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COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending 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

for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending 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

for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

establishing an Agency for the Cooperation of Energy Regulators

for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Regulation (EC) No 1228/2003

and for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Regulation (EC) No 1775/2005

EXPLANATORY MEMORANDUM

Electricity and gas are at the heart of the Europe's well-being. Without a competitive and efficient European electricity and gas market, Europe's citizens will pay excessive prices for what is one of their most fundamental daily needs. The electricity and gas market is also essential for Europe's competitiveness as energy is an important input for European industry.

Furthermore, a competitive and efficient electricity and gas market is a pre-condition to tackle climate change. Only with a functioning market is it possible to develop an effectively functioning emissions trading mechanism and a renewable energy industry that will meet the ambitious objective, agreed by the European Council of ensuring that the EU's energy mix is sourced 20% from renewable energy sources by 2020.

Finally, a competitive EU-wide electricity and gas market is crucial to ensure the security of Europe's energy supply, as only a Europe-wide and competitive market generates the right investment signals and offer fair network access for all potential investors, and provides real and effective incentives to both network operators and generators to invest the billions of Euros that will be needed in the EU over the next two decades.

The process of liberalising the electricity and gas market started about 10 years ago. During these 10 years, many of Europe's citizens have benefited from more choice and more competition, with improved service and security. The assessment carried out by the Commission and Europe's energy regulators has however demonstrated that the process of developing real competitive markets is far from complete. In practice, far too many of the EU's citizens and businesses lack a real choice of supplier. Market fragmentation along national borders, a high degree of vertical integration and high market concentration are at the root of the lack of a truly internal market.

Since the entry into force of the present electricity and gas Directives in July 2003, the Commission has constantly monitored their implementation and their effects on the market, and it has been in regular contact with all stakeholders concerned. In particular, the Commission has, every year, published its benchmarking report on the implementation of the internal electricity and gas market. It has organised the Electricity Regulatory Forum of Florence and the Gas Regulatory Forum of Madrid bringing together on a regular basis ministries, national regulatory authorities, the Commission, transmission system operators, suppliers, traders, consumers, trade unions, network users and power exchanges.

At the end of 2005, the Hampton Court European Council called for a true European Energy Policy. In response to this call the Commission published on 8 March 2006 a Green Paper on developing a common, coherent European Energy Policy. The public consultation yielded 1680 responses. Already in 2005, the Commission started an inquiry into competition in gas and electricity markets. The energy inquiry responded to concerns voiced by consumers and new entrants in the sector about the development of wholesale gas and electricity markets and limited choice for consumers. The Final Report of the inquiry was adopted by the Commission together with a comprehensive package of measures, to propose a new Energy Policy for Europe on 10 January 2007.

The Commission Communication of 10 January 2007 entitled "An Energy Policy for Europe"¹ highlighted the importance of completing the internal market in electricity and natural gas. It was backed by a comprehensive internal market report, the final results of the competition sector inquiry and in-depth reviews of the situation of the national electricity and gas market. In parallel, the Commission has carried out an impact assessment to assess policy options related to the completion of the internal gas and electricity market. The impact assessment included a stakeholder consultation. A total of 339 questionnaires were filled out by organisations having their roots in 19 countries. In addition 73 questionnaires were received by organisations not connected to a particular country. Interviews were conducted with 56 additional stakeholders, mainly companies which could be affected by the unbundling of their assets or increased transparency requirements.

The 2007 Spring European Council invited the Commission to propose further measures, such as:

- the effective separation of supply and production activities from network operation;
- the further harmonisation of the powers and enhanced independence of the national energy regulators;
- the establishment of an independent mechanism for cooperation among national regulators;
- the creation of a mechanism for transmission system operators to improve the coordination of networks operation and grid security, cross-border trade and grid operation; and
- greater transparency in energy market operations.

The European Council also underlined the need to strengthen security of supply in a spirit of solidarity between Member States.

In its Resolution on Prospects for the internal gas and electricity market adopted on 10 July 2007, the European Parliament expressed strong political support for a common energy policy, considering that "transmission ownership unbundling is the most effective tool to promote investments in infrastructures in a non-discriminatory way, fair access to the grid for new entrants and transparency in the market". Parliament underlined, however, that other measures were also necessary and that the differences between the electricity and gas markets might call for differing implementation arrangements. Parliament also called for enhanced "cooperation between national regulators at EU level, through an EU entity, as a way to promote a more European approach to regulation on cross-border issues".

The Council of European Energy Regulators (CEER) welcomed the Commission's Communication of 10 January, and strongly endorsed the call for new EU legislation to put the single energy market project back on track. On 6 June 2007, the European Energy Regulators published a set of six papers taking position on the main issues in the new energy legislation. They supported in particular the Commission's proposals for a strengthened independent regulatory oversight at national and EU level, and for effective unbundling of the

¹ COM(2007) 1 final.

transmission networks. The regulators clearly recommended that ownership unbundling of transmission should, in principle, be the model required in new EU legislation and should apply to both electricity and gas.

These elements were taken fully into consideration in drawing up the current proposals, which are summarised below.

1. EFFECTIVE SEPARATION OF SUPPLY AND PRODUCTION ACTIVITIES FROM NETWORK OPERATIONS

1.1. Existing unbundling provisions are not sufficient to ensure a well-functioning market

Existing legislation requires that network operations be legally and functionally separated from supply and generation or production activities. Member States have complied with this requirement by applying different organisational structures. Several Member States have created a totally separate company for network operation, while others have created a legal entity within an integrated company. The requirements of legal and functional unbundling have made a positive contribution to the emergence of competitive electricity and gas markets in several Member States.

However, experience has shown that where the transmission system operator is a legal entity within an integrated company, three types of problems arise.

Firstly, the transmission system operator may treat its affiliated companies better than competing third parties. In fact, integrated companies may use network assets to make entry more difficult for competitors. The underlying reason is that legal and functional unbundling do not solve the fundamental conflict of interest within integrated companies, whereby the supply and production interests aim to maximise their sales and market share while the network operator is obliged to offer non-discriminatory access to competitors. This inherent conflict of interest is almost impossible to control by regulatory means as the independence of the transmission system operator within an integrated company is impossible to monitor without an excessively burdensome and intrusive regulation.

Secondly, under the current unbundling rules, non-discriminatory access to information cannot be guaranteed as there is no effective means of preventing transmission system operators releasing market sensitive information to the generation or supply branch of the integrated company.

Thirdly, investment incentives within an integrated company are distorted. Vertically integrated network operators have no incentive for developing the network in the overall interests of the market and hence for facilitating new entry at generation or supply levels; on the contrary, they have an inherent interest to limit new investment when this will benefit its competitors and bring new competition onto the incumbent's "home market". Instead, the investment decisions made by vertically integrated companies tend to be biased to the needs of supply affiliates. Such companies seem particularly disinclined to increase interconnection or gas import capacity and thereby boosting competition in the incumbent's home market to the detriment of the internal market.

To sum up, a company that remains vertically integrated has an in-built incentive both to under-invest in new networks (fearing that such investments would help competitors to thrive

in “its” home market) and - wherever possible - to privilege its own sales companies when it comes to network access. This damages the EU's competitiveness and its security of supply and prejudices the attainment of its climate change and environmental objectives.

Investment figures from recent years show this: vertically integrated companies have, for example, reinvested significantly less of their receipts from cross-border congestion rents in new interconnectors than fully unbundled ones. Effective unbundling removes the kind of distorted investment incentives typical of vertically integrated transmission system operators. It thus promotes security of supply. The Commission has observed that effective unbundling of transmission system operators promotes TSO investment activity. The Member States concerned have subsequently attracted new infrastructure investors that, for example, build terminals for liquefied natural gas (LNG).

Moreover, the price of electricity on different markets in recent years shows the benefits of ownership unbundling: over the last 10 years, vertically integrated companies have raised prices more, and maintained higher prices, than fully unbundled ones.

1.2. More effective unbundling of transmission system operators is therefore clearly necessary.

The concrete proposal in this respect makes it clear that the preferred option of the Commission remains ownership unbundling. In practice this means that Member States must ensure that the same person or persons cannot exercise control over a supply undertaking and, at the same time, hold any interest in or exercise any right over a transmission system operator or transmission system. This provision also applies *vice versa*, that is, control over a transmission system operator precludes the possibility of holding any interest in or exercising any right over a supply undertaking.

This option allows for a situation in which the same person, for example a pension fund, holds non-controlling minority interests in both a transmission system operator and a supply undertaking. However, such a minority shareholder cannot have blocking rights in both undertakings, nor can it appoint members of their boards, nor can any person be a member of the boards of both undertakings. This option, making a clear ownership separation between transmission system operators and any supply undertakings, is the most effective and stable way of achieving effective unbundling of the transmission network and thus of solving the inherent conflict of interest.

In order to implement this option, Member States may choose the following arrangement which may help to fully preserve the interests of the shareholders of vertically integrated companies. The shares of the vertically integrated company may be divided into shares of the company owning the transmission system on the one hand and shares of the supply company on the other. Subsequently, these shares may be attributed to the shareholders of the previously vertically integrated company.

Whilst the Commission considers that ownership unbundling remains the preferred option it does however provide an alternative option for Member States that choose not to go down this path. This option must, however, provide the same guarantees regarding independence of action of the network in question and the same level of incentives on the network to invest in new infrastructure that may benefit competitors. This option, a derogation from the basic ownership unbundling approach, is known as the "Independent System Operator". This option enables vertically integrated companies to retain the ownership of their network assets, but

requires that the transmission network itself is managed by an independent system operator - an undertaking or entity entirely separate from the vertically integrated company - that performs all the functions of a network operator. In addition, to ensure that the operator remains and acts truly independently of the vertically integrated company, regulation and permanent regulatory monitoring must be put in place.

In some instances, vertically integrated energy companies may be forced to dispose of some of their assets, notably their transmission networks, or to hand over the operation of such assets to a third party, in order to comply with the proposed requirements of effective unbundling. But there does not appear to be any alternative to the options proposed if we are to ensure the full independence of the TSOs.

The two options apply in the same manner to the electricity and gas sector. Although the Commission recognises that progress towards ownership unbundling generally speaking is currently more advanced in the electricity sector in the EU, the Commission has found no convincing argument to justify different treatment of the two sectors. In particular, the fundamental conflict of interest between the supply and production activities on the one hand and network operation and development on the other applies equally to both sectors. Moreover, the key to concluding long-term supply agreements with upstream gas producers is not the ownership of the network but the existence of a strong customer base. The EU will undoubtedly remain a highly attractive gas supply market irrespective of the ownership structure of the purchasing companies which, once effectively unbundled, will be able to compete for gas on an equal footing. The Commission recognises, moreover, that gas transportation, as opposed to electricity transmission, involves the physical movement of gas molecules through pipelines. The TSO therefore has a greater degree of control in defining the direction of flows and the capacity utilisation in the system. This means that effective unbundling of the gas networks is at least as important as for the electricity networks.

However, with a view to encouraging investment in new energy infrastructures by supply and production companies, the present proposal includes the possibility of a temporary derogation to ownership unbundling rules for the construction of new infrastructure. This exemption will be applied on a case by case basis, taking into account in the economics of the new investment, the internal market objectives and the security of supply objective.

In keeping with Article 295 EC, the proposal applies in the same way to publicly and privately owned companies. This means that irrespective of its public or private nature, no person or group of persons would be able alone or jointly to influence the composition of the boards, the voting or decision making of both transmission system operators or the supply or production companies. This ensures that where supply or production activities are in public ownership, the independence of a publicly owned transmission system operator is still guaranteed; but these proposals do not require state owned companies to sell their network to a privately owned company. For instance, to comply with this requirement, any public entity or the State could transfer the rights (which provide the “influence”) to another publicly or privately owned legal person. The important thing is that in all cases where unbundling is carried out, the Member State in question must demonstrate that in practice, the results are truly effective and that the companies operate entirely separate from one another, providing a real level-playing field across the whole of the EU. It is on that basis that the Commission will assess whether in individual cases the distinct public bodies fulfil the unbundling requirements set out in this Directive.

Finally, for Member States that have no gas or electricity transmission networks but only a distribution network, the provisions on the ownership unbundling of transmission networks do not apply

1.3. Third country aspects

The present proposal requires the effective unbundling of transmission system operators and supply and production activities not only at national level but throughout the EU. It means in particular that no supply or production company active anywhere in the EU can own or operate a transmission system in any Member State of the EU. This requirement applies equally to EU and non-EU companies.

The package contains safeguards to ensure that in the event that companies from third countries wish to acquire a significant interest or even control over an EU network, they will have to demonstrably and unequivocally comply with the same unbundling requirements as EU companies. The Commission can intervene where a purchaser cannot demonstrate both its direct and indirect independence from supply and generation activities.

Furthermore, well functioning markets and networks are essential for the competitiveness of the economy and for the well-being of the citizens. The goal of the current proposal is to promote competition in the European energy markets and to promote the proper functioning of these markets. In this light it is imperative - without prejudice to the international obligations of the Community and in particular WTO rules – to ensure that all economic operators active on European energy markets respect and act in accordance with market investor principles. Therefore, the Commission proposes a requirement that third country individuals and countries cannot acquire control over a Community transmission system or transmission system operator unless this is permitted by an agreement between the EU and the third country. The aim is guarantee that companies from third countries respect the same rules that apply to EU based undertakings in both letter and spirit - not to discriminate against them. Finally, the Commission will also hold a rapid and in-depth review of the wider aspects of the EU's external policy in energy, and will make the results of that work public.

Concluding on the important question of unbundling, the present proposals for effective unbundling are a necessary and decisive step to achieving EU-wide market integration. It may ultimately help to create supra-national transmission system operators as the operators are no longer held back by mutual distrust. But at the same time, if supra-national transmission operators were created without ensuring their full independence, competition between affiliated supply and production companies would likely be weakened due to the risk of collusion. In the absence of effective unbundling such cooperation would therefore give rise to competition concerns. Notably, the present proposals include several additional measures to promote EU market integration, relating in particular to improved cooperation among transmission system operators.

2. ENHANCED POWERS AND INDEPENDENCE OF NATIONAL REGULATORS

2.1. Strong national regulators to oversee the running of electricity and gas markets

The existing electricity and gas Directives require Member States to establish regulatory authorities. In several Member States, Regulatory authorities are well-established bodies with substantial powers and resources, allowing them to ensure proper market regulation. In other Member States, regulatory authorities have only recently been established and their powers

are weaker or dispersed over different bodies. The comprehensive country reviews carried out by the Commission have revealed this lack of uniformity and in many cases the weakness of the regulatory authority.

The experience of Member States whose markets have been open for several years, and of other utility sectors open to competition, clearly indicates that strong regulators are necessary for a properly functioning market, in particular as regards the use of network infrastructures.

For these reasons, the present proposal aims to strengthen the powers of the regulatory authorities. First, they would be given a clear mandate to cooperate at European level, in close cooperation with the Agency for the Cooperation of Energy Regulators and the Commission, to ensure competitive, secure and environmentally sustainable internal electricity and gas markets within the European Union, and effective market opening for all consumers and suppliers.

Second, it is proposed to strengthen their market regulation powers, in particular in the following areas:

- monitoring compliance of transmission and distribution system operators with third party access rules, unbundling obligations, balancing mechanisms, congestion and interconnection management;
- reviewing the investment plans of the transmission system operators, and providing in its annual report an assessment of how far the transmission system operators' investment plans are consistent with the European-wide 10-year network development plan; monitoring network security and reliability, and reviewing network security and reliability rules;
- monitoring transparency obligations;
- monitoring the level of market opening and competition, and promoting effective competition, in cooperation with competition authorities; and
- ensuring that consumer protection measures are effective.

Electricity and gas differ fundamentally from other traded goods because they are network-based products that are impossible or costly to store. This makes them sensitive to market abuse and regulatory oversight over undertakings active in the electricity and gas market need to be increased. Regulators therefore need to have access to information on the operational decisions of the companies. It is proposed to oblige companies to keep record of the data related to their operational decision for five years at the disposal of national regulatory authorities, as well as at the disposal of competition authorities and the Commission, so that these authorities are able to control effectively allegations of market abuse. This will limit the scope of market abuse, increase the trust in the market, and thereby stimulate trade and competition.

Some types of traders (e.g. banks) already have such obligations under the Markets in Financial Instruments Directive, and they should not have double obligations. Therefore the record keeping obligations should be without prejudice to, and compatible with, the existing Community legislation on financial markets. Regulators of the energy market and the financial markets, need to cooperate in order to enable each other to have an overview over the markets concerned. Prior to adoption of guidelines defining record keeping requirements, the Agency for the Cooperation of Energy Regulators and the Committee of European

Securities Regulators (CESR) are invited to cooperate and advise the Commission on the content of the guidelines.

To enable them to perform their duties, regulatory authorities would be given the powers to investigate, to request all necessary information and to impose dissuasive sanctions. They are also requested to take full account of energy efficiency objectives while performing their regulatory functions.

2.2. Demonstrable independence of regulators brings market confidence

The independence of regulatory authorities is a key principle of good governance and a fundamental condition for market confidence. Existing legislation calls for regulatory authorities to be wholly independent of the interests of the gas and electricity industry. However, it does not specify how such independence can be demonstrably ensured, and it does not guarantee independence from short-term political interests.

As underlined by the 2007 Spring European Council conclusions and by the European Parliament, strengthening national energy regulators' independence is therefore a priority.

It is proposed that the regulatory authority be legally distinct and functionally independent of any other public or private entity, and that its staff and any member of its decision-making body act independently of any market interest and neither seek nor take instruction from any government or other public or private entity. For that purpose, it is proposed that regulatory authorities have legal personality, budgetary autonomy, appropriate human and financial resources and independent management.

3. AN INDEPENDENT MECHANISM FOR NATIONAL REGULATORS TO COOPERATE AND TAKE DECISIONS: THE AGENCY FOR THE COOPERATION OF ENERGY REGULATORS

3.1. The positive experience of ERGEG needs to develop into a formal cooperation structure

Although the internal market for energy has developed considerably, a regulatory gap remains on cross-border issues. In order to tackle this issue, the Commission initiated self-regulatory forums like the Florence (electricity) forum and the Madrid (gas) forum. These forums bring stake holders together in order to strengthen cooperation.

In addition, an independent advisory group on electricity and gas, called the "European Regulators Group for Electricity and Gas" (ERGEG) was established by the Commission in 2003 to facilitate consultation, coordination and cooperation between the national regulatory authorities in the Member States, and between these authorities and the Commission, with a view to consolidating the internal market in electricity and natural gas. ERGEG is composed of representatives of the national regulatory authorities.

ERGEG activities over recent years have made a very positive contribution to the completion of the internal market in gas and electricity by issuing non-binding guidelines and addressing recommendations and opinions to the Commission. Nevertheless, the initiation of self-regulatory forums and setting up of ERGEG has not resulted in the real push towards the development of common standards and approaches that is necessary to make cross-border trade and the development of first regional markets, and ultimately, a European energy market a reality.

As time has progressed the energy sector has become more complex and detailed, and involves to a greater extent different financial interests. The present approach within ERGEG, which in practice usually requires the agreement of 27 regulators and more than 30 transmission system operators to reach agreement, is not producing sufficient results. It has led to a number of non-binding codes and efforts to reach agreement on common approaches through "gradual convergence" but has not led to real decisions on the difficult issues that now need to be taken.

At present the technical rules that electricity companies must operate under, "grid-codes", differ enormously between Member States and often even within a single Member State. These need to undergo a process of convergence and then harmonisation if we are to integrate energy markets in the EU.

The Commission has evaluated the different options for organising the required tasks, including whether the Commission would be able to pursue these tasks itself. Harmonising these issues, as well as making progress on new infrastructure, is not a task that typically falls within the Commission's sphere of activities. The Commission has actually never carried out such an activity. It requires the specialist expertise in the 27 national regulatory agencies (NRAs) to work together; it is they that need to agree on amending their national grid codes. In practice, only a body emanating from the national regulators can catalyse all the necessary resources of national regulators that is fundamental to achieving success on these issues. The Agency can through its Regulatory Board – which consists of NRAs- call upon the staff of these NRAs. The Commission is not in that position.

The Commission has concluded that the tasks required could be best fulfilled by a separate entity, independent and outside the Commission. Both the European Council in the spring of 2007 as well as recent European Parliament resolutions, endorsed this conclusion².

The creation of a more powerful network of national energy regulators was therefore considered. The network of competition authorities created in 2004 under Council Regulation No 01/2003 provides a model. Nevertheless, this would necessitate the creation of autonomous powers for the Commission in the energy sector (currently these powers only exist in the area of competition rules). The powers of the NRAs should, in any event, be reinforced and harmonised.

Furthermore, the model of the system of European Central Banks could be applicable, but it lacks a legal basis in the Treaty. Such a model would simply require an amendment of the Treaty.

The Commission therefore came to the conclusion that if an independent body should be established which can make proposals to the Commission regarding decisions that involve substantive decisions and take individual regulatory decisions which are binding on third

² The European Council agrees in its conclusions to the establishment of an independent mechanism for national regulators to cooperate and take decisions on important cross-border issues, whereas the adopted Vidal Quadras report states that the EP "Welcomes the Commission's proposal to enhance cooperation between national regulators at EU level, through a EU entity, as a way to promote a more European approach to regulation on cross-border issues; underlines that the Commission should play a determining role, whilst not undermining the independence of regulators; believes that decisions by the regulators should be made on specifically defined technical and trade issues and on an informed basis considering, when appropriate, the views of TSOs and other relevant stakeholders, and should be legally binding;".

parties concerning detailed technical issues that are delegated to them, the only solution would be to establish an Agency.

The main proposed tasks would complement at European level the regulatory tasks performed by the national regulators. The structure should provide a framework for national regulators to cooperate, a regulatory review of the cooperation between transmission operators and scope for taking individual decisions concerning infrastructure in the territory of more than one Member State. This analysis reflects the principles defined by the Commission in the draft inter-institutional agreement on the operating framework for the European regulatory agencies³, in particular as regards the power to adopt individual decisions which are legally binding on third parties.

The following proposal draws also on the "ERGEG+" option mentioned in the Commission Communication of 10 January 2007 "An Energy Policy for Europe"⁴.

3.2. 3.2 Main tasks of the proposed Agency for the Cooperation of Energy Regulators

The Agency would complement at European level the regulatory tasks performed at national level by the regulatory authorities by:

- *Providing a framework for national regulators to cooperate.* It is proposed to improve the handling of cross-border situations. The Agency will lay down procedures for cooperation between national regulators, in particular as regards the exchange of information and the apportionment of competence where more than one Member State is involved. This framework will also promote regional cooperation between national regulators.
- *Regulatory oversight of the cooperation between transmission system operators.* The Agency will have responsibility for monitoring and reviewing the activities of the European Network of Transmission System Operators for Electricity and of the European Network of Transmission System Operators for Gas. In particular, it will be involved in the setting of priorities through the Networks' work programme, in the review of their 10-year investment plan, and in the preparation of technical and market codes. The review of the investment plan is without prejudice to the transmission system operators' liability for technical failures as defined under national law. As regards the technical and market codes, the Agency will be empowered to ask transmission system operators to modify their drafts or to tackle more specific issues in detail. It will also be able to recommend that the Commission make these codes legally binding where voluntary implementation by transmission system operators proves to be insufficient or not suited to certain issues. The Agency may recommend modifying the transmission operators' draft or recommend additional provisions to the Commission. In practice, this mechanism will take the form of a constructive and continuous dialogue between the Agency, transmission system operators and the Commission. The involvement of the Agency will be the key to ensuring that cooperation among transmission system operators proceeds in an efficient and transparent way to the benefit of the internal market.
- *Individual decision powers.* With a view to handling specific cross-border issues, it is proposed to vest the Agency with individual decision powers on exemption⁵ requests

³ COM(2005)59 final

⁴ OJ C [...], [...], p. [...].

concerning infrastructure assets of European interest and to decide on the regulatory regime applicable to infrastructure within the territory of more than one Member State. In addition, the Agency would be able to take specific decisions on individual technical issues when these are granted to the Agency under specific Guidelines adopted pursuant to the gas and electricity Directives, under a comitology procedure.

- *General advisory role.* The Agency would in general have an advisory role vis-à-vis the Commission as regards market regulation issues and could issue non-binding guidelines to publicise good practices among the national regulators. On a case-by-case basis, it would also have the power to review, in the light of implementing measures adopted by the Commission in application of Community legislation in the gas and electricity sector, any decisions taken by a national regulatory authority that directly impact on the internal market and provide an opinion to the Commission.

Even though its powers cannot be extended to cover normative decisions (such as the formal adoption of obligatory guidelines) the new Agency will overall play a crucial role in the development and implementation of European gas and electricity market rules.

3.3. Governance of the proposed Agency for the Cooperation of Energy Regulators

The institutional setting and governance principles of the Agency for the Cooperation of Energy Regulators are in principle based on standard rules and practices for Community regulatory agencies.

However, the necessary independence of regulatory functions needs to be taken into account. For that purpose, besides the Administrative Board responsible for all administrative and budgetary matters, it is proposed to create a Board of Regulators, responsible for all regulatory matters and decisions. The Director, appointed by the Administrative Board, after consulting the Regulatory Board, will be chosen from a shortlist adopted by the Commission. The Director will represent the Agency and shall be responsible for the day-to-day management. In addition, the structure of the Agency foresees in a Board of Appeal, which is competent to handle appeals against decisions adopted by the Agency.

3.4. Financial aspects

It is proposed that the Agency should have, given its tasks, a limited staff of 40-50 people. This assessment is based on an extensive analysis of the staff requirements of national regulatory authorities and a careful analysis of the minimum resources necessary to carry out the tasks proposed, in particular in the light of possibilities for synergies in harnessing the resources within national regulatory authorities to assist the work of the agency. The proposed staff is in line with these authorities' needs.⁶ As mentioned above, if the Commission were to endeavour to perform the Agencies' tasks, the number of staff required would be much higher.

The total annual costs of the Agency are estimated at approximately €6-7 million per year, of which €5 million for staff expenditure (taking as the average per person the cost of European Commission staff, i.e. €0.117 million per year, which includes expenditures associated with buildings and related administrative expenditures), €1 million operational costs (meetings, studies, as well as translation, publication and public relations costs) and the rest for capital

⁵ As defined in Article 22 of Directive 2003/55/EC and in article 7 of Regulation (EC) No 1228/2003

⁶ An organigram will be attached to the Explanatory Memorandum.

expenditures (relating to the acquisition of movable property and associated expenditure) and mission expenditures.

The Agency's annual costs will be covered by Community grants. The Agency has limited revenues stemming from fees to be paid by third parties which are charged when the Agency takes certain decisions.

3.5. The role of the Commission

There are in principle three different safeguards to secure the Commission's position and role as a guardian of the Treaty.

First of all, if the Agency takes a decision, such a decision would only be binding for specific technical situations explicitly foreseen in the Regulation and Directives or provided on a case-by-case basis by binding Guidelines. The Agency would have no political discretion outside this framework.

Secondly, if TSO cooperation or decisions by NRAs threaten effective competition and the efficient functioning of the market, the Commission shall immediately be informed by the Agency and can adopt subsequently the necessary measures to remedy the situation. The Commission may also choose to act on its own initiative.

Third, where a substantive decision needs to be taken, this can only be done by the Commission. In these cases the Agency has a preparatory and advisory role only. The Commission Legal Service has scrutinised the text carefully in this respect to ensure that the Agency has no power of discretionary substantive decision.

Furthermore, it would be for the Commission, through the adoption of binding Guidelines to further specify and lay down the role of the Agency.

4. EFFICIENT COOPERATION BETWEEN TRANSMISSION SYSTEM OPERATORS

4.1. Strong cooperation between transmission system operators is necessary for electricity and gas market integration

For market integration to take place, there also needs to be effective cooperation among transmission system operators (TSOs) and a clear and stable regulatory framework, including regulatory coordination. Network access rules and operational rules need to be compatible, there has to be effective exchange of information between transmission system operators and a good coordination of new investment to increase interconnection capacities. Transmission system operators in gas and electricity already cooperate voluntarily in existing structures such as the European Transmission System Operators (ETSO) and Gas Transmission Europe (GTE). They cooperate on operational issues at regional level and participate in technical bodies such as the Union for the Co-ordination of Transmission of Electricity (UCTE) and the European Association for the Streamlining of Energy Exchange (EASEE-Gas). These multi-layer cooperation initiatives have made a significant contribution to the internal market and have boosted the efficiency and the safety of the networks.

However, this voluntary cooperation has shown its limits for example in the form of network incidents and electricity black-outs due to poor coordination of network operation or missing links in the electricity and gas networks, and difficulties in proposing or agreeing common technical standards. It is therefore proposed to task the transmission operators with

strengthening their cooperation in a number of key areas, focusing on the following main issues.

- *Development of market and technical “codes”*. For the integration of the electricity and gas markets a coherent set of technical and market codes are needed. Today, these codes exist on a national basis or through recommendations of organisations such as UCTE or EASEE-gas. The problem with the current situation is threefold: firstly the existing rules do not cover all areas that need to be harmonised in order to make an integrated market function, secondly the national codes are often not compatible with each other and thirdly they are often not legally binding or enforceable. Examples of these codes are UCTE operational handbook for security and reliability of the electricity transmission networks and EASEE-gas recommendations on gas qualities.
- The proposal preserves the voluntary process of the transmission system operators as a pragmatic way of developing detailed technical and market codes. These codes are often technically complicated and there needs to be an efficient process to amend them when necessary. The proposal adds a strong regulatory oversight on the content and on monitoring of compliance and enforcement of these rules by national regulatory authorities, the Agency, and/or the Commission, depending on the nature of the proposal in question. In case the transmission system operators are not able to agree on necessary technical and market codes or do not implement them, these rules can be proposed and adopted through the comitology procedure on the proposal of the Commission.
- In total, the present proposal defines eleven main areas of cooperation. The annual work programmes of the European Network of transmission system operators (see chapter 1.2), prepared in consultation with all stakeholders and the new Agency for the Cooperation of Energy Regulators (see chapter 3), will set priorities and specify in more detail what technical and market codes are needed. Cooperation between transmission system operators should also include implementation monitoring of the technical and market codes.
- *Research and innovation activities of common interest*: TSO cooperation should establish a framework to identify, finance and manage research and innovation activities necessary driving the sound technical development and evolution of the European electricity and gas networks, in particular to promote security of supply and energy efficiency and to enable penetration of low carbon technologies.
- *Coordination of grid operation*. TSO cooperation includes the common operation of networks according to the agreed market and technical codes. It also refers to the exchange of network operational information and the coordinated publication of information on network access, for example through a common transparency platform.
- *Investment planning*. So as to make sufficient transmission capacity available to meet demand and to integrate national markets, network operators would need coordinated long-term planning of system development with a view to planning network investments and monitoring the development of transmission network capacities. The idea is that the European Networks of transmission system operators will publish network development plans, to include the integrated network modelling, scenario development and an assessment of the resilience and deliverability of the integrated system. These development plans should be sufficiently forward looking (e.g. at least 10 years) so as to allow for the

early identification of investment gaps, more especially with cross border capacities in mind.

For the last two of these tasks in particular, regional initiatives play a positive role in market integration. The cooperation of transmission system operators at European level should indeed be complemented at regional level, in order to ensure real practical progress, optimum management of the network⁷ and appropriate investment planning and delivery. The regulatory framework should promote, coordinate and develop regional initiatives between transmission system operator and regulatory authorities, as happens with the Regional Initiatives led by ERGEG and initiatives such as the Pentalateral forum in Northwest Europe and as recommended by major stakeholders like Eurelectric.

4.2. An improved cooperation mechanism

It is important for the transmission system operators' cooperation structures to be fully recognised at European level as having the authority to carry out the above tasks. For that purpose, the Commission will formally designate the European Networks of (gas and electricity) transmission system operators in charge of these tasks.

As companies, transmission system operators must be transparent about the way they cooperate. They may build on existing structures such as GTE and ETSO. However, the tasks and responsibilities required of the transmission system operators will mean a need for a central and permanent cooperation structure both in terms of organisation and practical tools for planning and operating the networks.

The Agency for the Cooperation of Energy Regulators will monitor how the European Network of transmission system operators carries out the tasks conferred upon it.

Involvement and consultation of stakeholders, such as producers, suppliers, customers and distribution system operators will be developed as standard practice by the transmission system operators from the beginning of their work on a specific subject. For that purpose, stakeholders will be consulted on any draft market and technical code prepared by the transmission system operators and they will be able to comment on the annual work programme of the transmission system operators. The Agency will oversee that consultation is done properly.

5. IMPROVING THE FUNCTIONING OF THE MARKET

The present proposal also aims at improving the legislative framework to facilitate third party access to key infrastructures, to increase transparency on the market, to enhance market integration and to improve access to retail customers.

5.1. Exemption regime

The current legislation allows major new infrastructure to be exempt from regulated third party access rules for a pre-determined period. Several infrastructures have been completed or are under way, including gas and electricity interconnectors and LNG facilities that have

⁷ For example, in electricity, it is clear that the setting of technical codes needs to be determined for each synchronous area for some issues.

made use of this possibility. This has helped to take forward projects which benefit security of supply and competition. At the same time, experience so far shows that project developers, regulators and the Commission could benefit from a streamlined procedure for applying for and granting exemptions as well as a clarification of some of the conditions. Therefore, the Commission proposes to formulate guidelines to assist applicants and regulators in applying the conditions for an exemption. To ensure that exempted infrastructure can nevertheless be used optimally by the market, it is proposed to make general the minimum requirements for the allocation of capacity and congestion management provisions for the new infrastructure that have so far been applied on a case-by-case basis.

5.2. Transparency

The internal electricity and gas market is suffering from a lack of liquidity and transparency hindering the efficient allocation of resources, limiting risk hedging possibilities and blocking new entrants. Trust in the market, its liquidity and the number of market participants need to increase, by increasing the information that is available to the market.

Current requirements on transparency focus on publication of capacity of the network, so that market participants are able to see if capacity is available and if all available capacity is being offered to the market. However, market participants also need to have equal access to information that determines wholesale price movements.

Currently, incumbents who are responsible for the largest part of the gas and electricity flows, and who own the majority of the assets in the market, have more and better access to information than new entrants. In electricity, there are requirements in the form of guidelines attached to the regulation setting out transparency requirements on the generation of electricity, but they are not sufficient, and in gas no such requirements exist at the moment. Therefore it is proposed to extend the transparency requirements to cover gas stocks, forecasts of demand and supply, costs for balancing the network and trading.

The correct and full application of these requirements needs to be controlled and monitored by the national regulatory authorities, so their powers need to be strengthened accordingly.

On the issue of transparency regarding derivatives and financial instruments and with respect to which these proposals do not provide for additional requirements on the companies concerned, the Commission will examine this issue in detail and reach a conclusion towards the middle of 2008. The Agency for the Cooperation of Energy Regulators and the Committee of European Securities Regulators are invited to cooperate to further investigate and advise on the question whether transactions in gas and electricity supply contracts and gas and electricity derivatives should be subject to pre and/or post-trade transparency requirements.

5.3. Access to storage

The existing Directive on the internal gas market provides that where storage is an essential facility in order to be able to supply customers, storage operators have to give access to third parties. Member States have the choice to ensure access to these storage facilities either through conditions defined by the regulator or by obliging storage system operators to negotiate access conditions with customers. The requirements in the Directive are limited to the principles, and leave a great deal of freedom to the Member States in defining their regulatory framework. Body was subsequently given to these principles through the Madrid Forum, where all stakeholders agreed to voluntary 'Guidelines for Good Third Party Access

Practice for Storage System Operators' (GGPSSO). However, ERGEG has concluded that overall implementation of these guidelines is poor.

For them to be effectively applied, the Commission proposes four measures:

- Make the principles in the guidelines legally binding and allow for detailed implementation of the guidelines through comitology;
- Establish legal and functional unbundling of storage system operators who are part of supply undertakings;
- Enhance the powers of national regulatory authorities to oversee access to storage;
- Require clarity on the regulatory regime that is applied to storage facilities.

To make the guidelines legally binding, the Regulation will be extended to define how storage system operators must offer third party access services, and how they should allocate capacity and manage congestion. It will also define the transparency requirements and propose measures to enable a secondary market in storage capacity to develop. These rules should ensure that all storage that is available to third parties is offered to the market in a non-discriminatory and transparent manner, and that capacity-hoarding is strongly discouraged. These rules shall also serve to ensure consistency with the proposed minimum requirements on exempted infrastructure.

By requiring legal and functional unbundling of storage system operators, effective access to storage will be greatly enhanced. The fact that currently, when suppliers need storage, they have to contact their competitors to contract their storage need, does not enhance market confidence and is a serious barrier for new entrants. Requiring unbundled storage operators will improve this situation and it will enable competitors and regulators to check that all available storage capacity is offered to the market.

The Commission proposes to erase the ambiguity that exists on the proportion of storage capacity that is offered to the market, requiring that all Member States need to define criteria when and how third party access to storage applies and this has to be made public. The regulator consequently has the task to control if these criteria are applied correctly to all storages.

5.4. Access to LNG terminals

The role of LNG in the supply of gas to the European Union is becoming ever more important, and a lot of investment in LNG terminals is planned or under way. For that reason, transparent rules on access to LNG terminals are needed. Regulators have identified the need, and ERGEG has prepared guidelines with a goal create a common approach to third party access for LNG terminals.

Although many LNG terminals constructed have used the possibilities to be exempted from third party access and regulatory intervention under Article 22 of the Directive, there are also LNG terminals for which third party access rules apply. -Since the current Directive only imposes a general requirement that access has to be regulated, this leaves room to diverging interpretations among Member States. Moreover, an exemption under Article 22 is always temporary, and when the exempted period has passed, LNG terminals will become regulated. Therefore the Commission proposes to impose more clearly defined third party access rules to

LNG terminals. To make the guidelines legally binding, the Regulation will be extended to define how LNG terminal operators should offer third party access services, and how they should allocate capacity and manage congestion. It will also define the transparency requirements and propose measures to enable a secondary market in terminal-capacity to develop. These rules shall also serve to ensure consistency with the proposed minimum requirements on exempted infrastructure.

5.5. Long-term supply agreements

Downstream bilateral supply agreements provide an opportunity to energy intensive industries to obtain more predictable prices. However, such agreements risk foreclosing the downstream market by preventing consumers from switching and thus limiting competition. To reduce uncertainty on the market, the Commission will, in the coming months, provide guidance in an appropriate form on the compliance of downstream bilateral long-term supply agreements with EC competition law.

5.6. A framework for the gradual establishment of a European retail market

Neither in the electricity nor the gas market is it yet possible to speak of a European retail market (households and small enterprises), as customers, assuming they have a choice, are still obliged to choose a supplier established in the same country. Establishing a true European end-user market is the ultimate goal of the internal electricity and gas markets: it is necessary for creating competitive markets and for achieving maximum efficiency. Liberalisation in the retail market is important to ensure that all EU citizens are able to benefit from competition. If liberalisation applied only to large customers, European households would end up subsidising their industry and investment signals for new generation and supply would be distorted. From 1 July 2007, all retail markets in the EU have opened up to competition, but in practice many consumers are tied to their historic suppliers because an appropriate legal framework had not been put in place as required. A European retail market can only be created gradually. To stimulate this process the Commission is considering setting up a retail forum by analogy with the positive experience of the Florence and Madrid Forums. This forum would allow to focus on specific retail issues, and it should serve as a platform for all stakeholders to promote the establishment of an EU wide retail market. The forum would provide guidance for the proposed obligations on the Member States and the regulatory authorities to establish clear rules on competition in the retail market, with a view to gradually harmonising the market rules to allow cross-border retail markets.

Well-functioning retail markets will also play a very important role in increasing people's awareness of domestic energy consumption and the cost of energy, as all measures to reduce CO₂-emissions and increase energy efficiency require action from households. Competition over supply to households will enhance people's energy-awareness. However, current practices whereby consumers only receive the final bill for their consumption after a year do not create such awareness, neither does it enable suppliers to develop competitive services that distinguish between households with specific needs. Suppliers therefore need to give more information to ensure that customers get more frequent information on their energy consumption and costs.

It is obvious that freedom of choice for consumers must be accompanied by strong guarantees on the rights of the customers. Vulnerable customers have already a high degree of protection in the current directive to ensure that they will have access to the energy they need to lead a normal life. These measures have however been incorrectly applied in some countries, and to

clarify the framework, the Commission proposes to define binding guidelines. At the same time, the Commission proposes to strengthen the rights of all customers, among others by giving them the right to change supplier at any time and requiring energy companies that bills are settled within a month after a consumer switches supplier.

Finally, the Commission has come to the conclusion that for Distribution System Operators (DSOs) the current legal and functional unbundling rules are sufficient. It does not therefore propose to extend the ownership unbundling rules outlined in chapter 4 above to DSOs.

6. COOPERATION TO REINFORCE SECURITY OF SUPPLY

6.1. Security of supply monitoring by transmission system operators

It is important to ensure that the electricity and gas systems can meet demand even in peak times. In the case of electricity, this is only possible when there is enough generation capacity (generation adequacy) and the network is capable of transporting the energy from generators to final consumers (network adequacy). In the case of gas, sufficient import and storage capacity need to be in place.

The directive 2005/89/EC requires the national regulators, with the help of the transmission system operators, to report yearly to the Commission on security of electricity supply. Directive 2004/67/EC requires Member States to report on the security of gas supply situation and on the regulatory framework to enhance investment in infrastructure. The proposed amendments to Regulations 1228/2003 and 1775/2005 give the task of making system adequacy forecasts for every summer and winter as well for the long term to the Network of European Transmission System Operators. A European outlook is necessary to take into account the possibilities to export and import electricity and gas in peak demand conditions. Due to the cross-border electricity and gas flows within the internal market, the outlook needs to be carried out at the European level.

6.2. Cooperation of Member States

EU legislation has two instruments dealing with security of gas supply. First, Directive 2003/55/EC introduced general monitoring obligations for the Member States. Second, Directive 2004/67/EC specifically concerns measures to safeguard security of gas supply. This later directive establishes the Gas Coordination Group and defines a "Community mechanism" in the event of supply disruption.

These instruments provide for a coordination platform. They do not define quantitative objectives as regards security of supply, nor do they impose any obligation as regards gas stocks. Finally, they do not provide a framework for regional cooperation in case of severe supply disruptions.

Directive 2004/67/EC was only recently transposed by the Member States. Its Article 10 provides for the Commission to report by 19 May 2008 on its implementation and in particular on the effectiveness of its instruments and that it may issue further proposals concerning security of supply. In particular, this report will address security of supply measures in relation to gas stocks.

For that reason, as a first step, the present proposals do not modify Directive 2004/67/EC and only address two issues:

- *Increased transparency obligations on the level of commercial stocks.* Each storage operator would have the obligation to publish on a daily basis the amount of working gas it has in its facilities. This obligation would considerably increase mutual confidence for regional and bilateral assistance in case of severe supply disruptions.
- *Solidarity* It is proposed that Member States cooperate in order to promote regional and bilateral solidarity. This cooperation is intended to cover situations which would be likely to result in severe disruptions of gas supply affecting a Member State. Examples of this coordination are the streamlining of national measures to deal with emergencies and the elaboration of practical modalities for mutual assistance. The Commission will adopt guidelines for regional solidarity cooperation, if needed.