

The EU's Third Energy Package: Tighter control over Europe's transmission network businesses

The European Parliament has adopted, by a large majority, a compromise agreed between MEPs and the Council Presidency in relation to the third energy package which was originally proposed by the European Commission in 2007 (the "Package"). As with most compromise measures, the text of the Package represents a complex mix of provisions, particularly as regards the extent to which transmission system operation must be separated from other activities.

Under the final Package:

- a compromise on ownership unbundling means the mandatory disposal of transmission network businesses can be avoided;
- enhanced managerial and legal separation requirements are likely to involve the restructuring of some network businesses;
- the Commission has retained a right to be involved in any proposed acquisition of a European transmission network business by a non-EU entity (the so-called Gazprom clause);
- a further boost is given to renewable and low carbon generation in relation to consenting requirements and the development of smart metering, smart grids and energy management services is promoted to encourage energy efficiency; and
- the regime for third party access exemptions for new infrastructure has been limited to exemptions of a definite time period, with the newly created Agency for the Cooperation of Energy Regulators ("ACER") taking on an advisory role for interconnectors.

The Package contains three Regulations and two Directives. The first Regulation requires the establishment of ACER (the "ACER Regulation"). The remaining four legislative proposals replace the existing Second Gas and Electricity Directives and associated Regulations.

A new unbundling regime

One of the most important features of the Package is the "unbundling" regime, ie, the separation of the operation of gas pipelines and electricity networks at transmission level from the business of producing or supplying either gas or electricity. Whilst the Commission and the European Parliament originally backed full ownership unbundling in both the gas and electricity sectors, political pressure from Member States opposing unbundling meant that a compromise had to be found. Under the agreement between the Council and the European Parliament, Member States will have three options:

- full ownership unbundling - requiring the separation and disposal of an integrated transmission business;
- an independent system operator (ISO) model - where ownership can be retained but operation must be independent; or
- an independent transmission operator (ITO) model - where ownership and operation can remain within an integrated utility.

The **ownership unbundling approach** entails a full separation between the operation of gas and electricity transmission networks from supply and production/generation activities. Under this regime, operators of gas and electricity grids can no longer be affiliated with or be part of a group which is also active in supply, generation or production. The operator of the network will be required to own and control the network.

Under the unbundling regime a person or company may still be able to hold shares in both a network operator and a supply/production undertaking as long as the shareholding only represents a non-controlling minority interest and does not carry any voting rights or rights in relation to the appointment of board members or the management of the relevant transmission system operator. This provision is of particular relevance to individual investors (eg, pension funds). No person may be a member of the boards of both undertakings.

In the **ISO approach**, vertically integrated companies may retain the ownership of their network assets, but the network is managed by an ISO. The ISO has to be an undertaking or entity which is completely separate from the vertically integrated company and must perform all the functions of a network operator. The ISO will need to comply with the same unbundling requirements as network operators in the ownership unbundling option. As such, the ISO may not hold any interest in a supply/production undertaking.

In order to strengthen the ISO model, the Package provides for a number of additional regulatory controls: a network owner that is still actively engaged in supply or production will have to legally and functionally unbundle that part of its company which owns the network, and will be required to finance investment decisions made by the ISO; the identity of the ISO must be approved by the Commission (with input from ACER); and, once appointed, the ISO has to commit to complying with a 10 year network investment plan agreed with the relevant regulatory authority in the Member State in which the network is located.

The third option – **the ITO model** – preserves integrated supply and transmission companies but obliges such companies to comply with additional rules to ensure that the activities are operated independently. Unlike the ISO model, an ITO can be owned by the network owner. Under the ITO model:

- there will be restrictions on the management of transmission system operators who may not hold certain positions of responsibility, or have an interest or business relationship, directly or indirectly, with the relevant vertically integrated undertaking for specified periods of time prior to or after the end of their appointment;
- the regulatory authority will examine network development and investment decisions taken by an ITO to ensure they are consistent with the relevant Community-wide plans;
- there will be rules preventing discriminatory behavior by the ITO (and any influence being exerted by the relevant vertically integrated undertaking), and restricting the ITO's access to the capital market, which must be overseen by a supervisory body; and
- there will be penalties, depending on the breach, in respect of the turnover of the ITO or its relevant parent company. The ultimate penalty for a persistently non-compliant ITO model would be the mandatory introduction and designation of an ISO.

The Commission will conduct a specific review of the ITO-related provisions, using effective and efficient unbundling as a benchmark, two years after implementation. Such a review would, in turn, lead, no later than three years after implementation, to proposals to ensure fully effective independence of the transmission system operator where necessary.

The ITO model will only be applicable in Member States where the transmission system operator belongs to a vertically integrated undertaking. Member States that have already introduced the ISO model or mandatory ownership unbundling models will not be able to revert to an ITO model. Therefore, the ITO model constitutes the lowest threshold for network unbundling which will be permissible legally within the EU.

The ITO model can perhaps best be characterised as the "status-quo-plus" model in that it will allow Member States such as France, Austria and Germany to maintain current arrangements where transmission system operators belong to a vertically integrated undertaking.

In the UK, the transmission system operator for England and Wales is already fully unbundled as per the ownership unbundling model. The new Electricity Directive contains a specific provision for the situation in Scotland, where the electricity transmission networks are owned by the two Scottish transmission companies (Scottish Power and Scottish and Southern Energy) and operated by National Grid. Whilst some administrative changes may be needed to bring the Scottish model into full compliance with the provisions of the Package which do not directly concern the unbundling regime, the Package acknowledges that where there are current arrangements in place which guarantee a more effective independence of the transmission system operator than the ITO regime, Member States will not have to apply the ownership unbundling or ISO model. The current model in Scotland is considered to fall short of the ISO model but held to be an effective model for the independence of the transmission system operator.

A softened third country clause

The original version of the Package contained a so-called third country clause, thought to be aimed at Russian energy giant Gazprom, which would have required non-EU companies to be unbundled in accordance with the EU regime if they wished to acquire a significant interest in, or control over an EU transmission network, and would have given the Commission a right to intervene in relation to such acquisitions. In the finalised version of the Package, the third country clause has been softened slightly, although the principle of the application of the unbundling regime to non-EU companies and tight controls over third country investments in EU transmission system operators remains firmly established.

The Package provides that national regulators are to certify transmission system operators before they are allowed to take up their functions. Under the new third country clause, national regulators are required to refuse certification if the relevant company does not comply with the unbundling requirements, and its market entry would jeopardise the Member State's or the EU's security of supply. In addition, national regulators must notify the European Commission if:

- a transmission system owner or operator that is controlled by a party from a non-EU country applies for certification; or
- if any circumstances arise which would result in a party from a non-EU country obtaining control of a transmission system owner or operator.

Transmission system operators must notify the national regulator if any circumstances arise that would result in an entity from a non-EU country acquiring control of the transmission system or its operator. The national regulator must also seek the view of the European Commission as to whether the foreign entity passes the unbundling and "security of supply" tests and take "utmost account" of the Commission's view.

When making a decision in relation to energy security, both the national regulator and the Commission must consider the particular facts, international law and any agreement between the EU or the Member State and the relevant non-EU country to address energy security issues. The implication is that the absence of such an agreement will make an approval much less likely. However, given that the unbundling provisions have been softened to include the ITO model, it is thought that compliance with the unbundling provisions of the Package will now be easier for non-EU companies as transmission system operators may, under the ITO model, remain part of a vertically integrated energy company.

Member States will have three and a half years to give effect to the third country clause, which is two years longer than the Package allows for the remainder of its Directives.

Agency for the Co-operation of Energy Regulators

The ACER Regulation creates an Agency for the Cooperation of Energy Regulators ("ACER"). Compared to the original version of the Package, the version adopted requires ACER to perform a range of additional tasks, which have widened ACER's scope considerably. ACER's tasks now include:

- participation in the development of European network codes;
- monitoring the development of the energy markets, in particular in relation to retail gas and electricity prices;
- monitoring the implementation of the transmission system operator's 10-year infrastructure investment (independently from the applicable unbundling model); and
- establishing non-binding "framework guidelines" on conditions for access to the network for cross-border electricity and gas exchanges.

Although the ACER Regulation will enter into force 20 days following its publication in the EU's Official Journal, it is unlikely that ACER will be fully operational before the Directives of the Package have been transposed into national law. However, various components of the Agency could be established quickly, such as the Board of Regulators, the Administrative Board, the Director of the Agency and his/her staff and the Board of Appeals. It is likely that the establishment of the ACER will be a priority for national energy regulators over the next two years. ACER is likely to be located in Brussels initially and relocated at a later date. So far, Slovenia, Hungary and Romania have expressed their interest in hosting ACER.

The Package promotes "regional solidarity" for security of supply

Other elements of the Package include:

- tasking the Commission with the adoption of binding network codes - eg, on procedures in emergency situations - based on ACER's guidelines;
- the establishment of European Networks of Transmission System Operators for electricity (ENTSO-E) and gas (ENTSO-G) which are to implement the network codes;
- an obligation on transmission system operators to submit a 10-year network development plan to the national regulatory authorities annually;
- measures to improve the regional cooperation between different national regulators; and
- measures to strengthen the independence of national regulators whose independence from political (ministerial) decisions is now enshrined in the Package.

The Package also promotes "regional solidarity" for energy supply security by requiring Member States to co-operate in the event of "severe disruptions" to gas supply. This could be particularly important in the event of an interruption to supply as occurred this winter in Hungary and Slovakia as a result of the Russia-Ukraine gas dispute.

In addition, Member States are tasked with taking measures to address energy poverty, such as introducing National Energy Action Plans or benefits in social security systems to guarantee an energy supply for vulnerable customers. Finally, the Package contains measures to facilitate the creation of

renewable and low carbon generation capacity and the development of smart metering, smart grids and energy management services in order to promote energy efficiency.

Implementation

Member States will have 18 months after publication in the Official Journal of the European Union to transpose the Directives into national law. The Regulations contained in the Package will enter into force 20 days after their publication in the Official Journal. It is thought that publication will occur within the next five or six months.