

## **Towards the Internal Energy Market: how to bridge a regulatory gap and build a regulatory framework**

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### **1. Introduction**

Regulation provides a modern and efficient interface between the public interest, the interests of consumers, the interests of those providing regulated services under monopolistic conditions and the interests of those using the monopolistic infrastructure.

Independent regulation was first introduced in the USA at the end of the 19<sup>th</sup> century, in the field of railways. The regulator's job was perfectly described by US President Theodore Roosevelt in 1905, as briefly recalled in Section 2. Since then, the regulatory function has been extended to several economic areas, in particular to the network industries.

Independent energy regulators are new in Europe - in fact, they are as new (or as old) as free energy markets in the European Union (EU). Both are children of the 1987 Single European Act which actively promoted integration of national markets into one single European market and invented the "1992 Internal Market" agenda. The three concepts of liberalization, independent regulation and supra-national integration of electricity and natural gas markets stem from the EU Internal Market project and are inter-related.

Most energy regulatory authorities were created in the 1990s <sup>3</sup> : a few before the first internal electricity market directive was approved, in 1996 <sup>4</sup>, others following the entry into force of this directive, in February 1997. With the second internal electricity and natural gas market directives<sup>5</sup> independent energy regulatory authorities became mandatory in all Member States. Norway and Iceland, who belong to the European Economic Area, have adopted these directives too and established independent energy regulators<sup>6</sup>.

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<sup>3</sup> Offer, the UK electricity regulator, started its activity on the 1st of September 1989.

<sup>4</sup> Hungary, Finland, Sweden, Spain, Portugal and Italy.

<sup>5</sup> Respectively directives 2003/54/EC and 2003/55/EC of the European Parliament and of the Council, both of 26 June 2003.

<sup>6</sup> In Norway, independent electricity regulation had been already introduced in 1992.

Co-operation among national regulatory authorities provides several mutual benefits, as illustrated in Section 3; therefore, it was no surprise that European energy regulators soon started co-operating.

The first Internal Energy Market (IEM) directives<sup>7</sup> defined some common rules to be applied by all Member States in order to open up their energy markets. For instance, the directives defined minimum unbundling requirements applicable to vertically-integrated undertakings, minimum eligibility thresholds, a menu of network access regimes, etc.. However, these directives provided little guidance as regards cross-border energy trade, development of regional markets, interaction with non-EU markets, development of interconnectors, supra-national integration of energy markets, etc.. Hence, a “regulatory gap” between national markets and the EU internal energy market emerged.

Informal co-operation between national energy regulators and the European Commission represented a pragmatic attempt to overcome the unintended “regulatory gap” created by the first internal energy market directives (or “common rules” directives). Since 1997, energy regulators have co-operated informally among themselves and with the European Commission in order to facilitate the development of an efficient internal energy market. This process is briefly described in Section 4.

EU energy regulators have actively contributed to the construction of the internal energy market, in close co-operation with the European Commission and through consultation of all interested parties. The Council of European Energy Regulators (CEER), established in 2000 (see Section 5) and the European Regulators Group for Electricity and Gas (ERGEG), set up by the European Commission in 2003, provide appropriate platforms for further developing the internal energy market through this co-operative model within the framework of the second IEM directives. Although these arrangements offer a reasonable solution to partially bridge the “regulatory gap” and facilitate the development of the internal energy market in a transparent and efficient way, they are not as logical and efficient as they should be and a “regulatory gap” still persists, as explained in Section 6.

This cooperative model raises several questions that may be considered at different levels, ranging from the “very technical” to the “very political”. In order to define the most appropriate and efficient co-operation framework it is necessary to address those questions without preconceived ideas. Because the concept of “regulation” has several meanings and it has been applied in multiple ways for different purposes, any attempt to close the “regulatory gap” leads inevitably to a “regulatory clash”. A long-term solution to the “regulatory clash” problem cannot be judged solely on the basis of its compliance with the objectives of the IEM: it is essential to be aware of the meaning and implications of any particular scheme in the wider context of redesigning European governance. This point is briefly developed in Section 7.

Moreover, the process of finding a solution may benefit from studying similar EU experiences in other economic areas, notably regulatory models adopted in telecommunications and financial

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<sup>7</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”, published in the O.J. No. L 27 of 30 January 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”, published in the O. J. No. L 204 of 21 July 1998.

services. Section 8 shows how, in order to ensure full coherence of national and EU regulatory actions, EU energy regulators are currently involved in building a coherent and transparent EU energy regulatory framework. Coordinated reporting and monitoring facilitates the present and future developments of the EU energy regulatory framework.

The “Europeanization” of energy markets through mergers of energy undertakings requires consistent application of competition law in order to guarantee a level playing field. In order to ensure that EU energy markets will deliver competitive energy prices to energy consumers, energy regulators also co-operate with the European Commission and with competition authorities in monitoring, investigating and, where appropriate, designing and implementing remedies, as mentioned in Section 9.

## 2. The role of independent regulators – some historical remarks

One of the best descriptions of the regulator’s role was delivered by US President Theodore Roosevelt one century ago.

The Interstate Commerce Commission - the archetype of all regulatory authorities - was established in the USA in 1887 in order to avoid discriminatory pricing and other forms of destructive competition among railway companies. However, the powers initially given to the Interstate Commerce Commission were not sufficient to solve the complex problems created by the railway industry to railway users - in particular, to the Middle West farmers – and to the US economy as a whole <sup>8</sup>. In 1906, the Hepburn Act changed the Interstate Commerce Commission statutes and reinforced its powers. In a communication to Congress on December 5, 1905, President Theodore Roosevelt supported these amendments as follows:

*“(...) The first consideration to be kept in mind is that the power should be affirmative and should be given to some administrative body created by the Congress. (...) I do not believe in the government interfering with private business more than is necessary. I do not believe in the government undertaking any work which can with propriety be left in private hands. But neither do I believe in the government flinching from overseeing any work when it becomes evident that abuses are sure to obtain therein unless there is government supervision. (...) I regard this power to establish a maximum rate as being essential to any scheme of real reform in the matter of railway regulation. The first necessity is to secure it; and unless it is granted to the commission there is little use in touching the subject at all.*

*(...) All private-car lines, industrial roads, refrigerator charges, and the like should be expressly put under the supervision of the Interstate Commerce Commission or some similar body so far as rates, and agreements practically affecting rates, are concerned. The private-car owners and the owners of industrial railroads are entitled to a fair and reasonable compensation on their investment, but neither private cars nor industrial railroads nor spur-trucks should be utilized as devices for securing preferential rates. (...) There should be publicity of the accounts of common carriers; no common carrier who engages in interstate business should keep any books or memoranda other than those reported pursuant to law or regulation, and these books or memoranda should be open to the inspection of the government.*

*(...) I urge upon the Congress the need of providing for expeditious action by the Interstate Commerce Commission in all these matters, whether in regulating rates for transportation or for storing or for handling*

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<sup>8</sup> Bernhard Schwartz (ed.), *The economic regulation of business and industry – a legislative history of U.S. regulatory agencies*, vol. I, Chelsea House Publishers, New York, 1973, pg. 17

*property or commodities in transit. The history of the cases litigated under the present commerce act shows that its efficacy has been to a great degree destroyed by the weapon of delay, almost the most formidable weapon in the hands of those whose purpose is to violate the law.*

*(...) It is because, in my judgement, public ownership of railroads is highly undesirable and would probably in this country entail far-reaching disaster, that I wish to see such supervision and regulation of them in the interest of the public as will make it evident that there is no need for public ownership. The opponents of government regulation dwell upon the difficulties to be encountered and the intricate and involved nature of the problem. Their contention is true. It is a complicated and delicate problem, and all kinds of difficulties are sure to arise in connection with any plan of solution, while no plan will bring all the benefits hoped for by its more optimistic adherents. Moreover, under any healthy plan the benefits will develop gradually and not rapidly. Finally, we must clearly understand that the public servants who are to do this particularly responsible and delicate work must themselves be of the highest type both as regards integrity and efficiency. They must be well paid, for otherwise able men cannot in the long run be secured; and they must possess a lofty probity which will revolt as quickly at the thought of pandering to any gust of popular prejudice against rich man as at the thought of anything even remotely resembling subserviency to rich men. But while I fully admit the difficulties in the way, I do not for a moment admit that these difficulties warrant us in stopping in our effort to secure a wise and just system.(...)"<sup>9</sup>*

This founding text clearly describes the separation between the economic and the political spheres and the role of independent regulatory authorities as a link between them. Regulation was seen as a multidisciplinary field combining technical, economic and legal knowledge in order to supervise a specific sector of economic activity exhibiting some monopolistic characteristics. To use a contemporaneous Wagnerian concept, regulation was seen as a kind of “*Gesamtkunstwerk*”, a new style in terms of State intervention.

In the early 20<sup>th</sup> century independent regulation was extended to other economic sectors in the USA, namely communications and energy. The Federal Power Commission was established in 1920 to regulate the electricity sector (at that time, mainly hydroelectricity).

Following the crisis of the 1920s and in particular the 1929 crash, anti-trust control and the powers of regulatory authorities were reinforced. In 1929 President Herbert Hoover asked for the powers of the Federal Power Commission to be upgraded. In January 1930 Representative Celler justified in the following terms a proposal he submitted to the House of Representatives:

*“ Criticism is being leveled at the prevalent practice of creating commissions.*

*(...) Why this multiplicity of commissions ? Is there a trend in the modern practice of Government toward commission regulation to supplement the inadequacy of the three constitutional branches to look after public affairs ?*

*The answer to this question may be found in the honest recognition of the single factor that there are some problems of their very nature so technical that neither the courts nor the legislatures are competent to handle them – problems such as utility rate making – that require specialized knowledge by trained experts.*

*It is because both courts and legislatures have singularly failed in their attempts to regulate and adjust technical matters that we have to-day realized the need for these tribunals of trained experts.*

*(...) What the Federal Power Commission needs first of all is three full-time competent commissioners. The present members are out-and-out figureheads. With all due respect to them, Congress might just as well have put the King of England, Mussolini, and Albert Einstein on the commission as far as any spontaneous, decisive action originating with the commissioners is concerned. (...)"<sup>10</sup>*

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<sup>9</sup> Ibid., pg. 613

<sup>10</sup> Bernhard Schwartz (ed.), *The economic regulation of business and industry – a legislative history of U.S. regulatory agencies*, vol. III, Chelsea House Publishers, New York, 1973, pg. 2049

Independent regulation of public utilities (transportation, communications, energy, water, etc.) became a reality in the USA almost one century before it was applied in Europe. However, some Europeans realized very early the need of independent regulation and provided detailed descriptions of the necessary institutional arrangements. Among them was Walter Eucken, one of the fathers of the German social market economy.

The German Government has recently decided to set up an independent regulator in charge of post, telecommunications, electricity, gas and railways. This idea was perceived as very innovative and perhaps also as very strange by part of the German public opinion. Therefore, I believe it is interesting to recall what Walter Eucken wrote in the old days of the Weimar Republic:

*“Strict observance of the principles can’t prevent the fact that competition rules contain certain aspects that are not compatible with the system. And just as important: even where full competition is achieved, there are weaknesses and shortcomings which need to be corrected.*

*Therefore, there is a need for certain ‘regulating’ principles to be used to ensure that the competitive system functions well.”*<sup>11</sup>

*“(…)In the competitive system there will be (…) monopolies, which do not help to maintain, but rather disrupt and endanger this. Some positions of power also develop when the principles are fully applied. For example, a gas works in a town, which in its own market has a supply monopoly. (…) Such monopoly positions have arisen as a result of genuine cost advantages – i.e. these are compatible with the system. (…) This provokes the question: what should happen to these monopolies?(…)*

*This question is not identical to the well-known question of monopoly (or just cartel) regulation (…). (…) The problem of monopoly regulation is only relevant for those monopolies that are mentioned, and which are inevitable.”*<sup>12</sup>

*“Monopoly regulation should therefore be assigned to a state agency for monopoly regulation. In order to prevent the influence of interested parties, which is always dangerous (even if this is weakened by the competitive system), this should be an independent agency, subject only to the law. For example, it should not be a department of the Economics Ministry, which is much more open to the pressure of interested parties.*

*This monopoly office should be solely responsible for all questions concerning monopoly regulation. This therefore requires a completely new central bureau, whose creation is as essential as it is realistic. The large, central figure of a monopoly office should appear within the context of a modern, industrial state. Without this, the competitive*

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<sup>11</sup> Walter Eucken, Grundsätze der Wirtschaftspolitik, J.C.B. Mohr, Tübingen, 6<sup>a</sup> ed., 1990, pg. 291

*“Die strenge Befolgung der konstituierenden Prinzipien kann nicht verhindern, daß die konkreten Wettbewerbsordnungen gewisse systemfremde Ordnungsformen enthalten (I). Und nicht weniger wichtig: Auch soweit die vollständige Konkurrenz verwirklicht ist, enthält sie Schwächen und Mängel, die der Korektur bedürfen (II.-IV.). Somit bedarf es gewisser ‘regulierender’ Prinzipien, deren Anwendung geboten ist, um die Wettbewerbsordnung funktionsfähig zu erhalten.”*

<sup>12</sup> Ibid., pg. 291-293

*“(…) in der Wettbewerbsordnung wird es (…) Monopole geben, die nicht ihrer Aufrechterhaltung dienen, die sie vielmehr stören und gefährden. Gewisse Machtpositionen entstehen auch bei vollständiger Anwendung der Prinzipien. So hat etwa ein Gaswerk in einer Stadt, also auf seinem Markt, ein Angebotsmonopol. (…) Solche monopolistischen Positionen sind auf Grund echter Kostenvorteile entstanden – also ‘systemgerecht’. (…) Hier entsteht die Frage: Was hat mit diesen Monopolen zu geschehen ? (…) Die Frage ist nicht mit den bekannten Frage der Monopol- (oder nur Kartell-) Aufsicht identisch (…). (…) Nur für die genannten, unvermeidbaren Monopole ist das Problem der Monopolaufsicht in der Wettbewerbsordnung aktuell.”*

*system and with it the modern constitutional state is threatened. The monopoly office is just as indispensable as the Supreme Court.”*<sup>13</sup>

*“Full competition leads to a constant, long-term pressure to rationalise production capacity. There should be a price control on monopolies which also exerts long-term, competitive pressure.”*<sup>14</sup>

*“Monopoly regulation also works prophylactic, and this aspect is of great importance. Mankind’s pursuit of monopoly positions, which is otherwise so strong and which – as has been shown – is a central fact in economic history, will be substantially weakened or will cease, if such an authoritative monopoly regulator is effective.”*<sup>15</sup>

These brief historical notes show that neither the theory nor the practice of independent regulation is new. What is new is its application to specific sectors in Europe, including energy. According to national law, administrative tradition, market structures and political choice, each Member State introduced energy regulation in a different way.

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<sup>13</sup> Ibid., pg. 294

*“Die Monopolaufsicht sollte also einem staatlichen Monopolaufsichtsamt übertragen werden. Um es den stets gefährlichen (wenn auch in der Wettbewerbsordnung geschwächten) Einflüssen der Interessenten zu entziehen, sollte es ein unabhängiges Amt sein, das nur dem Gesetz unterworfen ist. Es darf also nicht etwa eine Abteilung des Wirtschaftsministeriums sein, die weit stärker dem Druck der Interessenten ausgeliefert ist.*

*Dieses Monopolamt ist ausschließlich für alle Fragen der Monopolaufsicht zuständig. Es bedarf also eines neue, bisher fehlenden Zentralamts, dessen Aufbau ebenso notwendig wie durchführbar ist. Im Bilde des modernen, industriellen Staates hat diese große, zentrale Figur des Monopolamts zu erscheinen. Ohne sie ist die Wettbewerbsordnung und mit ihr der moderne Rechtsstaat bedroht. Das Monopolamt ist ebenso unentbehrlich wie der Oberste Gerichtshof.”*

<sup>14</sup> Ibid., pg. 297

*“In der vollständigen Konkurrenz entsteht ein dauernder, langfristig wirkender Druck, den Produktionsapparat zu rationalisieren. Es ist nötig eine Preiskontrolle der Monopole durchzuführen, welche einen langfristigen, wettbewerbsanalogen Druck ebenfalls zur Geltung bringt.”*

<sup>15</sup> Ibid., pg. 298

*“Die Monopolaufsicht wirkt auch prophylatisch, und diese Seite der Sache ist von eminenter Bedeutung. Das Streben der Menschen, zu monopolistischen Positionen zu gelangen, das sonst so lebendig ist und – wie sich zeigte – ein zentrales Faktum der Wirtschaftsgeschichte darstellt, wird wesentlich geschwächt oder hört auf, wenn eine so entschiedene Monopolaufsicht wirksam wird.”*

### 3. Co-operation among national regulators

Co-operation among national energy regulators may be justified by two orders of reasons:

- Because it improves the performance of individual regulators and therefore it has a direct positive impact on the markets regulated by the relevant regulators.
- Because the lack of co-operation would hinder the development of the regulated markets or it could harm some market players.

In the first case there are several examples, more or less trivial, that can be given:

- Exchange of experiences among regulators, especially in the start-up phase, can improve:
  - The management quality of the regulatory authorities.
  - The transparency and efficiency of the regulatory process.
  - The efficiency of the incentives and of the regulatory formulae adopted, as well as the effectiveness of implemented enforcement and supervision mechanisms.
- Exchange of information among energy regulators is important for several purposes, namely:
  - Benchmarking.
  - Supervision of multi-national companies, especially in a period of industry restructuring through mergers and acquisitions.

Cross-border electricity trade is a good example of the second type, where lack of co-operation results in a very difficult, or even impossible, functioning of the internal energy market. The European experience in this field will be briefly described in the next Section. In Section 5 the evolution of co-operation among energy regulators is briefly described.

### 4. The “regulatory gap” after the first IEM Directives

Before the first IEM directives, electricity exchanges within the Western European network were performed by the undertakings responsible for high-voltage transmission grids, according to the technical and economical rules defined by their association<sup>16</sup>. Cross-border transactions were limited to wholesale exchanges among the owners of the high-voltage grids, either on a bilateral or on a multilateral (transit) basis; final customers had no access to the interconnections. The “Council directive of 29 October 1990 on the transit of electricity through transmission grids”<sup>17</sup> had limited direct impact on electricity trade between Member States and the part of total physical exchanges related to consumption of the Western European system was about 10%.

The first internal energy market directives allowed Member States to shape their energy markets in several ways; in particular, they gave them the possibility of implementing different systems of network access, including access to interconnections. Looking at the way legislators and/or regulators started making use of this freedom, it was soon recognised that implementation of the “common rules” directives could lead to incompatible trading arrangements and block cross-border trade if nothing was done. In fact, parallel liberalisation of 15 energy markets did not ensure the compatibility – and even less convergence or integration – of these markets. This implies that diversity must be compatible not only with the principles of transparency and non-

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<sup>16</sup> UCPT: Union pour la Coordination de la Production et du Transport de l'Électricité, created in 1951

<sup>17</sup> Directive 90/547/EEC, published in the O.J. No. L 313 of 13 November 1990.

discrimination, but also with the primary goal of achieving integrated European energy markets in electricity and natural gas.

The European Commission realized the difficulties arising from the omissions of the first IEM directives and the need for some degree of institutional co-ordination in order to overcome the existing “regulatory gap”. Consequently, the Commission decided to convene the so-called European Electricity Regulation Forum and the European Gas Regulatory Forum – the first started in 1998 in Florence, the second followed one year later in Madrid. The main aim of these fora was to facilitate integration of national energy markets into one single European market. The method applied was voluntary cooperation: first of all, cooperation between national energy regulatory authorities and the European Commission; secondly, cooperation between the European Commission and national regulatory authorities, on the one hand, and system operators and network users (producers, traders, suppliers, consumers, market operators, etc.) on the other hand. The fora usually meet twice a year and bring together national regulators, Member States <sup>18</sup> and the European Commission, as well as a growing number of interested parties.

The first challenge faced by the “Florence Forum” was to create a simple, low transaction-cost mechanism for cross-border electricity trade while, at the same time, keeping different national market structures. To set up such a mechanism requires considerable efforts. First of all, it is necessary to define some common access and pricing rules and to introduce some degree of harmonisation in existing national rules. Then, it is necessary to adapt the existing mechanisms for technical co-ordination and settlement to the new rules.

The first important result was delivered by the European Electricity Regulation Forum in Spring 2000, when the European Commission, regulators and network users succeeded in convincing transmission system operators to accept a mechanism for cross-border electricity trade. This very simple mechanism enables consumers located in any place in Europe to get access to any supplier connected to the interconnected network. The consumer – and the supplier – only have to inform the local transmission system operator to which they are physically connected; afterwards, transmission system operators communicate among themselves and enable the commercial transaction to take place from the physical point of view. Of course, if that transaction crosses any congested border it has to go through appropriate congestion management mechanisms. Implementation of this mechanism, initially scheduled for October 2000, was delayed until 2003 due to the reluctance of some transmission system operators <sup>19</sup>.

This lack of practical results, combined with new political developments <sup>20</sup>, led the European Commission to present proposals for amending the “common rules” directives and for

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<sup>18</sup> The initial intention of the European Commission was to convene only regulators, since Member State energy representatives meet regularly within the Council framework. However, the lack of regulators in some Member States at that time led the Commission to invite both regulators and government representatives.

<sup>19</sup> Mainly German companies. Germany was the only Member State without an independent energy regulator; therefore, it was represented at the “Florence Forum” solely by the Ministry of Economic Affairs. However, it became apparent to all Forum participants that the Ministry was “captured” by the large power companies who had an obvious interest in blocking any agreement that would facilitate electricity exports to German customers.

<sup>20</sup> In March 2000 the European Council approved the “Lisbon Agenda”. Energy was considered one of the critical fields to improve competitiveness of European undertakings and the European Council asked the European Commission, *inter alia*, to present new directives to accelerate liberalization and integration of electricity and natural gas markets. These directives were presented by the Commission in 2001 and approved in June 2003.

introducing a regulation for cross-border electricity trade <sup>21</sup>. This regulation represents the Commission's attempt to close the "regulatory gap" that was created by Directive 96/92/EC and that participants in the "Florence Forum" were not able to overcome on a voluntary basis <sup>22</sup>.

Regulators played an important role in the critical review of industry proposals for the interim cross-border mechanism. The need for co-operation and concentration within the framework of the Florence Forum was one of the reasons for the creation of the Council of European Energy Regulators (CEER) in March 2000, thus re-enforcing the role of regulators. Since then, the CEER asked for the quick implementation of the interim agreement, provided guidelines for the improved mechanism of inter-TSO payments to compensate for cross-border trade and it has also provided guidelines on congestion management, among other initiatives. Although the CEER played a major role in identifying the problems and proposing solutions related to the "regulatory gap", the fact that Germany was not represented in CEER and the non-binding nature of the ITC mechanism voluntarily entered into via the Florence forum process, limited its impact.

Cross-border electricity trade was the first example that clearly showed the existence of a "regulatory gap" in the energy field. However, other examples can be provided, both in electricity and in natural gas, which show how the "regulatory gap" delayed market integration.

As regional organised markets, both physical and financial, became the focal point of energy trade and many companies changed ownership, size and scope, increasing activity in cross-border mergers and acquisitions, thus materializing a large energy market without internal frontiers, the "regulatory gap" became critical also in terms of global supervision and control.

The CEER provided support to the European Commission both within the framework of the Florence and Madrid fora and in preparation of the new internal energy market directives and regulations. Some further voluntary agreements were reached both in electricity and in gas, introducing more transparency (e.g. regular publication of available transmission capacities) and facilitating cross-border trade. However, voluntary agreements proved difficult to reach, to implement and to monitor because some transmission system operators were not properly separated from other interests (generation, trade, supply) and also because some countries, namely Germany and Switzerland, delayed the introduction of independent regulators <sup>23</sup> - regulated network access does not yet exist in these two countries whose geographical position is critical for the development of the internal energy market.

## **5. The Council of European Energy Regulators (CEER)**

Co-operation among energy regulators started in March 1997 among the Italian, Spanish and Portuguese regulators. Regular meetings of the three institutions took place, working groups

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<sup>21</sup> Regulation (EC) N° 1228/2003 of 26 June 2003, published in the O.J. No. L 176 of 15 July 2003.

<sup>22</sup> Although an agreement was reached, German TSOs blocked its implementation. The European Commission might have used its powers to enforce application of the agreement, but it preferred a two track approach: on the one hand, it tried to persuade the German government to accept the agreement; on the other hand, it put legislative proposals before the Council and the European Parliament.

<sup>23</sup> In May 2005, when this paper was written, Germany and Switzerland had not yet officially set up independent energy regulatory authorities.

were set up, seminars were organised and a joint paper was presented by the three chairmen at the second Florence Forum meeting on October 8-9, 1998<sup>24</sup>.

The Director-General for Energy of the European Commission was invited to attend a meeting of the three regulators in November 1997 where the Commission's proposal for a Forum on European Electricity Regulation (Florence Forum) was discussed, among other issues. The Florence Forum was launched in late 1997 and its first meeting was held in February 1998 at the European University Institute.

Meanwhile, the number of independent regulators was growing and cooperation among them was increasing. In March 2000, energy regulatory authorities from 10 European countries (Belgium, Finland, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden and United Kingdom) decided to sign a memorandum of understanding whereby the Council of European Energy Regulators (CEER) was created<sup>25</sup>. The main aim of the CEER was to increase cooperation – among regulators, on the one side, and between regulators and the European Commission, on the other side – in order to contribute to a more efficient internal energy market.

Since then, regulators were created in the other Member States and have joined the Council. In order to cope with a growing number of issues and improve cooperation at the operational level, regulators decided in 2003 to adopt a not-for-profit statute under Belgian law and to set up a small office in Brussels.

## 6. The “regulatory gap” after the second IEM Directives

In many economic sectors, EU directives now require Member States to introduce independent regulatory authorities (e.g. in energy, telecommunications and financial services) and they also prescribe the minimum regulatory powers to be delegated to these authorities. The directives also require national regulatory authorities to cooperate “with each other and with the Commission”<sup>26</sup>. However, EU legislation does not describe the institutional arrangements for sharing regulatory powers among national regulatory authorities and the European Commission.

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<sup>24</sup> Also published in *Oil & Gas Law and Taxation Review*, Issue 2, February 1999.

<sup>25</sup> The CEER objectives expressed in the Memorandum of Understanding signed by the European electricity and gas regulators were as follows:

1. Promote the development of efficient electricity and gas markets in Europe through the establishment of appropriate mechanisms.
2. Co-operate in order to achieve competitive European markets in electricity and gas, in which the principles of transparency and non-discrimination are ensured. The Members will reinforce and follow up the processes of liberalisation in the electricity and gas markets.
3. Set up co-operation, information exchange and assistance amongst The Members, with a view to establishing expert views for discussion with the institutions of the European Union, and, in particular, with the European Commission, and representative international organisations as other sectors which may be involved.
4. Establish coherent and expert knowledge and analysis such that the institutions with which Members wish to hold discussion naturally consult the Members at a formative stage in policy development.
5. Provide a framework for the discussion of regulatory issues and exchange of experience.
6. Provide the necessary elements for the development of regulation in the fields of electricity and gas.
7. Develop joint approaches vis-a-vis transnational energy utilities and companies that operate in separated regulated utility markets (multi-utilities).
8. Where possible work to establish common policies among Members towards agreed issues.

<sup>26</sup> Electricity directive 2003/54/EC, Article 23.12; similar provision in gas directive 2003/55/EC.

National energy markets are subject to regulation and regulation is performed by independent national regulatory authorities. The internal energy market is also a regulated market, but the regulatory function is not assigned to any particular institutional entity – be it the European Commission, a new European agency, or the collective body of national regulatory authorities.

The legislator was aware of the “regulatory gap” when the second IEM directives were produced as evidenced in the Recital to Directive 2003/54/EC (and a similar one in directive 2003/55/EC):

*“(16) The Commission has indicated its intention to set up a European Regulators Group for Electricity and Gas which would constitute a suitable advisory mechanism for encouraging cooperation and coordination of national regulatory authorities, in order to promote the development of the internal market for electricity and gas, and to contribute to the consistent application, in all Member States, of the provisions set out in this Directive and 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(5) and in Regulation (EC) No 1228/2003 of the European Parliament and of the Council of 26 June 2003 on conditions for access to the network for cross-border exchanges in electricity(6).”*

This awareness is also reflected in Article 23.12 of the same directive:

*“National regulatory authorities shall contribute to the development of the internal market and of a level playing field by cooperating with each other and with the Commission in a transparent manner.”*

Although the need for institutional co-operation is clearly recognized, the legislator did not provide the European Regulators Group for Electricity and Gas or any other equivalent body with regulatory powers, limiting its role to an advisory function. The European Regulators Group for Electricity and Gas (ERGEG), a consultative body, was established by a Commission decision of 11 November 2003<sup>27</sup>.

At national level, each regulator is provided with clear regulatory powers vis-à-vis the regulated network companies within his or her jurisdiction. For instance, Article 12.4 of directive 2003/54/EC ensures that regulators have appropriate enforcement powers:

*“Regulatory authorities shall have the authority to require transmission and distribution system operators, if necessary, to modify the terms and conditions, tariffs, rules, mechanisms and methodologies referred to in paragraphs 1, 2 and 3, to ensure that they are proportionate and applied in a non-discriminatory manner.”*

However, if problems related to cross-border trade require modification of network access terms and conditions regulators do not have the powers to address these problems collectively, enforcing the necessary modifications at EU level. Of course, regulators may decide to act collectively by introducing the same modifications at the same time in all 25 Member States; but this is a strange way of regulating the supra-national European internal energy market.

Not only enforcement of regulatory decisions at EU level is problematic. According to Regulation (EC) N° 1228/2003, the development of new rules related to cross-border issues is subject to comitology procedures, instead of being carried out cooperatively by regulators.

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<sup>27</sup> Official Journal No. L 296 of 14 November 2003, pp. 34-35

Regulatory decision-making through comitology fulfils EU formal rules but clearly contradicts the principle of independent network regulation established in the relevant electricity and gas directives. Application of the strict, “one-size-fits-all” comitology procedures to regulation of the internal energy market is like hanging two dozens colourful balloons to the Pisa Tower: it can be done, but clearly it does not fit the architecture and it does not improve the stability of the building.

## 7. The “Regulatory Clash”

Moving from one-system regulation to multi-system, multi-level regulation cannot be a conflict-free process because each national regulatory system reflects the legal, political, industrial and cultural identity of the country where it operates. Since the scope and the instruments available to each regulator vary from country to country, there are different perceptions of what competences should be shared, what initiatives should be carried out at supra-national level, which degree of harmonisation may be needed and how regulatory diversity should be accommodated.

When looking at the "regulatory gap" as an obstacle to the achievement of the internal energy market, and as a potential source of conflict and disfunctioning once it is fully established, national regulators and the European Commission may take different views:

- National regulators will usually take a bottom-up approach, wondering how the market rules of his or her system may be adapted in order to facilitate its full integration in the internal energy market. They will start by considering a list of technical problems to be solved through harmonisation or complementation of existing rules and regulatory procedures. Indeed, for regulators regulation is basically a way of correcting market failures, both at national and at EU level.

- The European Commission usually takes a top-down approach. For the Commission, regulation is more than just a set of technical rules; it is, first of all, the "new frontier" of public policy, a substitute for direct state intervention both at national level and at EU level<sup>28</sup>. From this perspective, regulation has played and continues to play an essential role in shaping EU governance.

The place of regulation in the overall architecture of EU institutions and in the balance of powers between Member States and EU institutions is still an open question. In July 2001 the European Commission published a White Paper on European governance where it proposed “opening up the policy-making process to get more people and organisations involved in shaping and delivering EU policy” by “following a less top-down approach and complementing the EU’s policy tools more effectively with non-legislative instruments”.

The White Paper recognised that “more effective enforcement of Community law is necessary not only for the sake of efficiency of the internal market but also to strengthen the credibility of the Union and its Institutions”. To that end, the Commission suggested several initiatives and different approaches. One of

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<sup>28</sup> Giandomenico Majone describes this process as "The Rise of the Regulatory State in Europe".

them was defining "the criteria for the creation of new regulatory agencies and the framework within which they should operate".

The White Paper recalled that

*"A range of national regulatory agencies exist across Member States in areas with a need for consistent and independent regulatory decisions. Increasingly these regulators have an important role in applying Community law. At EU level, twelve independent agencies have been created. The majority of these bodies have either an information gathering task (...) or they assist the Commission by implementing particular EU programmes and policies (...). In three cases EU agencies have a regulatory role"* <sup>29</sup>.

The White Paper clearly supported the creation of regulatory agencies:

*"The creation of further autonomous EU regulatory agencies in clearly defined areas will improve the way rules are applied and enforced across the Union. Such agencies should be granted the power to take individual decisions in application of regulatory measures. They should operate with a degree of independence and within a clear framework established by the legislature. The regulation creating each agency should set out the limits of their activities and powers, their responsibilities and requirements for openness.*

*The advantage of agencies is often their ability to draw on highly technical, sectoral know-how, the increased visibility they give for the sectors concerned (and sometimes the public) and the cost-savings that they offer to business. For the Commission, the creation of agencies is also a useful way of ensuring it focuses resources on core tasks.*

*The Commission will consider the creation of regulatory agencies on a case-by-case basis. Currently, proposals are before Council and the European Parliament for three agencies: a European food authority, a maritime safety agency and an air safety agency with only the latter having a clear power to take individual decisions."*

The White Paper recognised that the increasing number and role of EU regulatory agencies would imply the need to "refocus the institutions":

*"If these orientations are followed the need to maintain existing committees, notably regulatory and management committees, will be put into question. Therefore a review of existing committees would have to be undertaken and their continued existence assessed. This assessment should take account of the need for expert advice for the implementation of EU policies.*

*The adjustment of the responsibility of the Institutions, giving control of executive competence to the two legislative bodies and reconsidering the existing regulatory and management committees touches the delicate question of the balance of power between the Institutions. It should lead to modifying Treaty article 202 which permits the Council alone to impose certain requirements on the way the Commission exercises its executive role. That article has become outdated given the co-decision procedure which puts Council and the European Parliament on an equal footing with regard to the adoption of legislation in many areas. Consequently, the Council and the European Parliament should have an equal role in supervising the way in which the Commission exercises its executive role. The Commission intends to launch a reflection on this topic in view of the next Inter-Governmental Conference."*

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<sup>29</sup> These were the Office of Harmonisation in the Internal Market (Alicante), the Community Plant Variety Office (Angers) and the European Agency for the Evaluation of Medicines (London).

Unfortunately, the Inter-Governmental Conference did not pay enough attention to these matters and the governance question was not properly addressed. The lack of clear and efficient EU governance, including suitable regulatory mechanisms, became more evident after the last EU enlargement in May 2004.

Today the language of the European Commission is that of Better Regulation. The Commission's Work Programme for 2005 outlines a new approach with a real emphasis on delivering the highest standards for EU governance through delivery and better regulation<sup>30</sup>. It has launched a strategy to simplify and improve the regulatory environment which includes, *inter alia*, an emphasis on subsidiarity and proportionality, consultation and a simplification of the regulatory framework.

## 8. Building the regulatory framework

The new internal electricity and natural gas market directives came into force in 2003 and should have been transposed into national law before the 1<sup>st</sup> of July 2004; however, some Member States have not yet fully implemented these directives.

The 2003 directives and electricity regulation (EC) N° 1228/2003 of 26 June 2003 provide a clear and comprehensive legal framework for the development of the internal energy market, although they do not solve the “regulatory gap” problem. Serving 450 million EU citizens, this is the largest integrated energy market in the world, offering new perspectives both to energy consumers and to European energy undertakings.

Regulators are committed to facilitating the development of the internal energy market through two major lines of action:

- Cooperating with the European Commission in order to build up a comprehensive and transparent regulatory framework for the internal energy market according to the principles and procedures established in legislation.
- Cooperating with the European Commission and with competition authorities in order to ensure consistent application of competition law to the energy industry.

In a pragmatic way, regulators wish to develop the necessary regulatory framework and to perform the necessary regulatory function at EU level through co-operation – among them and with the European Commission.

Directive 2003/54/EC concerning common rules for the internal market in electricity and Regulation (EC) N° 1228/2003 on conditions for access to the network for cross-border exchanges in electricity provide the legal framework for the development of the EU electricity market. They foresee several regulatory actions to be undertaken by the European Commission and by energy regulatory authorities, such as:

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<sup>30</sup> Commission Work Programme for 2005, Communication from the President in agreement with Vice-President Walstrom, COM (2005) final, Brussels, 26 January.2005.

- Regulation (EC) N° 1228/2003 foresees that “[w]here appropriate, the Commission shall (...) adopt and amend guidelines”, according to comitology procedures, on three issues:
  - inter-transmission system operator compensation mechanism;
  - principles for the setting of transmission network tariffs;
  - management and allocation of available transfer capacity of interconnections.
  
- -Regulation (EC) N° 1228/2003 also foresees that “[t]he safety, operational and planning standards used by transmission system operators shall be made public [and] shall include a general scheme for the calculation of the total transfer capacity and the transmission reliability margin (...) subject to the approval of the regulatory authorities”.

On the other hand, Directive 2003/54/EC assigns to national regulatory authorities the responsibility for “fixing or approving” transmission tariffs and balancing service tariffs.

Clearly, all these issues - transmission tariffs, inter-transmission system operator compensations, balancing service tariffs, operational rules, reliability standards, calculation of available transmission capacities, management and allocation of available transmission capacities - are closely inter-related. Some “operational” issues have a strong economic impact and some “economic” issues raise complex technical questions. All issues have significant impact upon the information and communication infra-structure managed by transmission system operators, as well as upon the way they collect, process and disseminate data. Moreover, the way these issues can be handled depends on the way energy markets are organized, on a national or regional basis. Therefore, close co-operation between the European Commission and national regulatory authorities is essential to ensure consistency of the EU electricity regulatory framework.

In order to facilitate the discussion on and ensure consistency of rules and guidelines on different individual issues, it is necessary to first discuss the “regulatory framework”. This framework must be built based upon a model of interactions between transmission system operators at planning and operational levels. However, caution must be exercised so as to ensure an appropriate model of co-operation within the new regulatory framework.

Importantly, in each Member State transmission system operators are subject to the supervision of the respective energy regulatory authority. However, in meshed interconnected systems, such as the continental European electricity system, the behaviour of transmission system operators is strongly influenced by the rules governing the interconnected system. Therefore, national “Grid Codes” should reflect the rules agreed at European level. This set of rules governing interactions between transmission system operators should be agreed by the European Commission and by energy regulatory authorities - in close co-operation with network operators and network users and taking into account regional diversity in terms of density and technology of interconnections - and enforced nationally through national regulation and Grid Codes.

The present type of interaction between transmission system operators was inherited from the old days of vertically-integrated, more or less self-regulated monopolies. This old model is clearly not well adapted to the principles and rules of the internal electricity market, both in terms of contents (technical standards and procedures) and in formal terms (assignment of responsibilities, enforcement procedures, dispute settlement, etc.). Delays in introducing a new model, well adapted to unbundling and to other common rules, are responsible for unnecessary

risks (e.g. the 2003 Swiss/Italian blackout), unnecessary losses of economic efficiency (e.g. too restrictive criteria for calculating available interconnection capacity) and unnecessary conflicts.

It is urgent to replace the old, technically and economically unsuitable self-regulated models with an appropriate model coherent with the new “regulatory framework”. Currently within Europe there are a number of areas (Nordel, UCTE, etc.) applying different rules and procedures. Future guidelines and rules to be produced by the European Commission and by energy regulatory authorities, namely under the new Directives and Regulations, should be coherent with the commonly agreed “regulatory framework” and should not be developed on an *ad-hoc* basis. Such guidelines would provide a minimum set of reliability and security standards, including enforcement procedures, applicable across all of Europe.

Efficient regulation of the internal energy market requires not only a clear technical framework ensuring coherence of national, regional and EU regulatory developments, but also transparent procedures allowing all interested parties to participate in the regulatory process. ERGEG provides the appropriate platform to achieve these goals, both in electricity and in natural gas.

ERGEG’s objective is to “*advise and assist the Commission in consolidating the internal energy market, in particular with respect to the preparation of draft implementing measures in the field of electricity and gas*”<sup>31</sup>. It is ERGEG’s mission to “*facilitate consultation, coordination and cooperation of national regulatory authorities, contributing to a consistent application, in all Member States, of the provisions set out in Directive 2003/54/EC, Directive 2003/55/EC and Regulation (EC) N° 1228/2003, as well as of possible future Community legislation in the field of electricity and gas.*”<sup>32</sup> ERGEG Rules of Procedure and ERGEG Guidelines on Consultation Practices have been approved and are public.<sup>33</sup>

By way of example, ERGEG has published Guidelines on Gas Storage early this year and has recently put to public consultation draft guidelines on congestion management and on electricity network tariff harmonization, before formal advice will be forwarded to the European Commission and the comitology process begins.

## 9. Ensuring consistent application of competition law to energy

The “Europeanization” of energy markets leads naturally to mergers and acquisitions among energy companies - mainly historical incumbents. Because construction of the internal energy market is a step-by-step process, application of competition law in general and merger control in particular, is a challenging task.

Creating, managing and ultimately integrating regional energy markets into one single EU energy market is a complex process. This process may imply some short-term or medium-term distortions of competition. Therefore, it is crucial to address these risks and to design the appropriate mechanisms to ensure a level playing field for all EU players, as well as the quick and smooth convergence of all regional markets into a single EU energy market.

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<sup>31</sup> Commission decision of 11 November 2003 establishing the European Regulators Group for Electricity and Gas, Article 1, N° 2.

<sup>32</sup> *Idem*

<sup>33</sup> [www.ergeg.org](http://www.ergeg.org)

European Commission's Director General of Competition, Philip Lowe, has indicated as a general remark, "*that mergers can have pro-competitive effects when they allow new operators to enter national markets dominated by former legal monopolies. They can, however, have negative effects on competition when they strengthen the dominant position of a former monopoly.*"<sup>34</sup> It is not always easy to assess the positive and negative effects of individual cases. Therefore, further analysis and some joint action by the European Commission, competition authorities and energy regulatory authorities is urgently needed as regards the application of rules to the approval or refusal of mergers and acquisitions in the energy field.

Good regulation and a good regulatory framework are necessary but not sufficient conditions for competitive EU energy markets. Lack of robust, deep and liquid organised energy markets in most geographical areas - especially as regards natural gas - is a major obstacle to the achievement of a truly integrated and efficient internal energy market. Therefore, in-depth analysis of energy markets and assessment of effective competition is crucial, both at regional and at EU level. Of course, to assess the behaviour of market participants and their compliance with anti-trust legislation is a difficult task in any sector and it is particularly difficult in the newly liberalized network industries. Therefore, co-operation between the European Commission, competition authorities and energy regulatory authorities (through ERGEG) is also very important as regards the definition of "energy markets", the assessment of market power and effective competition and the definition of appropriate regulatory and anti-trust remedies.

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<sup>34</sup> Philip Lowe, Applying EU Competition Law to the new liberalised energy markets, Brussels, 13 May 2003, [http://europa.eu.int/comm/competition/speeches/text/sp2003\\_012\\_en.pdf](http://europa.eu.int/comm/competition/speeches/text/sp2003_012_en.pdf)