with the advent of the Constitutional Treaty<sup>95</sup> and the Treaty of Lisbon (Reform Treaty), has the idea of a separate chapter on energy as part of the fundamental Treaty regained attention and consideration. However, according to Hancher the inclusion of a separate energy chapter in the Treaty of Lisbon will not resolve all the legal problems surrounding the Commission's competence to deal with national energy matters<sup>96</sup>; it would, however, certainly strengthen the Commission's role as an initiator of changes in the national energy markets and would serve as a base for the common EU energy policy.

In this regard, the relevant energy chapter in the Treaty of Lisbon requires explanation. Energy, one of the shared competencies (Article 2C – *Title I Categories and Areas of Union Competences*)<sup>97</sup> of the Union (this is a major change proposed by the Reform Treaty), is addressed in Part I, which deals with the objectives, values, institutions, competences, and finances of the European Union. Additionally, the key provisions affecting the energy sector – especially with regard to the four freedoms, to competition rules and to State aid – are gathered in Part III, which outlines the policies and functioning of the Union. Energy is discussed in Title XXI Energy, Article 194. The inclusion of energy in the Treaty of Lisbon as an area of shared competencies should be perceived as an attempt to establish a “special cooperation modus operandi” between the Community and national governments in the interest of greater transparency with respect to the energy markets. Transferring some of the energy competencies from national government control to Community level would certainly serve as a very helpful step in further liberalizing the electricity and gas markets and creating a common energy policy.

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<sup>94</sup> COM (95) 682 final of 13 December 1995: Towards an EU Energy Policy (the White Paper). Available also at: [http://aei.pitt.edu/1129/01/energy\\_white\\_paper\\_COM\\_95\\_682.pdf](http://aei.pitt.edu/1129/01/energy_white_paper_COM_95_682.pdf)

<sup>95</sup> For the Constitutional Treaty see [www.euabc.com](http://www.euabc.com) or [http://en.euabc.com/upload/rfConstitution\\_en.pdf](http://en.euabc.com/upload/rfConstitution_en.pdf). For more on the European Constitution, its legal basis, process of creating, etc. See Ziller J. (2006) *Nowa Konstytucja Europejska*, WWZ, Warsaw.

<sup>96</sup> Hancher L. (2005) The New EC Constitution and the European Energy Market, in: Roggenkamp M.M., Hammer U. (eds.) *European Energy Law Report II*, Intersentia, Antwerp–Oxford, p. 3.

<sup>97</sup> In the majority of cases, when the shared competencies are involved, the relevant legislation can be adopted by the QMV (qualified majority voting) – i.e. at least 15 of the 25 members of the Council and representing Member States comprising 65% of the EU population. The unanimity under the EU Constitution would be required with regard to energy resources, energy supply policies and energy taxation. For more see Hancher L. (2005) *op. cit.*, p. 7.

Moreover, the amended EC Treaty will provide a direct legal basis for the EU's competences in the field of energy, especially since the European Parliament and the Council will be empowered to establish the measures necessary to achieve the objectives of the EU energy policy. Of course, this does not mean that the Member States will be deprived of any control over energy resources or supply policies. It would be similar as in the taxation domain of the Member States, where unanimity is required. Article 194 paragraph 2 states:

*(...) measures shall not affect a Member State's right to determine the conditions for exploiting its energy resources, its choice between different energy sources and the general structure of its energy supply (...).*

A separate chapter on energy included in the Reform Treaty was regarded by the Polish authorities with suspicion. Poland's Euro-skeptic government at that time claimed that it would accept new articles on climate change and energy as long as doing so did not mean more powers for the EU. Ironically, at the very same time Poland was the most enthusiastic supporter of inserting an energy solidarity clause into the Treaty, in the case of serious supply problems (see Article 194 paragraph 1), thus undermining its own policy on energy.

Article 194 paragraph 1 states:

*In the context of the establishment and functioning of the internal market and with regard for the need to preserve and improve the environment, Union policy on energy shall aim, in a spirit of solidarity between Member States to (...)*

*b) ensure security of energy supply in the Union*

The security of energy supplies has become a major popular political theme, aggravated by the fragile situation in which the new Member States find themselves, since they were and still are concerned about pressure from Russia over its former areas of influence. The idea of supply cuts weighs heavily on a number of Central and Eastern European leaders. Therefore, the energy solidarity clause, in case of the kind of serious supply problems envisioned by Poland, was a concern of the importer (consumer) of energy products, such as gas and oil. Insisting on the energy solidarity clause, Poland wanted to alleviate its concerns due to the tense relations with Russia, especially since it remains heavily dependent on Russia for approximately 70% of its gas and 90% of its oil consumption.

In fact, the solidarity clause proposed by Poland is not a novel issue. In early 2006, Poland proposed a plan to all NATO and EU countries

with support of the USA: the creation of a European Energy Security Treaty. Such an energy security pact would provide mutual support to members in the event of any energy crisis. It would require the creation of a political system applying the rule of solidarity, the rule of mutual aid when the energy security of one country within the Treaty is threatened. This Treaty would also require the construction of a joint energy storage, joint gas, oil pipelines, electricity networks as well as a mutual reaction in case of an emergency situation<sup>98</sup>. However, the energy solidarity pact proposed by Poland, most probably due to its complexity (suspension of domestic control over too many crucial issues for the national governments), was not acceptable for many Member States including the biggest ones, such as Germany and France.

The issue of choice in energy supplies became clearer in the European debate after the German decision to privilege Russian relations by developing a gas pipeline project (Nord Stream) under the Baltic Sea. This project is considered to be an affront by the Central and Eastern European countries and a selfish response to a problem that involves all Member States. Poland, which is bypassed by the new pipeline, considers this project to be a threat to its energy security. Some scholars<sup>99</sup> also argue that the realization of this project will detach Polish and Western European security of supply, thus undermine European solidarity and the prospects for the emergence of a common external energy policy. However, the most negative consequence of this project from a Polish point of view is the fact that Poland practically lost its leverage as a transit country, a status on which Poland relied while negotiating prices and for insurance against vulnerability in its relations with Russia.

Additionally, the Ukrainian crisis in 2006 and 2009 and several delivery incidents have increased the feeling of urgency for a common policy at EU level. However, even though it is clear that there is a need for a cohesive, EU-wide energy policy to ensure security of supply and reduce demand, thereby reducing the dependence of Europe on foreign energy supply, the actual creation of such a policy is a difficult task. Forces at play, such as Member State sovereignty, protectionism of national industries and diverse relations with Russia among the Member States, all create obstacles to establishing an effective European energy policy.

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<sup>98</sup> For more on this see Geden O., Marcellis C., Maurer A. (2006) *Perspective for the European Union's External Energy Policy*, Working Paper FG 1, SWP – German Institute for International and Security Affairs, Berlin.

<sup>99</sup> Wyciszkievicz E. (2007) One for All – All for One – The Polish Perspective on External European Energy Policy. *Foreign Policy in Dialogue*, Vol. 8, Issue 20, Dealing With Dependency. The European Union's Quest for a Common Energy Foreign Policy, Trier, Germany, 11 January 2007.





## Chapter 2

# The internal dimension of the EU energy policy

The internal dimension of the EU energy policy corresponds mainly to the creation of an internal/common energy market where secure and reliable supplies of energy (mainly electricity and gas) at competitive prices can be safeguarded. In other words, sustainable, competitive and secure energy will not be achieved without open and competitive domestic energy markets, based on competition between companies looking to be pan-European competitors rather than dominant national players. Open markets and not protectionism will strengthen Europe and allow tackling many energy problems, such as climate change. However, the opening of the electricity and gas markets is a lengthy process. It creates new opportunities for energy companies to develop and increase their profits. Some may perceive it as a challenge that they can meet only by cooperating with other energy providers. Such cooperation may take the form of mergers, acquisitions, or the formation of joint ventures leading to significant changes in the electricity and gas market structures. While such cooperation might promote competition, it might also impede competition insofar as companies abuse their positions of dominance or enter into anticompetitive agreements, which indeed restrains the creation of an internal energy market.

The following chapter is devoted to internal energy market directives and competition issues which arise due to the process of creating common energy market.

## 2.1. The internal energy market as a major component of the EU energy policy – electricity and gas directives

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Since the creation of an internal energy market involves both healthy competition and an alignment among national legal systems, this section will touch on the internal market electricity and gas directives. Directives are secondary legislative devices useful for aligning or harmonizing the laws within a certain area – for example the internal market. Directives can be addressed to the Member States, severally or individually, and are binding with respect to their aim and the time frame within which they are to be realized. Directives do leave some choice – concerning form and method of implementation – to the Member States<sup>1</sup>. Article 249 of the EC Treaty states:

*A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.*

Unlike regulations, which Member States must directly obey, directives require the Member States to have a certain latitude in implementing them according to Community Law. For this reason, directives are susceptible to uneven implementation and lend themselves to differing interpretations. How a Member State puts a directive into effect depends on the nature and capacity of its institutional domestic structures, some of which are believed to be more suitable for adopting European legislation than others. Some scholars<sup>2</sup> argue that certain state traditions and political-administrative cultures can explain the differences in the way Member States enact directives. They assume that some states have a longer or more developed tradition of following and implementing rules in general than others. Moreover, because the provisions of a directive generally represent a compromise as a result of protracted negotiations among the representatives of the Member States, each of which has its own legal traditions, and the Community institutions on complex matters, different Member States may well have different challenges in accommodating themselves to the legal parameters of the directives. In

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<sup>1</sup> Craig P., De Burca G. (1998) *EU Law: Text, Cases and Materials*, Second edition, Oxford University Press, New York, p. 108.

<sup>2</sup> Borzel T.A. (2001) *Non-compliance in the European Union: pathology or statistical artifact?*, EU Working Paper No. 2001/28, European University Institute, Florence.

theory, the compromises required of each Member State are well defined; in practice they are often problematic on many levels.

In fact, while the scope of the electricity and gas directives is complex and includes numerous requirements from the Member States, their objective is to transform the monopolistic base of the electricity and gas markets by making both the wholesale and retail markets free, open, and competitive. All in order to create a competitive internal energy market.

As of 1 July 2004, the European internal energy market liberalization process enabled non-household users<sup>3</sup> to purchase energy from suppliers of their choice. As of 1 July 2007, with regard to gas and electricity, the European internal energy market is theoretically open: all relevant companies on the market together with households<sup>4</sup> now possess the right to choose their supplier/producer of electricity and/or gas freely from the companies of the 27 EU countries<sup>5</sup>. This development gives end users (consumers) the opportunity to shop for lower costs and better service. It also allows producers (generators) and suppliers to compete for customers within the framework of a Single European Market, one that is based on unstrained competition and free market mechanisms. However, experience shows that the liberalization of the electricity and gas market within the EU-15 is still a major concern. Moreover, the complexity of this problem has increased with the accession of the twelve New Members.

The general regulatory regime that aimed at the liberalization and harmonization of the electricity and gas markets was laid down by the first (1996–1998), second (2003) and third set of electricity and gas directives (2009). The third wave of energy legislation is envisaged to be implemented by March 2011. Subsequent regulations – by establishing the general rules for the use of transmission capacities and interconnections, for cross-border trade and the related tariffs setting, and for congestion management – have also played a substantial role in creating a single market in electricity and gas. The legal base for the European regulations and policies involved in the gas and electricity sectors are Article 95 of the EC Treaty and Article 194. This article aims at harmonizing the legislation among the Member States, which leads to the creation of an internal market. Article 95 paragraph 1 states:

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<sup>3</sup> Industrial, commercial and professional customers.

<sup>4</sup> Household is understood as a single end user of electricity and/or gas.

<sup>5</sup> In practice, a number of Member States, such as the UK and Scandinavian countries, have already opened their markets entirely to competition, in advance of the 2007 deadline.

*1. By way of derogation from Article 94 and save where otherwise provided in this Treaty, the following provisions shall apply for the achievement of the objectives set out in Article 14. The Council shall, acting in accordance with the procedure referred to in Article 251 and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market.*

Cameron<sup>6</sup> maintains that the European Commission had an additional legal basis for its proposed directives on the internal market in electricity and gas – Article 86(3), which allows the European Commission to adopt laws on its own initiative concerning monopolies and concessions (exclusive rights) granted to companies by Member States. Cameron asserts that this Article vests the Commission with law-making powers, so that directives can be made, in principle without consulting with the Parliament and without a qualified majority support of the Council. It is possible to interpret Article 86(3) as giving the European Commission a specific duty to monitor public companies and those companies to which the Member States grant special or exclusive rights; and that it also gives the Commission the power to address appropriate directives to or render decisions concerning the Member States who enact or maintain measures contrary to the rules contained in the Treaty. However, such argumentation is selective and tends to focus only on companies entrusted with special rights; it does not apply to any company not entrusted with special rights and as thus it is not homogeneous for the entire energy sector.

Directives (concerning common electricity and gas market) that would be adopted under Article 86(3) and that would require Member States to remove any exclusive rights for import, export, transmission, distribution, production and supply of electricity and gas would have to be supplemented by two other directives, based on Article 95 of the EC Treaty, which would provide common rules for regulating (unbundling and TPA) of the electricity and gas markets. Therefore, the overall process of directive creation would be simply doubled and extended in time. Moreover, a potential clash with the European Parliament or the Council taking Article 86(3) as the legal base would probably be difficult for the Commission to bear. To date, only two directives have been adopted this way: the directive on transparency between Member States

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<sup>6</sup> Cameron P. (2002) op. cit., pp. 123–124. See also the argumentation in this regard provided by Marquis M. (2001) op. cit., pp. 71–74.

and companies (directive 80/723 [1980] OJ L195/35) and the directive on competition in the telecommunications sector (directive 88/301 [1988] OJ L131/73). Consequently, the main legal base for Community involvement in the electricity and gas sectors (actually articulated in the electricity and gas directive) is Article 95 of the EC Treaty. However, in the future, after the Treaty of Lisbon will be introduced, Community action in the field of energy within Article 95 will be supplemented by Article 176 of the new Treaty.

The first gas and electricity legal framework (directive 96/92/EC for electricity and directive 98/30/EC for gas) was not as successful as envisaged. The strategy was to set a timetable for a gradual energy market opening and a minimum level of opening for each stage. Unfortunately, due to the strong opposition of the Member States, a number of problems emerged that hindered the opening of the market. The most significant included:

- an unequal implementation of the first set of directives among Member States;
- not well defined access tariffs;
- the use of discriminatory methods for access to the networks and especially to interconnections;
- a weak regulation and unbundling mechanisms;
- the persistence of market dominance by incumbent electricity and gas companies in the domestic markets<sup>7</sup>.

The aforementioned problems slowed down the opening of an internal energy market. However, at the same time, the adoption of the first set of internal energy market directives (at least on the Community side)<sup>8</sup> has had some benefits for the overall energy sector. Until 1996–1998,

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<sup>7</sup> See Shuttleworth G. (2002) Opening European electricity and gas markets, in: Robinson C. (ed.) *Utility Regulation and Competition Policy*, Edward Elgar Publishing, pp. 130–142. Additionally see European Commission (2004) “DG TREN Draft Working Paper”. *Third benchmarking Report on the Implementation of the Internal Electricity and Gas Market*, 1.3.04; “Little progress is being made to improve the market structure of the electricity industry” (p. 5) and for gas, “the level of concentration at national level remains a problem” (p. 7).

<sup>8</sup> One has to remember that the provision of a directive generally represents a compromise as a result of long-lasting negotiations between representatives of the Member States and Community institutions on complex matters – often matters of harmonizing divergent bodies of law in different Member States. The electricity and gas directives are a very good example of how the process of directive creation can be stretched in time. The negotiations over the first electricity directive started in 1992 and it took over 4 years to finalize the overall process of negotiations and adopt the legal act. Finally, the electricity directive was adopted on the 19th of December 1996. The first gas directive followed a year and half later, being adopted on the 22nd of June 1998.

the generation, transmission/transportation, distribution, and supply of electricity and gas were not separated. In general, vertically integrated undertakings were involved in the whole chain of electricity and gas industry, this way creating natural monopolies. Competition was mostly non-existent. The two directives provided for the unbundling of transmission and distribution from generation and supply<sup>9</sup>. While it was assumed that competition could be promoted on the generation/production and supply side of the vertical integration, the transmission and distribution segments would remain natural monopolies on which the market mechanism would not work; transmission and distribution, therefore, would require regulation<sup>10</sup>. Unfortunately, the first set of directives did not require the appointment of any independent institution (regulator), which would foster regulation of the natural monopoly side of the vertically integrated undertakings and which could serve to settle disputes among incumbents and customers. The directives also did not require tariffs set by the transmission or distribution companies to be published or verified by a regulator or other independent public body<sup>11</sup>. Instead, they attempted to address these fundamental issues by providing general objectives, but without specifying the methods for achieving them. In particular, they contained:

- A general requirement for a Member State not to discriminate (Article 3(11) of the first electricity and gas directives);
- A general obligation on transmission and distribution operators not to discriminate against other market players (Article 7(5), 8(2), 11(2) of the first electricity directive and Article 7(2), 10(2) of the first gas directive);
- A general obligation to protect the confidentiality of commercially sensitive information (Articles 9 and 12 of the first electricity directive, Articles 8 and 11 of the gas directive);
- A general obligation to negotiate in good faith;
- An obligation to designate and submit to a dispute settlement authority in the case of any disagreement (Article 20 of the first electricity directive, Article 23(3–4) of the first gas directive).

<sup>9</sup> Four basic approaches to unbundling were generally proposed: accounting separation; functional separation; operational separation; and divestiture or ownership separation. For more on this see Energy Market Reform, Regulatory Reform: European Gas, OECD/IEA, 2000, p. 80–83. The notion of unbundling is thoroughly discussed in the following sections.

<sup>10</sup> Cameron P. (2005) *op. cit.*, p. 633.

<sup>11</sup> See for more on this Webster W. (2006) Recent Developments in EU Energy Markets, in: Hammer U., Roggenkamp M.M. (eds.) *European Energy Law Report III*, Intersentia, Antwerp–Oxford, pp. 3–4.

Two general tools for regulation, the principle of third party access (TPA) and unbundling were introduced. The first set of directives took a conformist approach to unbundling. For electricity, only the unbundling of accounting and management of transmission activities was required; for gas, only accounting needed to be unbundled. With respect to gas, no obligation existed to create an identifiable transmission system operator. Without such an obligation, a company could remain fully vertically integrated with its supply side. Moreover, with regard to management unbundling, the directive was very vague, leaving much room for misleading interpretation, and was applied only to transmission<sup>12</sup>.

This approach actually maintained the status quo of the electricity and gas market. However, the light at the end of the tunnel was the requirement that incumbent companies take more decisive steps in restructuring and market opening. Based on the principle of third party access, more companies were supposed to be able to participate in the energy market – i.e., to have equal, non-discriminatory and transparent access to the transmission and distribution networks. Although two forms of network access were available, neither one was a success. A negotiated form of access proved to be ineffective, partly because only the national monopolies were in the position to negotiate access<sup>13</sup>, and the Member States favored an imperfect regulatory approach. A Single Buyer system also proved to be unworkable<sup>14</sup>.

In the meantime, due to pressure from the European Commission, the Member States established sector-specific regulatory bodies, the National Regulatory Authorities (NRAs), and gave them some power over tariffs for networks access. Although not well developed yet, the NRAs are working to stimulate business efficiency in the transmission and distribution areas across Europe. France established an Electricity/Gas

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<sup>12</sup> Article 7(6) directive 96/92/EC stated *...unless the transmission system is already independent from generation and distribution activities, the system operator shall be independent at least in management terms from the other activities not relating to the transmission system...* See also Marquis M. (2001) op. cit., p. 74, pp. 80–85. Additionally see European Commission XXVIII-th Report on Competition Policy (1998) paragraphs 121–128.

<sup>13</sup> For more on this see Geradin D. (2001) *The Liberalization of Electricity and Natural Gas in the European Union*, Kluwer Law International, the Hague, pp. 216–218. Additionally see Bier Ch. (1999) *Network Access in the Deregulated European Electricity Market: Negotiated Third Party Access vs. Single Buyer*, Discussion Paper 9906, Center for the Study of Law and Economics (CSLE), June 1999.

<sup>14</sup> See for instance Shuttleworth G. (2002) op. cit., p. 140. See also Lovei L. (2000) *The Single-Buyer Model*. *Public Policy Journal for the Private Sector*, December 2000, note number 225, World Bank Group. Available also at: <http://rru.worldbank.org/Documents/PublicPolicyJournal/225Lovei-1211.pdf>

Regulation Committee; Italy created the Commission for Electricity and Gas Regulation; the United Kingdom instituted its Gas and Electricity Markets Authority; and Poland set up the Energy Regulatory Office. When Germany refused to establish an independent regulatory body, relying instead on *ex post* actions taken by the competition authority *Bundeskartellamt*, other Member States and interested parties objected. Eventually Germany relented and in July 2005 established its energy regulatory body<sup>15</sup>.

Based on the Benchmarking reports presented by the Commission<sup>16</sup>, the conclusion can be drawn that the significant differences in the way the market opening was being conducted among the Member States created major distortions of the sought after competition in the internal energy market. In addition, inadequate binding rules regarding cross-border commerce limited trade and competition among the Members States<sup>17</sup>. Moreover, the market dominance of incumbents also presented challenges that extended beyond the scope of the first set of directives.

Because the first set of the internal energy market directives concerning electricity and gas proved to be a partial failure, and because the European Commission gained additional supporters<sup>18</sup> in formulating and enforcing its energy liberalization policy, the Commission was able to overcome the resistance of some stronger Member States and incumbent market players towards liberalization and proceed with

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<sup>15</sup> Communication from the Commission to the Council and the European Parliament – Report on the progress in creating an internal gas and electricity market {SEC(2005) 1448} at p. 12. Available at: [http://ec.europa.eu/energy/electricity/report\\_2005/doc/2005\\_report\\_en.pdf](http://ec.europa.eu/energy/electricity/report_2005/doc/2005_report_en.pdf) In the pre-proposal phase of the second set of Electricity and Gas Directives, Germany argued that a sector specific regulator was unnecessary and that the competition law provided sufficient instruments to deal with the issues of third party access, non-discrimination as well as tariffs specifications. However, this view, in the light of substantial critique by other Member States and the Commission, was abandoned. The final text of the Directives adopted by the Council and European Parliament accepted the need for a sector specific regulator with specified powers to control tariffs, deal with complaints regarding discrimination, and to monitor activities of network operators/companies. However, due to strong pressure from Germany, the Directives do not require the regulator to be separated from the existing government structures, although in many countries this is the case (this will be discussed in detail within the section on regulatory authorities).

<sup>16</sup> The full text can be seen on [www.euenergylaw.com/benchmarking2](http://www.euenergylaw.com/benchmarking2) or [www.europa.eu.int/comm/energy](http://www.europa.eu.int/comm/energy)

<sup>17</sup> Regulations on cross-border trade in electricity and gas were consequently issued in 2003 and 2006.

<sup>18</sup> The European Parliament has acquired additional power, through a procedure of co-deciding with the Council in adopting Internal Energy Market legislation, through the Treaty of Amsterdam amendment.



more precise and rigorous tools in opening up the sectors. To deal with the shortcomings of the first regulatory framework, the European Commission had three main instruments at its disposal:

- further legislation in the energy field;
- stricter application of the competition laws and the provisions of the directives;
- voluntary negotiation of changes among the main players in the electricity and gas market<sup>19</sup>.

On 1 July 2004, new legislation that the Council and European Parliament had adopted a year earlier (on 26th June 2003) entered into force in the EU, bringing changes into the electricity and gas sectors of the Member States. This new regulatory structure repealed the first legal regime for electricity and gas in the EU, replacing it with a more detailed framework and an enhanced role for the National Regulatory Authorities (NRAs) in implementing and further developing the market. The two principal achievements of the first set of directives – again, the third party access (TPA) rule and the unbundling regime – have been considerably strengthened. The TPA rule under the new command is seeking to promote access to the networks for new entrants more effectively than the negotiated form of access or the feeble regulatory access articulated in previous directives, while the regime on unbundling as compared to the first set of directives also addresses the barriers to competition created by corporate structures<sup>20</sup>. Further, the degree of unbundling was significantly strengthened with legal separation required for all transmission companies by 2007 at the latest. In addition, more detailed requirements for functional unbundling were also established. Finally, tariffs and conditions for network access were to be subject to supervision by independent regulators<sup>21</sup>. With respect to both TPA and

<sup>19</sup> Cameron P. (2005) op. cit., p. 10.

<sup>20</sup> It is important to know that the issue of unbundling was one of the most difficult matters of the electricity and gas directives to reach a consensus upon in the Council. Some Member States were advocates of ownership unbundling, that is, full separation of vertically integrated undertakings, whereas others were more reserved, doubting whether legal unbundling was necessary at the distribution level. The different views of the Member States were sometimes very contradictory, which was a result of domestic political pressure. These diverse views certainly had a significant impact on the process of delayed electricity and gas directive transposition. Moreover, the provisions in the directives regarding monitoring and reporting, as well as the possible revision of the Directives with respect to unbundling, reflect the different opinions of the Member States.

<sup>21</sup> Webster W. (2006) Recent Developments in EU Energy Markets, in: Hammer U., Roggenkamp M.M. (eds.) *European Energy Law Report III*, Intersentia, Antwerp–Oxford, p. 4.

unbundling, practical success depends largely on the NRA enforcement. If TPA access rights are to be effective, they require more frequent monitoring and enforcement by the regulatory authorities than under the first set of electricity and gas directives.

Once transposed into national law, the new regime was expected to ensure that the single market process in energy would be kept on track by two main directives. The first directive (2003/54/EC) of the European Parliament and Council concerned common rules for the internal market in electricity and repealed directive 96/92/EC. The second directive (2003/55/EC) of the European Parliament and Council concerned common rules for the internal market in natural gas and repealed directive 98/30/EC. Unfortunately, neither directive was fully implemented within the deadline of one year. Only a few of the fifteen Member States have adopted the necessary legislative measures to implement the Directives as of July 1st 2004<sup>22</sup>. As of the end of 2005, almost all 25 Member States had plans to implement the main provisions of the 2003 internal energy market directives. Nonetheless, the Commission was in the process of taking five countries to the European Court of Justice for not notifying that they had adopted the necessary measures<sup>23</sup>. Moreover, since in practice many countries were late in transposing the directives into domestic law, the Commission launched 34 infringement procedures against 20 Member States for violating their obligation. Following letters of formal notice sent in April 2006. On 12 Dec 2006, the Commission decided to send 26 reasoned opinions to 16 Member States including all the biggest ones<sup>24</sup>. As a result, infringements proceedings before the European Court of Justice may take place.

The main difficulties that the Member States currently have in fulfilling the requirements of the operational European internal electricity and gas market are:

- insufficient independence of the regulatory authorities;
- compatibility of the unbundling measures adopted in Member States with the directives, under circumstances in which vertical integration

<sup>22</sup> However, it should be stressed that the existing legislation of many Member States already contained provisions, which substantially satisfied the liberalization requirements of the new Directives. For more on this see Cameron P. (2005) op. cit., p. 632.

<sup>23</sup> Infringement proceedings involved Greece (electricity), Luxembourg (electricity and gas), Portugal (electricity), Spain (electricity and gas), Estonia (gas). For more on this see also Webster W. (2006) op. cit., p. 5. Additionally see Commission Communication COM (2005) 568.

<sup>24</sup> See Communication from the Commission to the Council and the European Parliament – *Prospects for the internal gas and electricity market*, p. 6 COM (2006) 841 final.

of generation, supply and infrastructure favor incumbents (the lack of equal access to infrastructure and key market information, for example);

- insufficient unbundling of transmission and distribution system operators and as a result their non-discriminatory operations cannot be guaranteed;
- compatibility of the different arrangements for carrying out public service obligations, especially with regard to security of supply and prices for end users (there is still considerable concentration caused by vertical integration, a fact that permits incumbents to continue to influence prices and prevent the entry of new market players)<sup>25</sup>;
- non-discriminatory and transparent third party access – with regard to any difference in the treatment of existing (especially long-term) contracts versus new contracts, in particular, but also with regard to switching supplier or access to the gas storage capacities.

There are also problems of a technical nature, such as the lack of transmission capacity, especially cross-border transmission capacity (for example, for New Members, for Spain, and for France), which retards the development of cross-border trade and the creation of a common energy market. Also high and still rising prices for cross-border capacities, as established by capacity auctions, severely restrict trade. As a result, many markets remain segmented along national borders. In 2006, for example, cross-border flows of electricity stood at around 10.7% of total consumption, which is an increase of only around 2% compared to 8–9% in 2000<sup>26</sup>. The lack of electricity and gas infrastructure not only slows down the development of an efficient internal energy market but also brings the risk of shortages of supplies across the EU; such shortages, of course, would have extremely negative consequences for the whole European economy. Unfortunately, European energy networks, not to mention the interconnections among them, are operating close to their physical limits with the risk of temporary supply interruptions. With only 200 million Euros of annual investments in cross-border grids, the situation seems to be particularly grim for the electricity sector, since

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<sup>25</sup> Price differences in electricity for industrial customers in the EU are more than 100% in some cases. For more on this see *Report on Progress in creating the internal gas and electricity market*, {SEC (2005) 1448}. Available at: [http://ec.europa.eu/energy/electricity/report\\_2005/doc/2005\\_report\\_en.pdf](http://ec.europa.eu/energy/electricity/report_2005/doc/2005_report_en.pdf)

<sup>26</sup> See *Report on Progress in creating the internal gas and electricity market*, {SEC (2005) 1448}, p. 5. Available at: [http://ec.europa.eu/energy/electricity/report\\_2005/doc/2005\\_report\\_en.pdf](http://ec.europa.eu/energy/electricity/report_2005/doc/2005_report_en.pdf)

more than 60% of the European projects confirmed by the Council and European Parliament face significant delays<sup>27</sup>.

Europe also faces the prospect of market segmentation by virtue of the concentrated influence of a small number of companies as well as of those dominant incumbents in some Member States that have no interest in developing the networks, since doing so might aid competitors. As a result, the Community now must confront a difficult, delicate and essential matter in order to compete on the global market: how to encourage the main players in the energy sector to participate, actively and honestly, in the opening of the sector by fulfilling the main criteria of the directives and regulations? As the historical record shows, merely further legislation is not sufficient to achieve this objective.

## 2.2. Shortcomings of the present internal energy market framework – what can be improved?

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Most of the national electricity and gas markets (with the exception of the markets in England and Scandinavian countries) still suffer from a lack of liquidity and transparency, conditions that hinder the efficient allocation of resources and that block new entrants. Currently, incumbents in, for example, Germany, France and Poland are responsible for the greatest part of the electricity and gas flows, they own major portions of the infrastructure assets, and generally have more and better access to information than new entrants. As a result, in many countries competition is still significantly hampered.

To counteract anticompetitive features of the energy industry, the Member States must first strengthen their commitment to instituting the provisions of the directives and regulations leading to the creation of an internal energy market. 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 seeking third party access (by creating unnecessary technical barriers, maintaining artificially small balancing zones, or not making unused capacities available). Here, the Member States must prohibit discriminatory practices.

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<sup>27</sup> Press release *European electricity and gas networks: European Commission calls for urgent improvements*, Brussels, 10 January 2007 (MEMO/07/11).

The Member States must also find ways to prevent distortion of investment incentives, since current unbundling developments do not provide for this. Vertically integrated network operators simply have no incentive to develop networks in the interests of other market participants who are not linked to the vertical integrated company. To the contrary, they base their investment decisions on the needs of their supply and/or generation affiliates, once again hampering the efforts of new entrants to the market<sup>28</sup>. Here, the most feasible solution for getting system operators to manage and develop the networks in the interest of all market players would be ownership unbundling. Ownership unbundling should also be seen as a powerful instrument in a battle against concentrated markets where concentration tends to be one of the main obstacles to competition. Ownership unbundling, although not mandatory, has been already voluntarily introduced in several Member States and evidence suggests that it is successful in promoting the efficiency on the market, e.g., the UK. Drawing on this evidence, the Commission in its recent press release<sup>29</sup> has affirmed that in the next legislative acts<sup>30</sup> the Commission's preferred option of unbundling is ownership unbundling<sup>31</sup>.

However, a heated debate over ownership unbundling, which constitutes one of the key amendments proposed in the Commission's third legislative energy package, signifies that ownership unbundling is a controversial issue. In the view of the Commission and such Member States as the United Kingdom and the Netherlands, the most radical option for ownership unbundling would increase competition and clear the path for greater energy sustainability and security of supply. However, the push for ownership unbundling has brought strong opposition not only from the companies affected, such as E.ON and RWE or EDF and GDF,

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<sup>28</sup> See for instance the national sections on network operator and unbundling in the Commission Staff Working Document, implementation report on electricity and gas EU regulatory framework. Country reviews – SEC (2006) 1709; and the Technical Annex to the Communication from the Commission, Sector Enquiry under Article 17 of Regulation (EC) No. 1/2003 on the gas and electricity markets (final report) – SEC (2006) 1724, especially paragraphs 157 (gas) and 487 (electricity).

<sup>29</sup> IP/07/1361 (19/09/2007) Energizing Europe: A real market with secure supply.

<sup>30</sup> 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 211/55 from 14.08.2009); 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 (OJ L 211/94 from 14.08.2009).

<sup>31</sup> See for instance recital 11 of the directive 2009/72/EC.

but also from the governments of Germany and France<sup>32</sup>. Due to the structure of their industries and the strong national orientation of the sectors, the two countries have rejected ownership unbundling. France, supporting national champions, in September 2007 addressed a letter to the European Commission in which it emphasized that the aims of energy policy should be the reduction of the negative impact on the environment, security of supply, decrease of oil and electricity prices and not a wide liberalization as a tool for reduction of prices on energy carriers<sup>33</sup>. Germany opposes the idea to force private companies to sell their property as it is legislatively forbidden in Germany. It also believes that the division of assets will destroy the existing harmonious system of functioning of the German energy sector, which is based on mutual arrangements and obligations of private energy companies<sup>34</sup>. In fact, Michael Glos, the Minister of Economics of Germany, and the Minister of Finance of France, Kristin Legard, called the initiative of the Commission a pure bureaucracy, having declared their intention to prevent the obligatory sale of network assets<sup>35</sup>. Additionally, the two countries also argued that ownership unbundling may not be compatible with the relevant constitutional laws and the free movement of capital across the EU.

However, the idea of ownership unbundling is not to take away properties or harm the affected companies, but to foster competition in

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<sup>32</sup> In fact the Commission's proposal of ownership unbundling has been criticized by 8 countries: France, Germany, Austria, Bulgaria, Latvia, Luxembourg, Slovakia and Greece. The 8 countries in a letter to the European Commission and the chairwomen of the European Parliament's ITRE committee published in January 2008 (for more on this see Goldberg S. (2008) "Recent developments in the European Union energy sector", in *European Energy Review* published by Herbert Smith LLP in association with Gleiss Lutz and Stibbe) gave several main reasons for their opposition to ownership unbundling. They argue that ownership unbundling: i) may not be compatible with the relevant constitutional laws and the free movement of capital across the EU; ii) does not respect the principle of proportionality and they argue that other solutions are available; iii) is not a sufficient and appropriate tool to deliver the opening of the European markets and to reach the objective of guaranteeing an adequate level of investment in the networks and fostering the integration of the internal market; iv) generates negative social consequences, although not specified what kind; and v) will not have clear and positive consequences for grid investments and energy prices, as these are determined by other factors according to the eight, although again not specified what kind of factors.

<sup>33</sup> Ministère de l'Écologie, du Développement et de l'Aménagement durables de la France Marche intérieur de l'électricité et du gaz, 19 septembre 2007. Available at: [http://www.equipement.gouv.fr/article.php?id\\_article=2464](http://www.equipement.gouv.fr/article.php?id_article=2464)

<sup>34</sup> Glos M., *Completion of the Single European Market for Electricity and Gas – striking the balance between competition and energy security*, Berlin, 29 March 2007. Available at: <http://www.bmwi.de/English/Navigation/Press/speeches-and-statements,did=195184.html>

<sup>35</sup> EU unveils plan to dismantle big energy firms, 20 September 2007. Available at: <http://www.euractiv.com/en/energy/eu-unveils-plan-dismantle-big-energy-firms/article-166890?Ref=RSS>

those segments of the market in which natural monopolies have arisen. Ownership unbundling does not necessitate the nationalization of the properties in question. To the contrary, the unbundling that has been envisaged would rely on competition law – in particular, on the 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. In addition, in the present globalized business environment, ownership unbundling might not entail a pure separation of transmission or distribution assets. Instead, ownership unbundling might involve more sophisticated arrangements. For example, unbundling might 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 blocking rights in either company, could not appoint members of the boards, and could not have any of its own people serve as a member of the boards of either company. In other words, the precise way in which unbundling occurs can be quite varied. The key is to prevent conflicts of interest.

Nevertheless, countries such as France and Germany have resisted this course of action. Due to the structure of their energy industries and to the strong nationalist (protectionist) orientation of their energy sectors, these two countries advocate the so-called Scottish model of ownership unbundling that relies on independent system operators (ISOs). In the ISO approach, vertically integrated companies might retain ownership of their network assets, but the network itself would be managed by an ISO. This ISO would have to be legally and functionally separated from the vertically integrated company and empowered to perform all the functions of a network operator. The Scottish model could serve as a compromise between those calling for large energy groups to be divided and those in favor of less radical action. However, some countries, which have already implemented ownership unbundling, might perceive this compromise to be unfair. The reason why, is that in order to accomplish their ownership unbundling, the companies in question are obliged to sell their assets, an action that decreases the competitiveness and capitalization of the overall company. However, given the nature of political negotiations in Brussels, with their multi-party compromises, it may also turn out that the ISO approach will end up not quite as independent as envisaged.

Finally, one may conclude that markets in which there is less ownership unbundling – France, Germany or Poland – require more detailed

and complex regulation in order to prevent discrimination than do markets where ownership unbundling has been introduced.

In fact, enhancing the role of national regulators is another subject matter in fostering the creation of the internal energy market. In particular, regulators must be kept independent from governmental authorities and be given sufficient authority to act. The studies<sup>36</sup> of the Member States conducted by the Commission and the research of the Author made in previous publications<sup>37</sup> indicate that in some countries regulatory duties are split between a specified regulatory authority and the ministry or the body that oversees competition. In many cases, the affected agencies act at cross-purposes, without coordination among them, which is a circumstance that makes it difficult for the regulator to formulate and put into effect decisions on access tariffs, gas storage issues, unbundling provisions, and so on. Interagency conflict impedes the work of the regulators and retards the development of competition in the energy markets. For these reasons, the Commission, in its explanatory memorandum on its third energy package<sup>38</sup>, argued that regulatory authorities need additional powers to monitor and intervene in matters pertaining to: (i) all aspects of third party access; (ii) unbundling; (iii) balancing mechanisms; (iv) market surveillance of power exchanges; (v) the extent to which competition authorities open markets to effective competition; (vi) cross-border matters, such as the management of congestion and interconnection; (vii) consumer protection, including any end user price controls; and (viii) transparency obligations.

To move towards a common, operationally functional electricity and gas market, the Member States also need to make sure that their regulators address the ongoing problems of inconsistencies between national systems with regard to tariff structures, capacity allocation rules, trading timetables, and security of supply measures, all of which have led

<sup>36</sup> See Commissions Staff Working Document. Implementation Report – SEC (2006) 1709. Accompanying document to the Communication from the Commission to the Council and the European Parliament – Prospects for the internal gas and electricity market – COM (2006) 841 final. See also Commissions Staff Working Document SEC (2008) 460. Accompanying document to the Report on Progress in Creating the Internal Gas and Electricity Market COM (2008) 192 final.

<sup>37</sup> Nowak B. (2009) *Wewnętrzny Rynek Energii w Unii Europejskiej*, C.H. Beck, Warsaw, pp. 172–189.

<sup>38</sup> Explanatory Memorandum (19/09/2007) on the proposal for a Directive of the European Parliament and of the Council amending Directive 2003/54/EC and Directive 2003/55/EC; on the proposal for a Regulations of the European Parliament and of the Council amending Regulation No. 1228/2003 and Regulation No. 1775/2005 and of the proposal for a Regulation establishing an Agency for the Cooperation of Energy Regulators, p. 8. Available at: [http://ec.europa.eu/energy/electricity/package\\_2007/doc/2007\\_09\\_19\\_explanatory\\_memorandum\\_en.pdf](http://ec.europa.eu/energy/electricity/package_2007/doc/2007_09_19_explanatory_memorandum_en.pdf)



to fragmented domestic markets. In order to ensure that the decisions of the national regulators conduce to the development of the common energy market rather than impeding it, the Commission has proposed strengthening the coordination of regulators at EU level. Drawing on the ERGEG and Commission proposal, the Community has issued regulation No 713/2009 of the European Parliament and of the Council of 13 July 2009, establishing an Agency for the Cooperation of Energy Regulators (ACER)<sup>39</sup>. This Agency shall complement the national regulatory authorities at the European level by providing: (i) a framework for cooperation among the national regulators; (ii) regulatory oversight of cooperation among transmission system operators; (iii) decision-making powers so that individual regulators can take appropriate action in handling cross-border issues (such as facilitating cross-border energy trade); and (iv) adopting a general advisory role<sup>40</sup>. Along these same lines, the European Parliament, in a report prepared by the ITRE Committee<sup>41</sup>, proposed a significant increase of powers for the national regulators and rules of transparency, disclosure, and accountability. The major weakness of the Community model of ACER is the limited authority of the Agency (or the Commission in its role as the supervisor of the ACER) to have its decisions be legally binding for the energy parties involved. Neither the Treaty on the European Union nor the Treaty of Lisbon provides such autonomous powers and essential legal basis for the ACER to take legally binding decisions. Therefore, simply establishing the ACER without necessary changes in the Treaty will not produce the required effect. Currently, such autonomous powers given to the Commission by the Treaty exist only with respect to the rules of competition. Yet the repeating questions about the trend towards the European Commission becoming a kind of EU energy regulator are not a novel thing<sup>42</sup>.

However, most commentators agree that the new market-oriented regulation that emerged in the 1990s for network industries, already requires the active roles of independent regulatory authorities in the

<sup>39</sup> Regulation No. 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators (OJ L 211/1 of 14.08.2009).

<sup>40</sup> For more on the specific tasks of the ACER see Explanatory Memorandum (19/09/2007) for the 3rd energy package, pp. 11–12.

<sup>41</sup> ERGEG (2007) 3rd Legislative Package Input. Paper 5: Powers and Independence of National Regulators. An ERGEG public document, Ref: C07-SER-13-06-5-PD, Brussels.

<sup>42</sup> Matlary J.H. (1997) op. cit., p. 45. See also Buigues P.A., Guersent O., Pons J.F. (2001) *Alternative Models for Future Regulation*, in: Henry C., Matheu M., Jeunemaitre A. (eds.) *Regulation of Network Utilities. The European Experience*, Oxford University Press, New York, p. 281.

Member States. For this reason, it is unlikely that the Member States will accept the establishment of an EU regulator with the Commission adopting a role analogous to that of the Federal Energy Regulatory Commission (FERC) in the USA, which regulates interstate energy transmission. For instance, Germany's chancellor, Angela Merkel, at the March summit skipped the issue of granting energy regulatory powers to the Commission and instead focused on the need to diversify energy sources by opening up the energy grids and fostering much closer relations with countries from North Africa and the Middle East<sup>43</sup>.

What the Member States have accepted so far, is a significant transfer of powers from their national governments to their respective national regulatory authorities, a transfer that has entailed institutional changes. In this regard, it is important to keep in mind that the energy sector is a strategic economic sector that is very important to national policy makers. These people have only reluctantly and in piecemeal fashion ceded some of the national sovereignty in energy matters, which involved constitutional changes in some cases. The upshot is that the process of establishing a common energy market with coordinated regulation will force the Commission to cooperate closely with the regulatory authorities of the Member States, in order to actualize the legal framework of the liberalized gas and electricity markets.

The domestic regulatory authorities also need to be independent, legally and functionally separate from any other public or private entity. Moreover, their employees as well as decision makers need to act independently from the interests of any particular market player, any government body, or any other public or private entity. For this reason, the national regulatory authorities need to have legal, personnel and budgetary autonomy as well as appropriate human and financial resources and independent management.

The third legislative package is about strengthening national regulatory agencies by giving them independence from the legal person and a budgetary autonomy. Further on, the package clears up the competencies of national regulators, stating that they should exercise the monitoring of the implementation of directives on energy liberalization, analyze investments plans of transmission network operators, observe for transparency in the market and competition, and protect consumers. All these measures aim to equip regulators with legal, functional and financial independence.

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<sup>43</sup> Dempsey J., Bilefsky D. (2006) EU unity on power is elusive, *International Herald Tribune*, March 23, 2006. Available at: <http://www.ihf.com/articles/2006/03/22/business/energy.php>

Finally, in response to the increasing demand for energy, additional infrastructure must be built to strengthen the existing networks and ensure the development of cross-border markets, which would likely improve the security of supply, guarantee a high level of public service, maximize the benefits expected by consumers and after all lay tangible fundamentals for the common energy policy. In the energy sector, most investments are likely to come from private capital and financial institutions. The important thing is to create a favorable climate for investment. Therefore, if the actions of the natural monopolies on the energy market are to be regulated in order to enable investments, the competitive sections of the market should not be subject to price control, which might discourage new investments. The role of the state is to establish the political and legal frameworks needed for the network to be developed, in particular by promoting the major gas supply infrastructure projects, such as LNG, in but also outside the European Union.

### 2.3. Competition law as a tool to support the functioning of the internal energy market

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The fact that the gas and electricity directives provide a broad framework for the progressive elimination of barriers to competition does not prevent the application of EC competition rules, especially those set forth in Articles 81 and 82 of the EC Treaty in the electricity and gas markets. Article 81 prohibits anti-competitive agreements; Article 82 prohibits companies in a dominant position from abusing that position. Both Articles apply to public and private companies equally. Celli and Nygren have explained the relationship between the competition rules and the directives in the following way<sup>44</sup>:

*Whereas the EU internal market and energy policy is geared to removing legal obstacles to competition (such as the elimination of special or exclusive rights in the areas of production, transmission and distribution), EC and national competition laws mainly remove behavioral obstacles to competition. Enforcement of competition laws in the energy sector will therefore aim at complementing sectoral rules by preventing private arrangements or practices limiting emerging competition or favoring national markets against new entrants.*

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<sup>44</sup> Celli R., Nygren M. (2000) The Role of EC Competition Law in a Liberalized European Energy Market. *The European Antitrust Review: A Global Competition Review Special Report*, Vol. 16.

The gas and electricity directives establish the freedom of customers to choose their suppliers. Consequently, it should be obvious that any agreement that has the effect or the objective of preventing those customers from changing suppliers by importing or exporting electricity or gas would infringe Article 81(1)<sup>45</sup>. Article 81(1) states:

*The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market (...)*

A few words of clarification of Article 81(1) are required. Firstly, it is enough for an agreement to affect trade between Member States if it has a direct or indirect, actual or potential effect. In case 56 and 58/64, *Consten and Grundig versus the Commission*<sup>46</sup>, the ECJ stated that it is not a question of whether or not trade is negatively affected. Even if the agreement would lead to an increase of trade between Member States, it could still constitute an infringement of Article 81(1). Agreements whose effects are restricted to one Member State fall under the jurisdiction of this Member State, except when the operation or effects of the agreements constitute a threshold for the commercial actions by companies from other Member States.

Secondly, the criterion *distortion of competition* is achieved when the agreement intends to restrict competition, without differentiating its success or not. Establishing an intention to restrict competition is difficult and requires detailed analysis of the economic and legal context of the agreement in question<sup>47</sup>.

The issue raised above concerning agreements, concluded by electricity and/or gas companies, that have the effect or objective of preventing customers from changing suppliers by importing or exporting electricity or gas, would not only infringe Article 81(1) but would violate the rules of free movement of goods, which Articles 28 and 29 attempt to guarantee and protect by prohibiting quantitative restrictions on imports and exports. The case law of the European Court of Justice (for instance the

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<sup>45</sup> However, what should be clear is that only the clauses of the agreements, which restrict competition on the common market, are prohibited.

<sup>46</sup> Case 56 and 58/64 *Consten and Grundig v Commission*, [1996] ECR 00429.

<sup>47</sup> Roggenkamp M., Ronne A., Redgwell C., Del Guayo I. (2001) op. cit., p. 231.

Jahrhundertvertrag case<sup>48</sup>) extends these guarantees and protections by showing that agreements designed to enhance the security of supply and to improve generation and supply may be entitled to exemptions under Article 81(3). Briefly, the agreement in the aforementioned case established a quota system between the Association of the German Public Electricity Supply Industry and the General Association of the German Coalmining Industry, where the first agreed to purchase from the second 511.5 million tons of German coal over 15 years. Although the Jahrhundertvertrag violated Article 81(1) of the EC Treaty<sup>49</sup>, the Commission granted a series of short-term exemptions under Article 81(3), stating that the agreement protected electricity supplies.<sup>50</sup> Ironically, the mid 1990s were the years of significant decline in coal demand throughout Europe, a fact that led the German mining sector, the largest in Europe and one of the largest in the world, into significant difficulties.

The Scottish Nuclear case<sup>51</sup> also indicates the ambiguous applicability of Article 81. In this case two vertically integrated competing utilities, Scottish Power and Scottish Hydro-Electric, were to purchase, on take or pay basis, all of the power generated by two Scottish nuclear facilities. In consequence, the nuclear facilities were not permitted to supply parties other than Scottish Power and Scottish Hydro-Electric. The agreement was signed for 30 years. When the matter came before the Commission, the Commission flatly stated that these agreements were contrary to Article 81(1). It restrained the Scottish nuclear facilities from selling its power to other parties at better terms, and it prevented Scottish Power and Scottish Hydroelectric from choosing different sources of supply. The question was whether this agreement was justified for the exemption Article 81(3) provides. In the Commission's view the agreement enhanced the production and distribution of electricity, because it facilitated the long-term planning necessary to ensure security of supply. The agreement assured that the nuclear facilities would carry on generating

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<sup>48</sup> OJ L. 50/14 of 1993. For more on Jahrhundertvertrag case see also Cameron P. (2002) op. cit., pp. 241–243. See also Cisnal de Ugarte S. (2002) The Role of Competition Law in Infrastructure Industries: The European Energy Market, in: Beato P., Laffont J.-J. (eds.) *Competition Policy in Regulated Industries. Approaches from Emerging Economies*. Inter-American Development Bank, pp. 299–300.

<sup>49</sup> It should also be noted that the relevant provision in the ECSC Treaty, namely Article 65 (1), was also implicated.

<sup>50</sup> See also in this regard Commission decision 93/126/EEC of 22 Dec 1992 on proceedings under Art. 85 of the Treaty and Art 65 of the ECSC Treaty, OJ L 050 of 1993, 14.

<sup>51</sup> See Commission decision 91/329/EEC of 30 April 1991 relating to a proceeding under Article 85 of the EEC Treaty, OJ L178/31 of 1991. See also for more Cameron P. (2002) op. cit., p. 240.

power on a stable basis. This stability, in turn, would help to open up an independent supply market in Scotland, an outcome that would enhance competition. Therefore, the agreement should be eligible for the exemptions under Article 81(3). In a compromise, the Commission demanded that the agreement be cut to 15 years.

In another case, GDF versus ENI<sup>52</sup>, the Commission had to evaluate a contract concluded in 1997 between GDF and ENI for the transit of Norwegian gas through the GDF transport network to Italy. Article 2 of this contract provided that the transported gas was *destined for marketing beyond the point of redelivery*. In other words, this clause prevented ENI from reselling transported gas in France, even though the ban constituted an infringement of Article 81(1). (The parties put an end to this aspect of their agreement in 2003). Nevertheless, the Commission did not impose any fines on GDF, ostensibly because the gas market was at an early stage of liberalization. Under Article 82 of the EC Treaty, the Commission could have found that the agreement left GDF free to abuse its dominant position. It was possible to argue that by inserting the clause on reselling in its transportation conditions, GDF was using its dominant position as a network operator to protect its activities downstream in the French market for gas supplies, thus breaching the unbundling provisions of the gas directive.

The last case brings us to Article 82 of the EC Treaty, which should be scrutinized in relation to the issue of mergers and acquisitions. Cooperation agreements between electricity or gas suppliers, in general, tend to enhance competition if they allow these companies to enter the new electricity or gas markets, in order to trade at exchanges or network services. The same is true for joint ventures or mergers and acquisitions that aim at entering a new market, in particular if these are highly concentrated. However, persistent concentration, the Commissioner for Competition N. Kroes correctly observed, is now a core problem in the gas and electricity markets<sup>53</sup>. The preliminary report of the Energy Sector Review as well as the DG TREN benchmarking report both point to the highly concentrated character of the national electricity and gas markets today, to their segmented character, to the low level of transparency, to the low level of compliance with directives and regulations, and to the lack of liquidity in these markets<sup>54</sup>. Between 1998 and 2003, there were 135 mergers and acquisitions in the EU electricity and gas sector. One third was cross-

<sup>52</sup> Commission decision of October 26 2004 in case Comp 38/662 GDF/ENI.

<sup>53</sup> *Towards and Efficient and Integrated European Energy Market*, 16.02.06, speech.

<sup>54</sup> DG TREN Benchmarking Report 2005; DG COMP Sector Inquiry Preliminary Report; Green Paper on Energy Policy 2006.

border and two thirds had a national dimension<sup>55</sup>. The number of mergers and acquisitions has continued to rise. In 2005 and 2006 respectively, the value of all mergers and acquisitions on the EU level had reached 196.3 and 298.8 billion USD<sup>56</sup>. Much of this value is a result of corporate restructuring that led to new entry into the market and that increased the competitiveness of the EU energy market. However, in the highly segregated energy markets, mergers and acquisitions could easily lead to the creation or reinforcement of a dominant position on the market. Of course, a dominant position per se does not constitute a breach of Article 82; only abuse of such a position does, as would be the case when a merger occurs between existing incumbents or leads to the creation of a so-called national champion, a company with more than a 50 per cent share of the relevant market<sup>57</sup>. When a company has a market share of less than 50 per cent, it may nevertheless still occupy a dominant position by virtue of being able to block entry into the market of competitors. Once it has been determined that a company has a dominant position, Articles 2(2) and (3) of the Merger Regulation<sup>58</sup> lay down two criteria for determining whether or not the company is violating Article 82. (i) Does the merger or acquisition create and/or strengthen its dominance? (ii) Is or will effective competition in the common market be significantly impeded?<sup>59</sup>

However, it should be remembered that the EC Treaty provides no direct legal basis for action against anticompetitive concentrations of companies. Therefore the aim of Article 3(g) *ensuring that competition in the common market is not distorted* (due to anticompetitive concentrations of companies) could only be realized at the beginning by applying the provisions of Article 81 and 82<sup>60</sup>. For instance, in the 1971 Decision involving Continental Can, the Commission claimed that any concentration that aims at or results in the elimination of the remaining competition is forbidden as an abuse of dominant position in the meaning of Article 82. In Case 6/72, *Europemballage and Continental Can versus*

<sup>55</sup> Codognet M., Glachant J.-M., Leveque F., Plagnet M.-A. (2003) *Mergers and Acquisitions in the European Electricity Sector – Cases and Patterns*, Cerna. Available also at: [www.cerna.ensmp.fr/Documents/FL-MA-MAsEU-Cases-2003.pdf](http://www.cerna.ensmp.fr/Documents/FL-MA-MAsEU-Cases-2003.pdf)

<sup>56</sup> PricewaterhouseCoopers (2006) *Transakcje kapitałowe w sektorze energetycznym – Przegląd za rok 2006*, Warsaw, p. 4.

<sup>57</sup> Case C-62/86 *AKZO v Commission* [1991] ECR I – 03359.

<sup>58</sup> Council Regulation No. 139/2004 of 20 January 2004 on the control of concentrations between undertakings (EC Merger Regulation) OJ L 24, 29.1.2004

<sup>59</sup> Case T-2/93 *Air France vs. Commission* [1994] ECR II-00235, paragraph 79; Case T-290/94 *Kaysersberg vs. Commission* [1998] ECR II-04105, paragraph 156; and Case T-5/02 *Tetra Laval vs. Commission* [2002] ECR II-04381, paragraph 146.

<sup>60</sup> In fact, in the 1970s and 1980s there were only a few attempts to apply the competition Articles to counteract the anticompetitive concentrations of companies.

the Commission<sup>61</sup>, the ECJ upheld the argument of the Commission, but still overruled the decision of the Commission, because the Commission incorrectly indicated the relevant market. As a result, Article 82 ECT was interpreted as prohibiting only those concentrations of market position that were due to eliminating competition strengthening or reinforcing an already existing dominant position. The lack of a basis in the Treaty for counteracting anticompetitive concentrations of market power was corrected, after years of consultation, in the form of regulation 4064/89EEC, subsequently amended by regulation 139/2004/EC, the so called Merger Regulation. The Merger Regulation, which applied to concentrations of market power and position not addressed by the provisions of Article 81 and 82, created a uniform system of counteracting the anticompetitive concentration of such power and position. It did so based not on the rule of prohibition *ex lege* (as Articles 81 and 82 are based) but on the rule of control *ex ante*, which means that companies must notify the Commission of a merger or acquisition that affects the European Community and must submit to the Commission's ruling.

The Merger Regulation covers acquisitions, by a single purchaser or by a group or consortium of companies that will exercise joint control over the acquired business, in which the acquisition of direct or indirect control entails a lasting structural change. The Merger Regulation also covers full function joint ventures<sup>62</sup>. Control is assessed by the concept of decisive influence – that is, whether or not the acquired rights give the acquirer(s) decisive influence over the target (see Article 3 of the Merger Regulation). Certain turnover thresholds must also be exceeded for the Regulation to apply (see Articles 1 and 5). The purpose of the threshold rule is to ensure that the Commission is only required to assess larger transactions, which may have an impact on the entire Community. Transactions that do not meet these thresholds, although not subject to Community regulation, may be subject to regulation by the individual Member States<sup>63</sup>.

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<sup>61</sup> Case 6/72 *Europemballage and Continental Can v Commission* [1973] ECR 00215.

<sup>62</sup> Full function joint ventures arise where a joint venture is created that can operate on the market independently of its parents and will do so on a lasting basis. Full function joint ventures will occur where the parents' resources are combined on a permanent basis to create a new business and thereby cause a structural change. For more on this see Skoczny T. (2005) *Przeciwdziałanie nadmiernej koncentracji*, in: Barcz J. (ed.) *Prawo Unii Europejskiej. Prawo materialne i polityki*, Wydawnictwo Prawo i Praktyka Gospodarcza, Warsaw, p. 392.

<sup>63</sup> According to the *one-stop shop* rule, if a transaction is caught by the Merger Regulation, the national merger control rules in the EU will not apply. The Regulation provides for larger transactions with a significant impact within the EU rule, which avoids the need to make multiple national merger filings. For more on the one-stop shop rule see Skoczny T. (2005) *Przeciwdziałanie nadmiernej koncentracji*, in: Barcz J. (ed.) *op. cit.*, pp. 394–395.



In order to obtain approval from the Commission for a proposed merger or acquisition, it is necessary to notify the Commission of the transaction in advance (Article 6). Under the Merger Regulation, the Commission is empowered to review any planned transaction without the actual agreement being in place or even having been publicly offered. Indeed, no transaction may be completed and implemented until the Commission has granted its approval (Article 7). The Merger Regulation provides that the Commission cannot issue an approval decision if the transaction would *significantly impede effective competition in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position*. Clearly, the Commission may prohibit not only any transaction that creates or strengthens a company's dominant position in the market in question, but any transaction that would significantly impede competition. In fact, the Commission has used the Merger Regulation and Article 82 ECT to address situations where an enterprise with a dominant position acquired or is seeking to acquire another company in the same market.

A question remains as to mergers, acquisitions, or cooperation agreements between companies in the same market (such as the energy market), but operating in different sectors (such as the gas and electricity sub-markets). Due to its environmental advantages, gas is one of the main energy sources for efficiently generating electricity. For that reason, the potential of mergers between gas and electricity companies can be enormous. In practice, there are three possible scenarios. In the first scenario – a merger between two non-dominant companies – competition issues typically do not arise unless one of the companies already enjoys a significant advantage that could be used to raise barriers against other companies that might in the future try to enter the market. The second scenario – a merger between one dominant and one non-dominant enterprise – is problematic and tricky. According to Hancher<sup>64</sup>, the Commission is likely to permit this type of merger, but requires certain structural remedies. Further, Hancher suggests that the Commission would take into account the fact that even a dominant firm must be able to compete on a European-wide scale. The third scenario – a merger that produces a dominant gas and electricity firm – raises the prospect that the company will achieve numerous and important commercial advantages over its rivals under the circumstance that these rivals will be unable to take similar action because there is no comparable company remaining in the market with which to merge. Due to the limits of this book, only the following of the many possible variations of the third scenario will be discussed.

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<sup>64</sup> Hancher L. (2006) op. cit., p. 37.

A merger between a dominant electricity producer or supplier and a dominant gas importer and/or wholesaler may allow the electricity supplier to gain ascendancy over competitors in electricity generation, and this ascendancy might lead to the abuse of its position on the market, thus breaching Article 82. The fact that the importance of gas as a fuel for electricity generation has increased over the last years underscores the dangers of permitting such mergers. Since, as Albers<sup>65</sup> observes, competing electricity producers (who intend to enter a new geographical market<sup>66</sup> based on a gas-fired plants) may have to purchase their fuel from the incumbent dominant electricity supplier. The dominant electricity producer very well may be able to influence what choices industrial consumers will make about whether to produce electricity themselves or to purchase from the incumbent.

Competition problems have emerged in the past when a dominant electricity producer intended to merge with a dominant gas importer and wholesaler. Thus, the Commission initially blocked the mergers in the cases of Tractebel/Distrigaz and Neste/IVO. However, the Commission later approved both mergers after the parties took steps to trade their bulk gas sales business to a third party<sup>67</sup>.

Therefore, already from the beginning the application of Article 82 of the EC Treaty in the energy sector has not been an easy task. In many cases the arguments in favor of or against a merger or an acquisition that leads to the creation or reinforcement of a dominant position are subjective, open to multiple interpretations, and thus at risk of being overruled.

Article 82 in conjunction with Article 86 of the EC Treaty is complicated for another reason: it might create additional dilemmas for energy

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<sup>65</sup> Albers M. (2001) Competition Law Issues Arising from the Liberalization Process, in: Gerardin D. (ed.) *The Liberalization of Electricity and Natural Gas in the European Union, European Monographs*, Vol. 27, Kluwer Law International, The Hague, p. 13.

<sup>66</sup> The relevant geographical market has been defined by the Council Regulation No. 139/2004 of 20 January 2004 on the control of concentrations between undertakings (EC Merger Regulation) in Article 9(7) as follows: (...) *the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogenous and which can be distinguished from neighboring areas because, in particular, conditions of competition are appreciably different in those areas. This assessment should take account in particular of the nature and characteristics of the products and services concerned, of the existence of entry barriers or of consumer preferences, of appreciable differences of the undertakings market shares between the area concerned and neighboring areas or of substantial price differences.* In the energy sector the Commission has generally taken the view that the relevant geographical market is the national market.

<sup>67</sup> See Commission decisions from 1 September 1994 in case IV/M.493 – Tractebel/Distrigaz (II) & 47–49 and from 2 June 1998 in case IV/M.931 – Neste/IVO & 47–46.

companies. It might happen that companies, which have been granted exclusive right to transport and/or distribute electricity or gas in a given territory (based on a public service obligation relating to the security of supply, to the regularity of supply, to quantity and prices of supplies, or to environmental protection), will be regarded as being in a dominant position compared to other companies, thus potentially breaching Article 82. Although the prohibitions of Article 82(1) are designed to apply to all firms that hold or enjoy a dominant position, some of them may be exempted by the provisions of Article 86(2) by virtue of being entrusted with providing services of general economic interest<sup>68</sup>. This is an area of some sensitivity in relation to the internal energy market, since it raises the prospect of being counter to the liberalization of the market on the grounds that protecting the security of supply or of the public in general must take precedence. Such exemptions are the source of actual or potential constraints on actions to promote competition in the energy markets in the EU as well as the overall competitiveness of the common energy market. As a result, Member States are allowed to establish exclusive and special rights on the one hand. On the other hand, however, they must observe the rules of the Treaty, in particular the rules on free movement and competition.

In sum, opening up of the electricity and gas markets creates new opportunities for energy companies to grow. Some may perceive the liberalization of the domestic energy markets and creation of an internal energy market as a challenge that they can only overcome in cooperation with other energy providers. Therefore, the liberalization process is encouraging energy companies to restructure by means of cooperation agreements, mergers, acquisitions, and the formation of joint ventures. Such restructuring can have a pro-competitive character; it can lower costs through technological innovations and economies of scale, and it can provide an assurance of supply. Such restructuring can also have negative consequences for competition. Mergers and acquisitions, especially in highly segregated energy markets, can enable the merged group to eliminate existing competition, prevent new entry, or lead to the abuse or reinforcement of a dominant position in the market. As a result, the rules on competition set forth in the EC Treaty and secondary legislation should be seen as particularly relevant tool for dismantling dominant market structures present in many domestic gas and electricity markets,

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<sup>68</sup> Specific grounds for exemption include public policy and public security. Public security is also ground for exemption under Article 30. In general, Member States can impose restrictions on import or export of energy if these restrictions can be justified under Article 30.

especially in the case when anticompetitive domestic structures may impede free and fair competition in the common internal energy market. However, competition law cannot open markets by itself, therefore relevant Community and domestic institutions need to complement and maximize their enforcement efforts through an improved application of the legal framework in general.

## 2.4. Conclusions

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Europe's aim of achieving fully integrated and competitive electricity and gas markets comprised of 27 national markets is a unique mission, which is difficult but not impossible to achieve. A reliable and continuous supply of both electricity and gas at reasonable prices is an essential public service. Such supply of energy depends on the transmission and distribution infrastructure – mainly networks – which are very costly to construct. Because return on capital investments in networks is calculated on a long-terms basis, the energy market is unattractive to potential medium private investors, who usually expect quick returns. The result is that the construction and operation of the networks is left to the natural monopolies, which have an incentive to use their dominant positions to deny access to the infrastructure for potential competitors and to slow down the opening of the common energy market. For this reason, in the absence of an open and competitive infrastructural market, independent regulation is necessary to secure nondiscriminatory third party access to the infrastructure. In the past, in almost all the Member States electricity and gas were supplied by one or a small number of vertically integrated companies with control over the entire gas and electricity industry, from generation to supply, and with cross subsidization of their activities as well as with state subsidies, being able to offer artificially lower prices, thus blocking competition and causing segmentation of national markets. Therefore, once again, regulation is necessary to open the market. The national governments of the Community, the EU institutions themselves, independent regulators, independent system operators and private interest groups need to take on significant roles in order to liberalize the electricity and gas markets. The first step should be to fully implement the four basic measures of the electricity and gas directives: i) third party access; (ii) unbundling; (iii) proper fulfillment of public service obligations; and (iv) independent regulation.

While the scope of the electricity and gas directives is complex and includes numerous requirements for the Member States, their objective is to transform the monopolistic base of the electricity and gas markets

by making both the wholesale and retail markets free, open and competitive. To this end, the directives outline a balanced approach to access to the system and competition. In addition, they broadly apply the principle of subsidiarity to permit the individual nations to adopt the means of fostering competition that are most suitable to their particular economic, social, political and legal traditions, thus facilitating the incorporation of directives into national law. However, the legalities involved in enacting the directives and harmonizing the divergent energy laws in the Member States on the way towards creating European internal energy market are complex and require huge institutional and human effort. The goal of a free, open and competitive energy market requires more than just hiring more civil servants or judges; it requires changing the very structure and operating methods of companies and governmental institutions. Sometimes existing institutions have to be redefined and reorganized; sometimes new institutions have to be created, as is the case with the establishment of energy regulators. This is not an easy task, especially with certain Central and Eastern European nations. Poland, for example, is still affected by the legacy of the past, which makes transposition of the directives and the whole process of energy law approximation more difficult. Until the very late 1990s, regulation was a foreign concept to Polish organizational and legal theory as well as practice, and an unwanted one to policy makers, who viewed independent regulators as a threat to their control of the economy. For both of those reasons, Poland's implementation of the EU rules to create national sector regulation and the regulatory authorities to go with them has been painful. An additional reason is that EU laws, particularly in the telecommunication and energy sectors, tend to be vague. They provide general goals; however, in the spirit of deferring to the traditions and cultural singularities of the individual Member States, they typically leave it to the national legislative bodies to interpret them and find what is the most appropriate way of acting on them given their particular social, economic, and political circumstances<sup>69</sup>. As a result, the approximation of laws is not simply a technical legal matter, but also a sociological matter of finding a way to integrate the social fabric of the individual countries with the common European standards and the laws that support them.

These differences are important for understanding the difficulties the Member States have encountered in endeavoring legislatively to transpose and incorporate the directives. The members of the European Union have not transposed the directives in a uniform manner but differentially

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<sup>69</sup> For more on the regulation in the Polish legal system see Hoff W. (2007) *Polish Energy Regulation in its European setting*, LKAEM Publishing House, Warsaw, pp. 63–65.

– some more quickly and more effectively than others. Indeed, only a few Member States of the EU-15 transposed the electricity and gas directives by the 1 July 2004 deadline. Moreover, even though since the end of 2007 almost all 27 Member States had committed themselves to implementing the main provisions of the 2003 internal market directives, the Commission had to launch no less than 34 infringement procedures against 20 of the Member States for violating or not transposing them<sup>70</sup>.

However, with all their limitations, the second set of directives improve the legal framework for governing competition in the gas and electricity industries, as they are in the process of becoming increasingly liberalized. Nevertheless, the critical issues of proper and full unbundling, of nondiscriminatory third party access, and of the sound operation of the networks remain in need of further attention, as does the role of the independent regulators, whose presence is critical to continuing the development of the competitive market and whose decisions on network access tariffs and other key rules will profoundly shape the development of the energy markets. Again, although the directives are not perfect, they have helped making the process of liberalization irreversible. Any imbalances that have occurred in the unequal opening of the markets, both on the supply side and the demand side, should be addressed either by pursuing infringement proceedings or by recently amended a third set of electricity and gas directives and regulations<sup>71</sup>. However, energy liberalization will not be fully accomplished without the rigorous enforcement of the present sector-specific rules and a proactive application of the competition rules by the responsible domestic authorities. After all, competition law should serve the fundamental requirement of an internal energy market – i.e. free and fair competition.

In the case of Poland, sector monopolies in key services – such as gas and electricity, telecommunication, or postal services – often proved to be cost-inefficient and unable to satisfy customer needs and expectations

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<sup>70</sup> See Communication from the Commission to the Council and the European Parliament – Prospects for the internal gas and electricity market, p. 6, COM (2006) 841 final.

<sup>71</sup> 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 211/55 from 14.08.2009); Regulation EC No. 714/2009 of the European Parliament and of the Council of July 13 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing regulation EC No. 1228/2003. (OJ 211/15 from 14.08.2009); 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 (OJ L 211/94 from 14.08.2009); Regulation (EC) 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 and repealing Regulation (EC) No. 1775/2005 (OJ L 211/36 from 14.08.2009).

for quality and price. Since 1 May 2004, the purview of the Polish competition authority has been strengthened by the cooperation with the European Commission and the competition authorities of other EU Member States within the framework of the European Competition Network. This cooperation is aimed at coordinating competition protection activities at Community level and results from the national authorities being entrusted with applying the Community competition law (e.g. Article 81 and 82 of the EC Treaty). In Poland, however, a particular difficulty likely to be encountered in applying these Articles to the energy market is the fact that the electricity and gas sectors are undergoing fundamental changes. Article 81(1), for instance, may be declared inapplicable in those situations that contribute to economic progress in Poland, especially during times of global financial crisis. In such situations, Poland could adduce its position referring to the GFU case<sup>72</sup>, where the Norwegian Gas Negotiation Committee negotiated natural gas sales contracts with a limited number of clients on behalf of all Norwegian gas producers and thus fixed the selling price, volume and all other trading conditions. This agreement, based on a Norwegian law, was held to infringe Article 81(1) and could not be exempted under Article 81(3). However, because the energy markets were undergoing fundamental changes, the Commission did not fine the participants. Instead, the Commission accepted the pledge made by the Norwegian gas producers that they would market their gas individually in the future.

Additionally, Poland might be reluctant to follow EU law in general and the EC competition law in particular. For instance, a merger that would create or strengthen a public company's dominant position in the national market would be carried out with the aim of creating a pan-European energy company able to compete at a pan-European level, and not with the aim of potentially obstructing EU competition law. Moreover, a state-owned champion could expect less rigorous treatment from the authorities insofar as it received State aid. Such a situation has been visible for years in the Polish shipyard and coal industries, where coal subsidies had an impact on the supply options of the electricity market, and thus prevented the growth of renewables in Poland. Until a coherent European energy strategy is put in place, not only the Polish initiative to create national champions but also similar initiatives of other Member States will continue to give rise to Commission action under the EC competition law.

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<sup>72</sup> Case Comp/36/072, GFU – Norwegian Gas Negotiation Committee, IP/02/1084, 17 July 2002. Additionally see *Liberalization of European Gas Markets – Commission settles GFU case with Norwegian gas producers*, Competition Policy Newsletter 2002 (3), p. 51.





## Chapter 3

# The external dimension of the EU energy policy

The European Council in 2006 has endorsed the vision of a long term framework for the external energy dimension set out jointly by the Commission and the Council<sup>1</sup>. The main priorities to be pursued by an external EU energy policy according to this vision should include:

- Building up energy relations with the EU neighbors, following up the Commission's recent proposal to strengthen the European Neighborhood Policy (ENP)<sup>2</sup> also in the field of energy, with possible EU-ENP energy Treaty.
- Reducing threats of possible disruptions or physical destruction of important energy infrastructure in the EU and beyond the EU borders through exchange of best practice with all concerned EU partners.
- Enhancing relations with other major energy consumers. In particular with partners such as China and the US. The scope of such relations should include promotion of open and competitive global energy markets, energy efficiency, regulatory cooperation and research.
- Driving forward international agreements such as the Energy Charter Treaty.
- Deepening dialogue and relations with key energy producers and transit countries, especially with Azerbaijan, Kazakhstan, Turkmenistan

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<sup>1</sup> European Commission/High Representative paper. *An external policy to serve Europe's energy interests*. June 2006 S 160/06; followed by External Energy Relations – from principles to action. COM (2006) 590.

<sup>2</sup> Communication from the Commission to the Council and European Parliament on strengthening the European Neighborhood Policy – COM (2006) 726.

and Uzbekistan. The EU strategy here should facilitate the transport of the Caspian energy resources to the EU. This strategy should also look further to maximize the geographical diversification of EU energy supplies to areas like the Middle East.

- Enhancing relations with Russia through the negotiation of a new comprehensive framework agreement. This should emphasize the mutual long-term benefit to both Russia and the EU and be based on market principles and those of the Energy Charter Treaty and draft Transit Protocol.

Russia is the main energy supplier of the EU. Therefore, there is a need for an energy partnership with Russia, offering stability and predictability for both sides, and paving the way for the necessary investments in infrastructure. Such partnership would also mean more transparent and nondiscriminatory access to markets and infrastructure on a reciprocal basis. Those principles could be integrated into the legal framework of EU-Russia relations. However, the energy partnership will not go further if priority is not given to the rapid ratification by Russia of the Energy Charter Treaty and the Transit Protocol.

### 3.1 The Energy Charter Treaty

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The Energy Charter Treaty was signed by 51 countries in Lisbon on 17 December 1994<sup>3</sup>. It was preceded three years earlier by the European Energy Charter, a declaration of non-binding character, adopted and signed on 17 December 1991 in The Hague. The European Energy Charter represented a first formal step in formulating and establishing the Energy Charter Treaty. The European Energy Charter was actually drawn up in reaction to the collapse of the Soviet Union. The main idea was to establish economic activity in the former Soviet Bloc countries, and especially to promote mutually beneficial east-west industrial cooperation by providing legal safeguards in areas such as investment, transit and trade<sup>4</sup>. In the view of the former Prime Minister of the Netherlands, Ruud Lubbers, the best place to start such cooperation was the energy sector<sup>5</sup>. Russia and some of its neighbors were rich in energy resources (mainly gas and oil), but lacked the advanced technology and investment

<sup>3</sup> The Energy Charter Treaty is available at: <http://www.encharter.org/index.jsp>

<sup>4</sup> Roggenkamp M., Ronne A., Redgwell C., Del Guayo I. (2001) op. cit., p. 172.

<sup>5</sup> Jones C. (1995) The European Energy Charter Treaty, in: Hancher L. (ed.) *The European Energy Market: reconciling Competition and Security of Supply*, ERA volume 13, p. 79.

funds necessary for extraction. While Western Europe was in a position to supply such capital and technological assets, it was also anxious to secure access to the potentially wealthy Eastern energy markets. In other words, the countries of Western Europe had a strategic interest in securing the supply of and in diversifying their sources of energy. As a result, well-recognized political and business aims served as a basis for the co-operation between the countries of the West and East.

Invited by the Council to investigate how to put west-east cooperation into effect, in 1991 the European Commission proposed the European Energy Charter. Because the scope of this concept went beyond the European Community itself, the Community called an International Conference in Brussels in July 1991, which culminated with the signature of a Concluding Document in The Hague on 17 December 1991. The European Energy Charter was signed by 51 countries, including the 15 states of the EC, all other countries of Western Europe, all countries of Central and Eastern Europe, apart from some former Yugoslavia Republics, 12 independent Republics of the former Soviet Union, four major non-European OECD countries – the United States, Japan, Canada and Australia (their signatures giving the Charter and later the Treaty its international character). Unfortunately, although Russia signed the Treaty, it has not yet ratified it. The main problem for the Russian authorities is the Energy Charter Protocol on Transit, according to which the admission of the foreign companies to national transport infrastructure is provided under internal tariffs<sup>6</sup>. Russia is afraid that ratifying the Energy Charter Treaty will increase the influence of Central Asia and Caspian countries in the world trade of gas and oil, which will seek to transport their resources to Europe via Russian territory under the protection of the Energy Charter Treaty. This would decrease Russian energy dominance in the region and shake its position of the main energy partner with Europe.

The Charter was a political declaration that promoted mutual investments, trade and co-operation in the energy field. The emphasis was placed on the role of industry and on the creation of an open international energy market. However, since the Charter was a non-binding declaration of policy and goodwill, it was essential to create a framework of legal safeguards for company operations. In response, the EU developed a legal instrument, The Energy Charter Treaty, for co-operation between East and West. This binding, multi-lateral Treaty was finally signed in Lisbon on 17 December 1994 and entered into force in April 1998.

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<sup>6</sup> 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. 208.

The aim of the Treaty is set forth in Article 2:

*(...) to establish a legal framework in order to promote long-term co-operation in the energy field, based on complementarities and mutual benefits, in accordance with the objectives and principles of the European Energy Charter.*

Its scope encompasses energy materials and products. The Treaty deals also *inter alia* with issues pertaining to investment, trade, transit of energy goods, competition and the environment. As Walde and Andrews-Speed observed “(...) *the ECT was the most ambitious attempt to date to set up an international regime for both investment and trade (...)*”<sup>7</sup>. The economic and legal scope of the Treaty is extensive. Economically, it encompasses different kinds of market-oriented systems, from semi-centrally planned to capitalism. Legally, it includes both hard and soft law commitments and instruments.

For the purpose of this book, the crucial issue of the Energy Charter Treaty is a matter of the transit of energy goods and its relation to the liberalization/market opening of the electricity and gas sectors in the EU. The success in opening the energy markets in Europe in the mid 1990s was strongly linked to the ability to secure the freedom of energy transit both legally and economically. As Jenkins explained “(...) *it is not an exaggeration to say that the success of all western oil and gas investment in the (FSU) effectively hangs on the reliable provision of economically viable transit routes from point of production to hard currency markets.*”<sup>9</sup> This concern was particularly due to the previous absence of a legal framework within the FSU, on account of which transit laws remained largely *non-existent or immature*<sup>10</sup>. Therefore, the Energy Charter Treaty, mainly through Article 7, was seen as an instrument for legitimizing the transportation of energy materials and products. Article 7 requires each contracting State to take:

*(...) necessary measures to facilitate the transit of Energy Materials and Products consistent with the principle of freedom of transit and without distinction as to the origin, destination or ownership of such Energy Materials or Products or discrimination as to*

<sup>7</sup> Walde T., Andrews-Speed P. (1996) *Will the Energy Charter Treaty help international investors?*, 12th Biennial Conference on International Energy and Resources Law, International Bar Association, Prague, 24–29 March, p. 3.

<sup>8</sup> Former Soviet Union.

<sup>9</sup> Jenkins D. (1996) *An Oil and Gas Industry Perspective*, in: Walde T. (ed.) *The Energy Charter Treaty: An East-West Gateway for Investment and Trade*, Kluwer Law International, London–The Hague–Boston, p. 187.

<sup>10</sup> Walde T., Andrews-Speed P. (1996) *op. cit.*, p. 34.

*pricing on the basis of such distinctions, and without imposing any unreasonable delays, restrictions or charges.*

However, although prior to the Energy Charter Treaty there was no multi-lateral, international agreement, which would have tackled the issue of the transit of energy materials and products, the European Community had addressed it by way of two directives, the European natural gas transit directive (91/296/EEC) and the electricity transit directive (90/547/EEC). The directives have been brought under the auspices of Article 100A of the EEC Treaty (the Single European Act amendment) and constituted the first stage in establishing an internal market for the generation, transmission and distribution of electricity and gas, which, again, was designed to increase energy efficiency and to insure transparency of costs and prices within the EU common energy sector. The second stage involved introducing the first set of gas and electricity directives. One of the main provisions of the internal market directives for gas and electricity was the possibility of mandatory third party access (TPA) to grid systems, where incumbent transmission and distribution companies would be obliged to offer access to their networks to companies that sought to transport electricity and/or gas through the networks and to do so at reasonable rates. Additionally, since the negotiations of the TPA within the gas and electricity directives were conducted at the same time as the Energy Charter Treaty negotiations, and since the third party access principle is related to the transit of energy products and materials, the EC deliberation on TPA clearly influenced the debate on the Energy Charter Treaty transit provisions<sup>11</sup>. Some scholars<sup>12</sup> even perceived the transit provisions in the Energy Charter Treaty as a *potential Trojan horse for the introduction of such access into the EU to circumvent the difficulties that the European Commission was experiencing in securing the passage of the proposed electricity and gas directives*.

Therefore, it is worthwhile to ask whether Article 7 of the Energy Charter Treaty on transit matters itself expresses or generates some sort of pro-third party access to pipelines or transportation grids? The answer is: no. Although there are some similarities – transit is to be allowed without any unreasonable delays, restrictions, or charges and without discrimination in terms of access to energy transport facilities and to terms and conditions of carriage – Article 7 is not a TPA principle articulated in the electricity and gas directives. Article 7 imposes a general obligation to

<sup>11</sup> Moreover, since the Directives tackled only EU relations, and the Russian Federation has obviously been left outside the scope, the need for a relevant legal framework for the transit of energy from east to west became obvious.

<sup>12</sup> Cameron P. (2002) op. cit., p. 83.

grant a transit request by reference to “the principle of freedom of transit”, although there is no such principle in international law as freedom of access to transit<sup>13</sup>. Furthermore, the Understandings, included in the Final Act of the Conference on the Charter, stipulate that *the provisions of the Treaty do not oblige any Contracting Party to introduce mandatory third party access*<sup>14</sup>. Therefore, any claim that Article 7 generates mandatory TPA is misleading. Although the legally binding Transit Protocol to the Energy Charter Treaty advocated transparent and non-discriminatory transit access, it excluded mandatory third party access. In fact, the TPA made explicit that the directives, which have a binding force on the EU countries, could not be applied to third countries. Therefore, in order to legitimize the transit of energy resources from a non-EU country, another internationally binding legislation was needed.

In the meantime, Article 7 of the Energy Charter Treaty, which was supposed to facilitate the transit of energy, has actually failed. The main problem was Russia which, together with Gazprom, the main Russian gas player and the main European gas player, balked at ratifying it. The EU unfortunately lost momentum at the end of the 1990s, when the prices of gas and oil were rather low and Russia badly needed foreign investments. That was a perfect time for the EU oil and gas companies to begin cooperating with state-owned Russian companies. Today, when the price of gas is high (to some extent caused by the high prices of oil) and the demand is constantly growing, and when Russia is the main gas producer in the world with control of one-third of the world's gas reserves, it can either develop its own technology or buy it from independent contractors without handing reserves over to foreign companies. As a result, the future of an Energy Charter Treaty that would bind countries to opening up their energy markets to foreign companies is rather bleak as long as the prices of gas or oil are high.

## 3.2. Security of supply of the EU Members

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Another important aspect of the EU energy policy that is currently widely discussed in Europe is the issue of the security of supply. The security of supply has its domestic and external dimension (e.g. third countries

<sup>13</sup> Liesen R. (1998) Transit under the 1994 Energy Charter Treaty, 3 *Centre for Energy, Petroleum and Mineral Law and Policy*, p. 8. On-line Journal 17 at: [http://www.dundee.ac.uk/petroleumlaw/html/article 3-7.htm](http://www.dundee.ac.uk/petroleumlaw/html/article%203-7.htm)

<sup>14</sup> Final Act of the European Energy Charter Conference, Understanding 1(b)(i) OJ L 69/5 of 9.3.98.

relations). With regard to domestic aspects, the obligation to secure electricity supply in Member States entails three responsibilities<sup>15</sup>. (i) The first is to provide system security in terms of a safe network infrastructure. Each Member State must take appropriate regulatory and monitoring measures that meet its security standards. To this end, Article 4 (paragraph 1a) of directive 2005/89/EC<sup>16</sup> states that Member States *shall ensure that the transmission system operators set the minimum operational rules and obligations on network security*.

The task of physically securing the network infrastructure should not be affected by the creation of a common, European, internal market for energy even though such a market is at risk of being congested by unscheduled electricity flows due to trade activities across electrical systems in Europe. For instance, on 14 July 1999 the Belgian TSO was faced with demands on its system exceeding those scheduled for that day. The TSO had to react immediately in order not to overload and damage the entire system. Because the various TSOs did not share key information<sup>17</sup>, and because they were unaware of where the electrical surges were coming from, the Belgian TSO was legitimately obliged to limit its scheduled dispatch of electricity. In 2003, a similar situation occurred: an insufficient exchange of information between Italy and Switzerland led to the flow of electricity being blocked; the resulting congestion problems throughout Europe significantly damaged the infrastructure. Unfortunately, the lessons from the breakdown of the Italian electrical grid in 2003 were not learned, and on 4 November 2006 another pan-European blackout occurred.

These three examples of congestion problems could be multiplied. This is partly due to the fact that technical problems in the transmission of electricity are unavoidable. When such unpredictable problems arise, they have to be treated as security priority. In this regard, better cooperation among European electricity TSOs, which should be publicly

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<sup>15</sup> DG TREN Note on Directives 2003/54/EC and 2003/55/EC on the Internal Market in Electricity and Gas. Measures to secure Electricity Supply. Available at: [http://ec.europa.eu/energy/electricity/legislation/doc/notes\\_for\\_implementation\\_2004/security\\_of\\_electricity\\_supply\\_en.pdf](http://ec.europa.eu/energy/electricity/legislation/doc/notes_for_implementation_2004/security_of_electricity_supply_en.pdf)

<sup>16</sup> Directive 2005/89/EC of the European Parliament and of the Council of 18 January 2006 concerning measures to safeguard security of electricity supply and infrastructure investment (OJ L 33/22 of 04.02.2006).

<sup>17</sup> Cooperation between national TSOs is crucial for network security and the internal market. This is also pointed out by recital 7 of the Directive 2005/89/EC which states that *cooperation between national transmission system operators in issues relating to network security including definition of transfer capacity, information provision and network modeling is vital to the development of a well functioning internal market and could be further improved. A lack of coordination regarding network security is detrimental to the development of equal conditions for competition*.

accountable for their actions, is undoubtedly necessary, as the European Commission acknowledged when it proposed its third legislative package for the electricity and gas market<sup>18</sup>. The proposal recognized two key elements for integrating the market, being the need for TSOs to cooperate in exchanging information and the need for Member States to coordinate new investments to increase interconnection capacities. In the meantime, Member States have the right, according to Article 22 of the electricity directive, to take appropriate measures and, if necessary, to suspend third party market access for a limited time.

The second responsibility of the obligation to secure electricity supply entails Member States to guarantee adequate generation capacity<sup>19</sup>. To this end, Member States need to be fully transparent in how they calculate capacity and allocate their electricity. They must specify in advance the criteria for determining how new generation capacity is to be authorized in relation to the electricity directive mandate stating that all components of the electrical grid and the overall system itself have to be safe and secure<sup>20</sup>. The body responsible for the authorization should be a national regulatory authority (NRA) or an equivalent authority, one that is unconnected to the generation, transmission, distribution or supply of electricity.

The third responsibility of the obligation to secure electricity supply is to secure the primary energy sources (gas, coal, uranium and so on) used for generating electricity. At this stage, the EU is concerned about the heavy, indeed excessive, and deepening dependence on gas. This dependence might give gas companies potentially intimidating and anti-competitive influence over the companies involved in the European electricity system. To counteract this possibility, Member States may (according to Article 6, paragraph 2(g) of the electricity directive) refuse to authorize new generating plants that require a source of energy, such as gas, on which the country is already overly dependent. However, before they do so, the Member States should individually and collectively monitor the degree to which they rely on the various resources in question. If they then determine that certain actions must be taken to limit reliance on a particular primary source of energy for generating electricity, the directive gives Member States the right to take appropriate action.

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<sup>18</sup> For more on this see Explanatory Memorandum (19/09/2007) on the proposal for a Directives of the European Parliament and of the Council amending Directive 2003/54/EC and Directive 2003/55/EC; on the proposal for Regulations of the European Parliament and of the Council amending Regulation No. 1228/2003 and Regulation No. 1775/2005 and of the proposal for a Regulation establishing an Agency for the Cooperation of Energy Regulators, pp. 13–14. Available at: [http://ec.europa.eu/energy/electricity/package\\_2007/doc/2007\\_09\\_19\\_explanatory\\_memorandum\\_en.pdf](http://ec.europa.eu/energy/electricity/package_2007/doc/2007_09_19_explanatory_memorandum_en.pdf)

<sup>19</sup> See for more on this recital 10 and Article 1 paragraph. 1a) of Directive 2005/89/EC.

<sup>20</sup> Electricity Directive – Article 6 paragraph 2.



In the gas sector, security of supply entails a different set of issues. This is due to the fact that while each country can generate electricity, not every country has gas fields from which this source of energy can be extracted. Natural gas is a resource good, subject to global supply and demand and thus a major focus of export policies<sup>21</sup>. Because the EU has been increasingly dependent on imported gas, mainly from Russia, it has had to address two security issues<sup>22</sup>. The first is the short-term security of supply. Article 26 of the gas directive stipulates the regulatory safeguards Member States must take against supply disruptions. Member States must clearly define their security objectives and assign appropriate responsibilities among the different market players in accordance with these objectives and do so without violating the European Union competition rules. The second security issue concerns the long-term security of supply in relation to the strategic and geopolitical position of the European Union in a global economy. To this end, Member States must sufficiently diversify their supplies and make the necessary investments to meet their growing demand for gas, especially in relation to the implications of their increasing dependence on Russian gas supplies. To this end, Member States, based on Article 3 (paragraph 2) of the gas directive, have to require, as part of the public service obligations they impose, that the gas companies engage in and implement non-discriminatory long-term planning, taking into account third parties seeking access to the system.

One of the main infrastructural tools to diversify gas supplies is the LNG (liquefied natural gas) terminal, which, as a matter of fact, should be seen as a complementary infrastructure to gas pipelines. In fact, LNG has important implications for the security of supply: by eliminating the physical connectivity (and therefore dependence) of pipelines, natural gas can be sourced from around the world. This in turn limits the ability of pipeline owners to block their customers. The EU, being aware of the energy problems with gas supplies to the Member States, has issued in 2004 the Council directive 2004/67/EC<sup>23</sup>. The directive establishes measures to safeguard an adequate level of security of gas supply. While contributing

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<sup>21</sup> Of course there are other issues that should or could be taken under consideration when discussing demand for & supply of gas, such as long-term supply contracts or take-or-pay contracts. But this is an issue for another discussion paper and therefore it will not be covered in this paper.

<sup>22</sup> For more on this see also: DG TREN Note on Directives 2003/54/EC and 2003/55/EC on the Internal Market in Electricity and Gas. Security of Supply Provisions for Gas. Available at: [http://ec.europa.eu/energy/electricity/legislation/doc/notes\\_for\\_implementation\\_2004/security\\_of\\_gas\\_supply\\_en.pdf](http://ec.europa.eu/energy/electricity/legislation/doc/notes_for_implementation_2004/security_of_gas_supply_en.pdf)

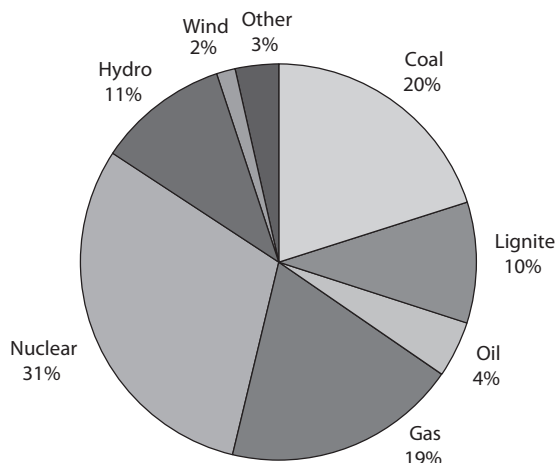
<sup>23</sup> Council directive 2004/67/EC of 26 April 2004 concerning measures to safeguard security of natural gas supply (OJ L 127 of 29.4.2004).

to the smooth functioning of the internal gas market, it provides for a common framework within which Member States will define general, transparent and non-discriminatory security of supply policies that are compatible with the requirements of a competitive internal gas market. The directive clarifies the general roles and responsibilities of the different market players and implements specific non-discriminatory procedures to safeguard security of gas supply. In fact, in accordance with the subsidiarity principle, directive 2004/67/EC does not impose specific instruments for the realization of energy security policy of domestic gas markets on the Member States, but only suggests certain instruments and tools that should lead to the realization of the directive goals. One of such instruments is terminal LNG. In fact, LNG is the best way to increase the number of gas providers, hence the flexibility of the EU system as a whole, and, at the same time, to increase the amount of imported gas, in order to address the declining domestic production, the increasing demand and especially gas pipeline transmission problems. This was particularly highlighted in January 2006 and 2009 when Russia cut off the gas supply to the Ukraine. At that time, the EU, being dependent on gas from Russia delivered by pipelines through the Ukraine and Belarus, realized the full extent of its vulnerability in the sphere of energy security and the need for a common EU energy policy on security of supply.

Generally speaking, Member States have addressed the physical security of the network infrastructure, the security of supply, and the making of adequate generation capacity in the electricity sector by monitoring, enabling the NRAs to take appropriate measures and, if necessary, suspending third party access for a limited time in case of congestion problems pursuant to Article 23 of the electricity directive. The EU countries have also addressed these issues by adopting the strict criteria for the authorization procedures concerning new generation capacity. The following data illustrates how some of the Member States: Great Britain, France, Germany and Poland tackled the internal dimension of the concept of security of supply.

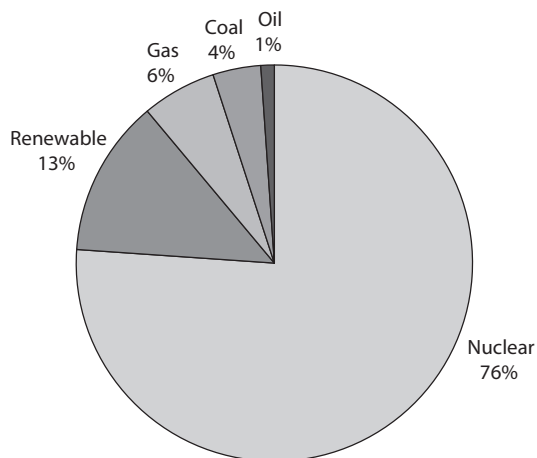
The four countries have similarly addressed the security of primary energy sources used for generating electricity and gas by legislatively requiring a certain amount of fossil/solid fuels to be available in case of supply interruptions. How they have done this depended on which energy sources they rely on for generating electricity. Some rely heavily on nuclear energy, whereas others depend on coal or gas. Figure 1 represents the different percentages of electricity sources in the 27 EU nations.

In France, nuclear energy accounts for 76.7% of electricity generation, far above the EU-27 average of 31%. The share of renewable sources, mainly hydro-electric generation, is around 13%. Coal and gas together



**Figure 1.** Electricity generation sources in the EU-27

Source: Commission Staff Working Document SEC (2007) 602, Annex to the Commission Report on the Application of Council Regulation (EC) No. 1407/202 on State Aid to the Coal Industry – COM (2007) 253 final.

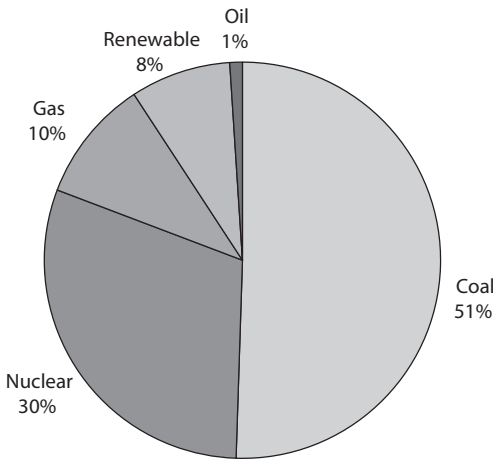


**Figure 2.** Electricity generation by primary energy sources – France 2007

Source: own measures based on *Newsweek – Polska* 7/2007 from 18.2.2007 and France – Energy Mix Facts Sheets available at: [http://ec.europa.eu/energy/energy\\_policy/doc/factsheets/mix/mix\\_fr\\_en.pdf](http://ec.europa.eu/energy/energy_policy/doc/factsheets/mix/mix_fr_en.pdf)

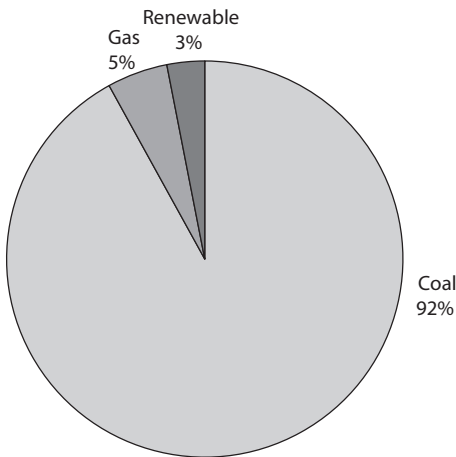
contribute to around 10%, however, the share of gas is increasing<sup>24</sup>. The sources of gas imports to France are well diversified, which suggests that France has taken the necessary steps concerning security of gas supply.

<sup>24</sup> France – Energy Mix Facts Sheets available at: [http://ec.europa.eu/energy/energy\\_policy/doc/factsheets/mix/mix\\_fr\\_en.pdf](http://ec.europa.eu/energy/energy_policy/doc/factsheets/mix/mix_fr_en.pdf). For additional information see also *Gas and electricity market statistics* – data from 1990-2006. Available at: [http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-76-06-289/EN/KS-76-06-289-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-76-06-289/EN/KS-76-06-289-EN.PDF)



**Figure 3.** Electricity generation by primary energy sources – Germany 2007

Source: own measures based on *Newsweek – Polska*, 7/2007 from 18.2.2007 and Germany – Energy Mix Facts Sheets available at: [http://ec.europa.eu/energy/energy\\_policy/doc/factsheets/mix/mix\\_ge\\_en.pdf](http://ec.europa.eu/energy/energy_policy/doc/factsheets/mix/mix_ge_en.pdf)



**Figure 4.** Electricity generation by primary energy sources – Poland 2007

Source: own measures based on *Newsweek – Polska*, 7/2007 from 18.2.2007 and Poland – Energy Mix Facts Sheets available at: [http://ec.europa.eu/energy/energy\\_policy/doc/factsheets/mix/mix\\_fr\\_en.pdf](http://ec.europa.eu/energy/energy_policy/doc/factsheets/mix/mix_fr_en.pdf)

The key gas suppliers include Norway, Saudi Arabia, Russia, Kazakhstan and Iran. Additionally, France has one of the lowest CO<sub>2</sub> per capita emissions in the EU and the lowest in comparison with Great Britain, Germany and Poland.

In Germany, lignite and hard coal are the main energy source, providing nearly half of the generated electricity. Although it is has been scheduled to be phased out, starting in 2010. Nuclear energy provides 29.8%.

The shares of natural gas (9.9%) and renewable energy (7.6%) have been increasing significantly. Germany has the largest installed wind capacity, not only in the EU but worldwide with over 18 GW since the end of 2005<sup>25</sup>. The net efficiency of thermal power plants in Germany is 39%, the highest in Europe<sup>26</sup>. Germany has secured its supply for electricity generation by diversifying its primary energy sources, including its gas supply seems to be in good condition, one-fourth of which it imports from Russia, Norway, the Netherlands and Arab countries through LNG terminals. Germany generates 10% of its electricity from gas, the third highest percentage (behind the United Kingdom and the Netherlands)<sup>27</sup>.

Electricity generation in Poland is based almost exclusively on domestic coal – 92% in 2008, the highest in the EU. In consequence, Poland depends less on energy imports (with regard to primary energy sources in electricity generation) than any other EU nation – 14.7% compared to the EU-27 average of 50.1%. However, Poland's exclusive dependence on coal has also negative consequences, especially in terms of high GHG emissions and therefore the necessity to buy extra limits of CO<sub>2</sub> emissions on the free market. In 2005, CO<sub>2</sub> intensity (tCO<sub>2</sub>/toe) reached 3.2, whereas the average for EU-27 was 2.2<sup>28</sup>. Poland ranked third among the EU-27 in total CO<sub>2</sub> emissions from electricity generation and district heating, having reached as much as 162 million tons.

Poland's reliance on natural gas to generate electricity has been increasing; nevertheless it is still very low. Lately, some have worried about the security of the country's gas supplies, with Russia being by far the major supplier. In order to diversify its supplies, Poland has been in discussions with Norway. The problem is that Poland's present gas transmission pipelines run in an east-west direction only. In order to import gas from Norway, Poland would have to develop some north-south pipelines as well as a LNG terminal (which is underway). In the meantime, Poland has agreed on a *power bridge* with Lithuania and plans to develop a new nuclear plant either in cooperation with Russia in Kaliningrad or alone. Finally, Poland generates a small percentage of its electricity from oil and renewable resources.

In Great Britain, gas has replaced coal as the main fuel for generating electricity, mainly due to environmental pressures and the increased

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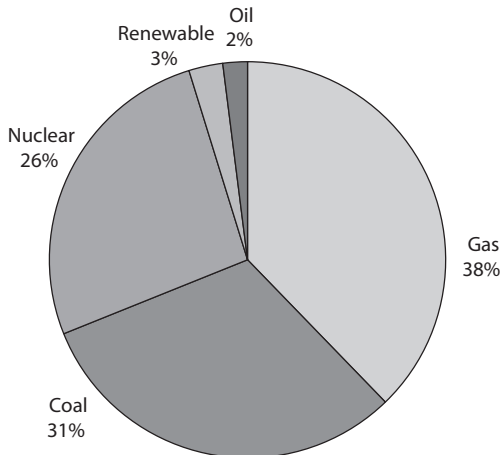
<sup>25</sup> [www.ewea.org](http://www.ewea.org)

<sup>26</sup> Germany – Energy Mix Facts Sheets available at: [http://ec.europa.eu/energy/energy\\_policy/doc/factsheets/mix/mix\\_de\\_en.pdf](http://ec.europa.eu/energy/energy_policy/doc/factsheets/mix/mix_de_en.pdf)

<sup>27</sup> See *Gas and electricity market statistics – data from 1990–2006*. Available at: [http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-76-06-289/EN/KS-76-06-289-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-76-06-289/EN/KS-76-06-289-EN.PDF)

<sup>28</sup> Poland – Energy Mix Facts Sheets, available at: [http://ec.europa.eu/energy/energy\\_policy/doc/factsheets/mix/mix\\_pl\\_en.pdf](http://ec.europa.eu/energy/energy_policy/doc/factsheets/mix/mix_pl_en.pdf)

availability of gas, especially from Norway. Gas currently accounts for around 40% of total electricity generation, coal for 33%, nuclear power for 22.7%, renewable sources for 2.8%, and oil for 1.8%. Until recently, Great Britain depended on oil, gas and coal. However, the gradual depletion of the oil and gas reserves and a significant decrease in coal production have led Great Britain to rely increasingly on imports. Nevertheless, Great Britain is still the largest producer of oil and gas in the EU. Since the end of 2005, it had proven oil reserves of around 4 billion barrels and gas reserves of around 0.53 trillion cubic meters<sup>29</sup>. The fact that GB is the largest producer of gas in the EU does not mean that it consumes its own reserves. It imports a lot of gas from Norway and Arab countries. The United Kingdom imports 5.2% of its energy consumption – which is less than France, Germany and Poland, and much, much less than the EU-27 average of 50.1%.



**Figure 5.** Electricity generation by primary energy sources – GB 2007

Source: own measures based on Newsweek – Polska 7/2007 from 18.2.2007 and Poland – Energy Mix Facts Sheets available at: [http://ec.europa.eu/energy/energy\\_policy/doc/factsheets/mix/mix\\_fr\\_en.pdf](http://ec.europa.eu/energy/energy_policy/doc/factsheets/mix/mix_fr_en.pdf)

### 3.3. Diversification of the energy mix and third country aspects

Security of supply, especially of gas, is a concern of individual nations, but it should be seen from the perspective of the European Union as a whole.

<sup>29</sup> UK – Energy Mix Facts Sheets, available at: [http://ec.europa.eu/energy/energy\\_policy/doc/factsheets/mix/mix\\_uk\\_en.pdf](http://ec.europa.eu/energy/energy_policy/doc/factsheets/mix/mix_uk_en.pdf)

The need for a common EU energy policy on security of supply, more evident now than ever before, has been particularly highlighted in January 2006 and 2009 when Russia cut off the gas supply to the Ukraine. At that time, the EU, being dependent on gas from Russia delivered by pipelines through the Ukraine and Belarus, realized the full extent of its vulnerability in the sphere of energy security and the need for a common EU energy policy on security of supply. Shortages of energy supplies carry implications not only for domestic producers and consumers, but also for the external security of the entire EU. In fact, energy becomes a strong bargaining chip and a political toll for Russia who can easily exert pressure on the EU members – especially those who do not possess their own supplies and whose energy sources are not diversified. However, the problem of dependence on foreign gas is common to all European countries, albeit to a different extent. While in the Western European countries the level of dependence on a single source hardly exceeds 30%, the CEE level of energy dependence on Russian gas oscillates between 50–100%<sup>30</sup>, and for Poland it is 65%. Because of this shared requisition, the EU demands a more cohesive common policy. This might not necessarily prove to be a common one at the beginning, but one that at least shows solidarity, on the part of the European Union in terms of energy supply. In fact, as a solid bloc, the EU possesses an enormous buying power that comes from being one of the world's largest energy consumers. However, Europe's approach to energy in the past has been *disjointed, failing to connect different policies and different countries*<sup>31</sup>. Member State different levels of dependence on energy sources, protectionist policies of governments and the disparity in perceptions towards Russia between CEE states and Western Europe, just to name a few issues, are responsible for lack of a common policy in the sphere of energy.

In this regard, the concept of an internal energy market strongly corresponds with the objectives of security of supply. Firstly, the internal market for electricity and gas with common rules is certainly a strong incentive for new investments in generation/production and infrastructure capacity. Secondly, competitive and integrated markets support diversification, since the flexibility to react to market conditions is encouraged. Here, the EU has aimed to provide its energy companies, through an integrated market with many different and accessible supply routes, a much stronger bargaining position in the global markets. However, cross-border interconnections remain a major concern with respect to a fully

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<sup>30</sup> Balmaceda M. (2003) op. cit.

<sup>31</sup> "Europe's Energy Challenge, *International Herald Tribune*, March 8, 2006. Available at: <http://www.iht.com/articles/2006/03/07/opinion/edbarroso.php>

operational and integrated market. Moreover, the EU does not speak with one voice, especially concerning gas supplies, mainly because there are still 27 different energy mixes and import dependence structures. As a result, the EU energy security policy largely relies on intergovernmental co-operation, in which each Member State may exercise veto power<sup>32</sup>.

In fact, the problem with a joint energy policy, one that takes into account European dependence on gas imports, and especially dependence on Russia, also rests on the disparity in perceptions towards Russia between the new Member States and the old Member States. Poland supported by the Baltic States envisaged the European Union as a union where the new Member States would move quickly to reduce their energy dependence on Russia and the EU itself would adopt a much tougher and collective position in its relations with Russia. But Germany and France did not seem to realize the legacies of difficult relations with the Soviet Union for the CEE countries, thus claimed they were unwilling to isolate Russia, preferring instead to engage in a long energy relationship that is beneficial to both sides. For France and Germany, where imports of gas from Russia constitute around 30% of all imported gas<sup>33</sup>, cooperation with Russia is not perceived as deeply threatening to the domestic security of supply. For the CEE countries, on the other hand, where dependence on Russian gas oscillates between 60% to 100%, close cooperation with the former regional hegemon is politically hard to accept. Moreover, the fact that especially Germany has staked on strengthening relations with Russia, allows speaking about special or strategic relations between Russia and Germany<sup>34</sup>. In this, signing the agreement for the project of Nord Stream, where the head of this project was chosen to be Gerhard Schröder, the former Chancellor of Germany, actually meant the finalization of the political union between Russia and Germany. Such a special relation with regard to energy sources, especially among those two countries, is difficult to accept by the new Member States and especially by the Baltic countries.

<sup>32</sup> See for more Egenhofer Ch. (2002) *Turning Point: European Energy Policy*, Center for European Policy Studies. Available at: [http://www.british-energy.co.uk/documents/Turning\\_Point\\_-\\_European\\_energy\\_policy.pdf](http://www.british-energy.co.uk/documents/Turning_Point_-_European_energy_policy.pdf)

<sup>33</sup> Bundesministerium für Wirtschaft und Technologie (2006) Kurzbericht. Verfügbarkeit und Versorgung mit Energierohstoffen. Berlin, March 29. Available at: [www.bmwi.de/BMWi/Navigation/Presse/pressemitteilungen,did=127764.html](http://www.bmwi.de/BMWi/Navigation/Presse/pressemitteilungen,did=127764.html)

<sup>34</sup> For more on this see Rahr A. (2007) *Germany and Russia: A special Relationship*, The Center for Strategic and International Studies and the Massachusetts Institute of Technology, p. 1. See also Gusev A. (2008) *Energy Relations between the European Union and Russia: content, problems, prospects*, L'Institut Européen des Hautes Études Internationales, Nice, pp. 68–74. Available at: <http://www.iehei.org/bibliotheque/memoires2008/Gusev.pdf>



Consequently, due to a lack of a common external energy policy, many Member States have negotiated long-term supply contracts, particularly with Gazprom, on the basis of their individual domestic political needs rather than, on the basis of their collective need for secure supply, a development that has had a negative impact on the EU efforts to liberalize the gas market. Gazprom, of course, has not objected, since a highly liberalized market in Europe certainly would not be good for it. Gazprom likes its long-term contracts with big, dominant companies; it does not want liquid markets in which smaller downstream companies compete to buy sources. As Sergey Korovin, Gazprom's deputy head of international business, acknowledges in his interview with *Gas Matters*<sup>35</sup>, Gazprom *would rather keep negotiating with its old customers under the framework of long-term contracts. If it works, why change it?* It is much easier for Gazprom to enter the European market in cooperation with the largest players than in cooperation with small, fragmented ones. Additionally, high gas prices help Gazprom maintain its dominant position in the European upstream market.

One way to loosen Gazprom's stranglehold while minimizing the risk of reduced or interrupted gas supplies to Europe would be to turn to renewable energies. In a power-generating portfolio, renewables, even if they cost more, will reduce generating costs and risks, because their costs are not linked to resource depletion (Hubbert's peak), as are the costs of fossil fuels. In other words, diversifying the generation portfolio through renewables reduces expected generating costs and risks. Moreover, a ten percent increase of the worldwide shares of renewable-based generation is worth approximately \$200 billion in avoided GDP losses. If converted into a per-kilowatt effect, it is estimated that about a quarter of the investment cost of every kilowatt of new wind, geothermal or solar energy would be offset by avoiding a GDP loss<sup>36</sup>.

Clearly, using renewable energies does not minimize the risk of reduced gas supplies that are used for other purposes than electricity generation – for example, heating, cooking or the petrochemical industry. Once natural gas became a tool of political pressure, the security of Europe's gas supply was considerably shaken. As a matter of fact, the EU is currently in a very difficult situation. Lack of solidarity and common policy among Member States gives Gazprom a wider spectrum of

<sup>35</sup> European incumbents display opposition to ownership unbundling at Flame, *Gas Matters March 2007*, p. 20.

<sup>36</sup> If the investment is \$1000 per kilowatt e.g., in wind turbine, \$250 is potentially offset by avoided GDP losses. For more on this see Ahmels P., May H. (2006) Renewables can best reduce the economic risks. *New Energy*, Vol. 2.

possibilities for negotiating upstream supply contracts with individual Member States. Unfortunately, the EU is to some extent responsible for this situation. Regrettably, the EU lost momentum at the end of the 1990s when the prices of gas were low and Russia badly needed foreign investments. It was a perfect time for EU gas companies to secure their supply interests and to begin cooperating with state-owned Russian companies. They missed this signal opportunity. Today, the price of gas is high and the demand is constantly growing. Russia is the main gas producer in the world – it controls one-third of the world gas reserves – and can either develop its own technology or buy it from independent contractors. In consequence, it will not have to hand its reserves over to foreign companies. As a result, the future of the EU legislation that would bind Member States to open up their energy markets to foreign companies, legislation such as the Energy Charter Treaty, is bleak as long as prices of gas or oil remain high.

Additionally, it seems that the main reason why Russia did not ratify the Energy Charter Treaty is the presence of the Transit Protocol in the Treaty, according to which the admission of foreign companies to national transport infrastructure is provided under internal tariffs. As a result, countries like Azerbaijan, Georgia, Kazakhstan, Turkey, Turkmenistan and Uzbekistan, having large oil and gas resources and desiring to transport them to the EU on favorable terms through the territory of Russia, would be able to do so under the umbrella of a legally binding Treaty. In fact, all these countries have signed and ratified the Energy Charter Treaty and are directly interested in the ratification of the Energy Charter Treaty by Russia. Russia on the other hand, is afraid that ratifying the Energy Charter Treaty will increase the influence of Central Asia and Caspian countries in the world trade of gas and oil, thus decrease Russia's control over commodity streams in the world market and its influence on political decisions and dominance in the region. Russian apprehensions are confirmed by the fact that the cost of gas in Caspian countries is below the average of Russia. Therefore, it is rather clear that the ratification of the Energy Charter Treaty by Russia would increase deliveries of gas from Central Asia and Caspian countries to the EU markets, thus potentially decreasing the flow of Russian gas to the EU. From the EU perspective, a wider spectrum of choices as to gas sources would, apart from increasing the security of supply, reduce the price of gas delivered to Europe in general.

Finally, it is true that Europe is dependent on gas from Russia, but conversely, the EU is also Russia's largest client. If Russia loses credibility as a reliable supplier of gas, it stands to lose revenues in the future. However, two main issues seem to hamper a healthy relationship

between the EU and Russia when it comes to supplies of energy: the European Energy Charter, which Russia refuses to ratify, as well as liberalizing energy networks within Russia with access granted to the EU<sup>37</sup>.

### 3.4. Conclusions

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The external dimension of the EU's energy policy is of crucial importance, as Europe is heavily dependent on external energy resources. Moreover, EU's increasing energy dependence, together with a decrease of its energy production, and limited contribution from renewable energies in many Member States, add further doubts and increase the feeling of urgency for a common energy policy. In fact, the Commission's Green Paper on Secure, Competitive and Sustainable Energy considers a coherent external energy policy with security of supply as a priority area of the overall EU energy policy. An enhanced security of energy supply in the EU requires diversification. The best way to achieve diversification of energy supplies is through the creation of additional infrastructure and finding new upstream suppliers. Here the establishment of a competitive internal energy market is of paramount importance. Competition fosters innovative solutions, as well as investments in new infrastructure, research and development leading to new technologies. As competition develops, the number of upstream producers supplying EU gas markets will continue to increase, both regarding pipelines and LNG supplies, linking Europe with new supply regions and routes. In fact, the combination of a well-functioning internal energy market and the formation of partnerships with EU's main energy partners-suppliers (especially Russia and perhaps in the future also the Caspian countries), constitutes a solid EU energy policy in its external dimension. However, in order to achieve such a model, the Member States need to speak with one voice. Unfortunately, the EU is not speaking with one voice regarding gas supplies. As a result, the Community goals are shifted to a second plan, giving priority to domestic aims, often creating tensions between the Members. Moreover, the extensive dependence on imports on the part of certain Member States and the lack of a coherent European strategy towards the security of supply significantly affect the bargaining position of the Community. This gives Russia the possibility to use gas supplies as a bargain chip, increasing its power while negotiating with particular Member States.

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<sup>37</sup> For more on this see EU's energy dilemma: with or without Russia? *EU Business*. March 22, 2006. Available at: <http://www.eubusiness.com/Energy/russia>

Finally, at present, the gas and electricity market dynamics and levels of competitiveness vary enormously across the EU 27, due to the diverse patterns of energy consumption, fuel mixes, sources of supply and the natural resources among them. This variation, which is both historical and structural, among Member States has created the current variation in openness to competition and most probably will continue to hamper the emergence of a truly external energy policy for a number of years.

# General conclusions

The nature and number of infringement cases<sup>38</sup> across the European Union clearly reveal the insufficiencies of the current EC energy legal framework. So does the disappointing pace at which the European electricity and gas markets have been opened to competition and harmonized across national borders in order to create a common energy market. What are the main obstacles to a healthy competition in both gas and electricity markets? They include highly concentrated markets, the protectionist policies of domestic governments, different import dependences, the vertical integration of supply, generation, transmission and distribution, infrastructural obstacles to equal third party access, and insufficient investment in infrastructure, especially in interconnections among national systems. They also include domestic markets that are dominated by the national champions, which seek further consolidation rather than market opening, as the EDF and GDF in France and the RWE and E.ON in Germany illustrate. These corporations are domestic monopolies that are also some of the largest vertically integrated gas

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<sup>38</sup> Until January 2007, the Commission has launched 34 infringement procedures against 20 Member States for violation and non transposition of the existing Electricity and Gas Directives. All four compared countries have received Letters of Formal Notice from the Commission. Poland and France have been charged with absence of or insufficient legal unbundling distribution system operators, absence of the notification of the public service obligations; preferential access for certain contracts in the electricity market. France additionally has been alleged for maintaining regulated prices, which block the arrival of new suppliers and the non-publication of commercial conditions for access to storage. Germany and the UK have received Letters of Formal Notice regarding the E-Directive for maintaining preferential access for certain historical contracts in the electricity markets and Germany additional for the absence of the notification of public service obligations. For more on this see also Memo/06/152 on infringement procedures opened in the gas and electricity market sector, by Member State. Available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/06/152&format=PDF&aged=1&language=EN&guiLanguage=en>

and electricity companies in the EU. Further consolidation on their part would not promote but interfere with competition in the domestic and common European markets. In this regard, the recent merger of Gaz de France and Belgium's Suez may well create a global player able to compete across all European markets and expand overseas. However, it is also likely to reduce competition in their respective home markets. Similarly, Poland's recent consolidation of the electricity sector along with the already established consolidation of the gas market are obstacles to competition. Poland's gas champion, PGNiG, illustrates how vertical integration is harmful for competition and customer choice. The only fully vertically integrated company controlling the entire Polish gas chain as well as gas storage capacity, PGNiG, has the means to get rid of any competition (Emfesz case). In addition, such Polish authorities as the Ministry of Economy and the Ministry of Treasury, the state owner of energy monopolies, do not seem to take the lack of competition in the gas sector seriously. As a result, vertical integration and high market concentration are at the root of the lack of a truly competitive gas market in Poland.

In fact, the implementation of the energy *acquis* leading to the creation of a competitive energy market after the 2004 enlargement has faced several obstacles in Poland. Firstly, there are gaps in the implementation relating to unbundling and to a nondiscriminatory third party access (TPA) to the infrastructure. TPA provisions are most often perceived by stakeholders in Poland to be complex, creating unnecessary restraints for new players on the market. Five years after the EU enlargement, problems remain concerning non-transparent capacity allocation, insufficient network information and priority access for long term contracts. Secondly, the lack of a proper and modernized energy infrastructure in Poland represents a rather significant obstacle to the enhancement of competition and internal energy market creation. Since economic indicators show that the current demand for energy services greatly exceeds the available supply, Poland's growing energy needs will require both domestic and foreign direct investment. The opening of the energy sector to investments as a mean of alleviating energy shortages in Poland is not an option but a necessity that has become increasingly urgent over the past years. Poland suffers from a long-standing lack of investments in production capacity and from a lack of development and appropriate maintenance of the electricity and gas transmission and distribution grids.

In addition, as a new member Poland has faced various institutional weaknesses while implementing the energy *acquis*. Prior to accession, the insufficient quality and quantity of administrative resources for the

application of the EU energy legislation and the enforcement of this legislation – that is, the insufficient personnel, financial resources and technical capacities of the responsible agencies, most notably the regulatory and competition authorities – was not adequately recognized. Poland's poor implementation is less a matter of deliberate avoidance than of inefficient national bureaucracies. Therefore, there is still a significant discrepancy between the declared policy aims and existing administrative capacity, and the resources for achieving those aims. Also the independence of the regulatory body – URE – is in question. In Poland, where statutory regulation is still a fairly new concept, there is neither a general legal framework nor a commonly held view about how agencies should function in practice. Limits to the political independence of regulators and to the scope of their powers are still being debated. The trend, however, is clear: in spite of residual constitutional doubts and democratic concerns, independent regulators have become a necessary component of effective governance in all industrialized countries.

Indeed, independence of regulators can be promoted or protected by: (i) legal and statutory provisions; or (ii) a regulatory culture, traditions, and practices. However, in the case of accession, a country's regulatory "tradition and culture" should not be taken for granted; thus legal and statutory protection are essential<sup>39</sup>.

Finally, the energy sectors of all Member States are in reality dominated by national interests. One has to remember that the energy sector is economically and strategically very important to national policy makers. Not surprisingly, the electricity and gas industries have particularly been subject to high degrees of government ownership and control. Because the Member States have been very reluctant to give up control over energy policy and hand it over to the European institutions, a majority of the Member States wish to retain maximum control over their national energy policies.

To overcome the dominance of national interests, the EU not only needs to complete the establishment of an internal energy market, it also requires a common energy policy and a system of energy solidarity, especially in the case of supply problems. The present practice of individual Member States taking important energy decisions without consulting or assessing their impact on other Member States hampers the coordination of the energy policy and the establishment of common objectives for the EU as a whole. Another important issue is the endowment of

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<sup>39</sup> For more on this see Majone G., Surdej A. (2006) *Regulatory Agencies in Economic Governance. The Polish case in a comparative perspective*, KICES working papers, Koszalin Institute of Comparative Administrative Studies, No. 5/2006.

Member States with natural resources. Some of the countries are producers, such as the UK and the Netherlands, while the majority of them are energy importing countries. As a result, there is a great variation in the level of import dependence among EU countries, which, apart from disparities in the relations with Russia among Member States, creates a rather difficult obstacle to energy market integration and a common energy policy. Other significant reasons impeding the common approach in energy policy are the differences in the energy mixes of the Member States and the different structures of the national energy sectors. This predetermines different national energy priorities and sets the pattern for respective energy policies, such as protectionism. The protectionist trends are visible for instance in France and Poland. The first fears that in an open market it could lose its national champions, and the second that its energy sector will end up under Russian control, giving rise to its energy security.

The Treaty of Lisbon should bring, among other things, provisions to the primary law, which refer to the principle of energy solidarity anticipated by Poland as well as other new Member States. However, in order to enable energy solidarity, the EU will not only have to develop rules for strategic stocks and crisis management mechanisms for fossil fuels, but it also has to support the construction of storage and network infrastructure. Perhaps in combination with a real internal energy market, such developments will enable the Member States to have comparable energy mixes and import dependencies and therefore similar interests in the field of external energy policy.



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Academic and Professional Press  
First edition  
Pages: 120  
Typesetting: Editions KeyText, Warsaw  
Printing and binding: Fabryka Druku Sp. z o.o., Warsaw