

**The Long and Winding Road  
to the Internal Energy Market  
– Consistencies and inconsistencies in EU policy**

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# Contents

1	Background and research questions .....	1
	1.1 Organisation of the report .....	2
2	The shaping of EU internal energy market policy .....	3
	2.1 The energy directive procedure applied as a means to achieve an internal energy market.....	4
	2.1.1 The first stage – 1989–1998 .....	4
	2.1.2 Market policies after the Electricity and Gas Directives .....	6
	2.1.3 Commission request for more power to change the scope and depth of its regulatory competence .....	8
	2.2 The general Community Law procedure applied in the process of establishing the internal energy market.....	9
	2.2.1 The case of general merger control regulation in the European Community .	12
	2.2.2 Competition legislation and state aid.....	14
	2.3 Conclusion – the consistency of EU internal energy market policies with the principle of free and fair competition .....	15
3	Other EU energy policy goals and policies – consistency with the principle of free and fair competition in the internal energy market?.....	16
	3.1 EU environmental policy as it affects the energy industry .....	17
	3.2 European Commission efforts to reconcile environmental policy measures with internal market principles.....	20
	3.3 EU level initiatives and policies aimed at reaching security of supply in the Union	22
	3.4 Summary: EU efforts at sorting out inconsistencies between energy policies aimed at different goals .....	26
4	Explaining deviations from the principle of free and fair competition .....	28
	4.1 Lack of regulatory capacity and coordination problems at the EU level.....	28
	4.2 National interests curtailing the EU internal energy market project .....	29
	4.3 Concluding remarks – explaining barriers to internal market implementation.....	32
	References.....	35
	Annex I National asymmetries recorded in the European Commission 2002	
	Benchmarking report on the implementation of the Electricity and Gas Directives	37



# 1 Background and research questions

It is now 16 years since the European Commission in 1988 issued its first Green Paper on the implementation of the internal energy market in Europe.<sup>1</sup> The major philosophy behind the internal energy market was that *free and fair competition* between energy companies across the European Community would lead to large efficiency gains, lower and more similar prices for consumers across the Community, increased competitiveness for energy-using industries, economic growth and increased welfare. Given this background it would not be unnatural to ask how far the EU has come in establishing an energy policy that adheres to the principle of free and fair competition. Free and fair competition should mean that energy companies encounter similar regulatory and competitive pressures in their respective home markets. An energy policy consistent with this principle will be crucial, not just for the efficiency of EU energy policy, but also for its legitimacy.

In this report, we investigate the consistency of EU energy policy with respect to the principle of free and fair competition as it developed during the 1990s and right up till 2004. At the outset, we can think of several potential sources of inconsistency in EU energy policy:

- Asymmetries in implementation across member states of *already established* EU energy policy legislation might be inconsistent with the principle, in that enterprises in some countries may come to experience less competitive pressure than enterprises in others.
- Still-unregulated barriers to free trade and competition may shield trade and industry in member states with the most extensive barriers.
- Thirdly, inconsistency between different measures established at the EU level to promote competition in the internal market can lead to distortions of the principle. The EU has adopted different procedures to enforce market opening. On the one hand, specific directives have been adopted to ensure that national *governmental policies* are harmonised and consistent with the principle of free and fair competition. On the other hand, the EU has adopted general competition rules to clamp down on *anticompetitive practices in industry* once national regulatory frameworks have been harmonised. Surely, a policy consistent with free and fair competition requires not only harmonisation of government regulations but also the abolition of anti-competitive *industrial* behaviour in liberalised markets.
- Fourthly, the existence of other energy policy goals is a potential source of inconsistency. The two other major goals formulated for EU energy policy concern improving security of supply at the EU level – aimed at minimising risks and impacts of supply disruption on the EU economy and society – and improving environmental protection of EU energy systems – aimed at directing energy production and use in such a way to avoid jeopardising ecological and geophysical balances. If the policy instruments put in place for reaching these goals are not reconciled with those

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<sup>1</sup> Commission of the European Communities, *The Internal Market for Energy* (working paper of the Commission), COM (88) 238, final 2.5.88.

intended to secure the internal market, they might in various ways lead to breaches of the principle of free and fair competition.

This report explores the impact of regulatory policies and potential insufficiencies of regulatory power at the EU level on efforts to create and maintain an internal market where competition is free and fair.

The main question posed by the study is:

- What has the European Union accomplished with respect to minimising deviations from the *ideal* of an internal energy market with free and fair competition?

To this end we look more closely at

- Developments in EU energy policy in the 1990s relating to aspirations for an internal energy market based on free and fair competition;
- Symmetric implementation of EU internal market policies by member states;
- Whether the European Commission has succeeded in reconciling different policies directed at creating the internal energy market;
- And whether it has managed to reconcile internal energy market policies with policies aimed at reaching environmental and energy security goals.

Our contention at the outset is that a poorly devised and asymmetrically implemented EU energy policy would probably give rise to some degree of deviation from a free and fair market for energy companies in the Union. A further likely cause of deviation, we maintain, is related to poorly coordinated energy policy goals and tools.

That the EU is still far from achieving a completely free and fair energy market should come as no surprise. We advance two hypotheses that may explain why.

- Deviation problems are caused by factors at the EU level – by the suboptimal harmonisation of energy policy goals;
- Deviation problems are caused by asymmetries in interests and power across member states – leading to inter-member state asymmetries in the implementation of measures to ensure a level playing field for internal energy market players, and to the blocking of necessary institutional capacity growth at the EU level.

Both types of problems can have serious repercussions. Harmonisation problems may, however, be more easily corrected than problems emanating from fundamental differences in interest among member states.

## **1.1 Organisation of the report**

In chapter 2 we investigate the various aspects of EU internal energy market policies. In chapter 3 we look at how EU market policies articulate with related policies areas, notably

environmental and energy security policies. In chapter 4 we discuss in more detail why the EU has encountered problems in creating an internal energy market with free and fair competition. We firstly discuss EU-level causes, asking whether problems are due to lack of EU regulatory capacity to reconcile and coordinate goals and measures. Next, we discuss whether problems are rooted in member state interests that are not fully compatible with a free and fair market. Chapter 4 also recaps our initial assumptions and explores the implications of our findings for EU energy policy.

## 2 The shaping of EU internal energy market policy

Whereas *energy security in the Community* was the goal characterising much of the earlier common energy policy efforts, free and fair competition in the internal energy market came to attract the bulk of Council attention in the late 1980s. The internal energy market proposals reflected more general contemporary policy reforms aimed at revitalising the *general principles* guiding Community co-operation – removal of barriers to trade and movement of capital across member states and free competition as means to increase growth and welfare in the region. The EU Council adoption in 1987 of the Single European Act was a pivotal part of the reform. It strengthened supranational authority in a number of EU policy areas, opening for greater use of qualified majority voting in decisions on EU-wide market rules, thus removing blocking votes of member states sceptical to increased harmonisation of national policies.

Although energy was not part of the reform programme from the start, the general drive towards common internal market rules created a new dynamic where energy market actors became more active in redefining traditional energy policy issues (Andersen, 2000). European enterprises argued for deeper integration also of national energy markets, as a means to make energy supply more efficient, to align and cut energy prices across the region, and hence, to increase global competitiveness of European industry. From 1986 onwards, the Council of Ministers discussed greater integration of the domestic energy markets (Stern 1990, Andersen, 2000), and the Commission set out to identify procedures for the creation of an internal energy market.

In a 1988 green paper entitled ‘The Internal Energy market’,<sup>2</sup> the Commission identified four procedures that would be applied in the creation of an internal energy market. The first involved implementing the *general single market provisions* in the energy sector (i.e. harmonisation of rules and technical norms, the opening up of public procurement markets and the removal of fiscal barriers). The second involved the determined application by the Commission of already existing *general EC Treaty Law*, such as the general competition rules. The third involved finding a satisfactory equilibrium between energy and the environment and, the fourth, the application of additional, appropriate and specific case-by-case means (*specific energy directives*) to be adopted by the Council (Lyons, 1992:7; Smeers, 1993:25).

The Commission concluded that existing Community law and general single market provisions would be sufficient for removing barriers to competition in the downstream oil industry and coal and nuclear sectors. The former was already characterised by a high degree of competition. A reduction in state subsidies for the two latter would be required. For the downstream gas and electricity and upstream oil and gas industries, on the other hand, additional specific directives were regarded as necessary, since the structures and practices of these sectors deviated considerably from the internal market logic (Lyons 1994: 6-7). The initial reform work of the Commission therefore focused on the latter.

This chapter provides an overview of procedures and policy measures discussed and established in the early 1990s in order to empower the European Commission to work for the establishment of an internal energy market. The Commission identified a need to apply both *general EC Treaty law*, such as the rules on competition and specific *Council energy directives* as procedures in the process. Section 2.1 deals with the process of adopting specific energy directives and the degree to which this procedure succeeded in maintaining the principle of free and fair competition for energy companies in the internal energy market. Section 2.1.1 deals with the first stages of this process, and ends with the establishment of the Electricity and Gas Directives in 1996 and 1998. Section 2.1.2 deals with the period after this point in time and discusses how and why the Commission saw the directives as insufficient for establishing free and fair competition in the internal energy market. In section 2.1.3 we conclude on the achievements of the EU by 2002, and discuss recent evaluations of policy consistency with the principle of free and fair competition. Section 2.2 deals with the application of *general competition rules*, the second procedure identified by the Commission as a means to establish a free and fair energy market. The conclusion we draw is that whereas general EC Treaty competition rules were regarded as an important instrument back in the early 1990s, they were sparingly used after that to press forward an internal energy market. Section 2.3 summarises the main findings, and asks if asymmetries in the implementation of EU market policies and the lack of compatibility between general competition rules and specific internal market directives impacted on EU efforts to ensure a level playing field for market actors.

## **2.1 The energy directive procedure applied as a means to achieve an internal energy market**

### **2.1.1 The first stage – 1989–1998**

A package of proposals for specific energy directives needed for ensuring free and fair competition in the electricity and gas sectors was adopted by the Commission and sent to the Council of Ministers for approval in 1989. The Commission presented the package as a first stage initiative, to be followed up by new directives that would eventually lead to the establishment of a ‘common carrier’ system for gas and electricity across member states. A

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<sup>2</sup> Commission of the European Communities, *The Internal Market for Energy* (working paper of the Commission), COM (88) 238, final 2.5.88.



common carrier system would entail a system whereby any consumer could purchase energy from any supplier, regardless of ownership of the intermediary grid structures. This initial package also proposed a less comprehensive system, however, a ‘common transit system’ that would allow only national grid system operators to purchase electricity or gas across the territory of another member state (Lyons, 1992:8). Widespread opposition in the Council to a common carrier system prompted the Commission to embark on a stage-by-stage procedure.

In 1990 the Council adopted the least contentious of the directives in the proposed reform package, the price transparency directive.<sup>3</sup> This directive instructed electricity and gas suppliers to increase the transparency of pricing systems, prices and volumes sold to different customer groups. The Council also adopted a directive on ‘common transit’ rights for transmission grid operators in the electricity sector in 1990.<sup>4</sup> The similar ‘common transit’ directive for natural gas caused more problems, and was adopted in 1991 by a qualified majority.<sup>5</sup> Germany and the Netherlands voted against. A fourth directive proposal, the investment transparency directive, aimed at ensuring exchange of information to achieve a better coherence of large-scale investment projects in the Community, failed due to strong opposition from a number of member states.

These problems forced the Commission to revise its strategy. Instead of a top-down strategy, it proceeded with bottom-up, one involving extensive negotiations with member state representatives and experts in working groups. The outcome, more far-reaching directive proposals for the electricity and gas markets, was presented to the Council in 1992. The new proposals required member states to introduce *third party access* rights to a limited number of high volume gas and electricity consumers. The term ‘third party access’ or TPA represented a more limited form of common carriage where only energy consumers of a certain size were given free access to suppliers (Lyons, 1992:8). The proposals would also instruct member states to abolish exclusive rights in electricity generation as well as in the construction of gas and electricity transmission lines, and order vertically integrated companies to unbundle their accounting and management systems. The latter was important to increase transparency in transmission activities and prevent cross-subsidisation of transmission and other commercial activities. Despite pre-consultations in the working groups, the proposals failed to pass the Council, which sent them back to the Commission with detailed political instructions for future work.

Complex negotiations continued. In 1993, the European Parliament – through its energy committee – took an active role in finding a compromise that was acceptable to both the Council and Commission. Based on this compromise, a new Commission proposal was presented to the Council of Ministers in December 1993 (Andersen, 2000). Despite these moves, several rounds of negotiations were to pass before the Council and Parliament finally adopted the Electricity Directive in December 1996 and the Gas Directive in 1998.

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<sup>3</sup> 90/377/EEC

<sup>4</sup> 90/547/EEC

<sup>5</sup> 91/296/EEC

The final directives were heavily watered-down versions of the Commission's initial plan of a common carrier system. The Electricity Directive instructed member states to open at least 25.3 per cent of their market to free competition by 1997, increasing to 28 per cent in 2000 and 32 per cent in 2003. The Gas Directive left open for the member states to decide on how fast and effective reforms were to be carried out (Stern, 1998). The deadline given member countries for implementing the Electricity Directive into national legislation was February 1999. The deadline for implementation of the Gas Directive was August 2000. Rather than strict, invariable instructions, which characterised the Commission's initial proposals, the new directive proposals basically offered a *framework* for further liberalisation of the electricity and gas sectors, with considerable freedom for member states to choose pace and regulatory measures. Member states could opt for a system of regulated third party access (giving eligible customers the right to access on terms (transmission prices) made transparent ex-ante) but should not be denied the opportunity to apply a system of negotiated access (where the transmission system operator negotiates terms of access with eligible customers).

The Commission also had to accept the French requirement that member states could choose a single buyer system, in which a single firm would still control imports. France claimed this option to ensure that governments still had the powers to induce public service obligations (PSOs) on their firms.<sup>6</sup> The directive text stated, however, that 'such obligations must be clearly defined, transparent, non-discriminatory and verifiable; they, and any revision thereof, shall be published and notified to the Commission by member states without delay'.<sup>7</sup> Included in such PSOs were security of supply, regularity, quality and prices of supplies, and environmental protection. The directive provided for explicit deviation from general rules on access to the grid for generators of electricity, in favour of those generating electricity from renewable energy sources (Article 8 (3))<sup>8</sup>

Hence, the early energy directive procedure applied by the Commission produced only modest results in terms of legislative pressure on national governments to open up electricity and gas markets. More success was recorded in other parallel internal energy market processes. The Council adopted in 1990 a directive deciding that the energy sector should be included in general single market procurement rules even though the sector had been exempt from the Single Market Directive. In 1994, the Council adopted a directive which established common rules for regulators granting and authorising the prospecting, exploration and production of oil and gas, aimed at removing special privileges to national or state-owned companies (the Hydro-Carbon Licensing Directive).

### ***2.1.2 Market policies after the Electricity and Gas Directives***

The Commission had to accept that its original intention of creating a common carriage system for electricity and gas, and even the less ambitious system of harmonised national systems of third-party access, had not succeeded. It could only hope that over time attitudes in

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<sup>6</sup> Hence, article 3 (2) of the electricity directive actually provides member countries with opportunities to instruct the industry to take on public service obligations (PSOs), in the general economic interest.

<sup>7</sup> Article 3, Directive 96/92/EC.

the member states would change and market opening would proceed faster than actually demanded by the directives. It also had to accept that public service obligations (PSOs) were included in the text, enabling member states to legitimately favour national firms operating with such obligations. Moreover, EU decision-makers also realised that there were additional barriers to the creation of an internal energy market that were not covered by the directives. Both directives therefore instructed the Commission to submit reports to the Council and the European Parliament on further harmonization requirements, beyond those mentioned in the directives.<sup>9</sup>

In the first communication report on the Electricity Directive, which came in 1998,<sup>10</sup> the Commission addressed the problem of reconciling the Community's environmental policy with the goal of creating an internal energy market. More specifically, the report discussed the need of ensuring that provisions in the 1997 White Paper on renewable energies<sup>11</sup> were not at odds with free and fair competition in the internal energy market. The Commission concluded that the existence of various schemes for the promotion of renewables in member states would most likely lead to trade distortions. The Commission concluded that further analysis of existing national support schemes for electricity from renewable energy sources would be needed, and announced plans for a directive on the harmonisation of national schemes by the end of 1998.<sup>12</sup>

A second report on the Electricity Directive, which came in 2000,<sup>13</sup> addressed additional means beyond the directives to correct shortcomings of cross-country transmission systems (in terms of deviating transmission prices, congestion management systems and outright lack of transmission capacity), acting as barriers to trade across the member states. Already in 1998, the Commission had established the Electricity Regulatory Forum of Florence (the Florence Forum) to identify complementary measures in order to avoid ending up with 15 separate markets evolving in the Union. The Forum consisted of national regulatory authorities, member states, European Commission, transmission system operators, electricity traders, consumers, network users, and power exchanges. The Forum represented a new Commission instrument (consensus-seeking through discussion with member state stakeholder groups), beyond the more narrow working group system that had been applied earlier in the 1990s.

The Commission submitted the first communication report on the Gas Directive in 1999.<sup>14</sup> Also this report focused on obstacles to cross-border trade. A range of technical and national legal specification issues were raised as obstacles to cross-border trade in natural gas. Similar to the Electricity Directive a broad Forum of regulatory authorities – the European

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<sup>8</sup> 'A Member State may require the system operator, when dispatching generating installations, to give priority to generating installations using renewable energy sources or waste or producing combined heat and power.'

<sup>9</sup> Article 25 (1) of the Electricity Directive and Article 27 of the Gas Directive.

<sup>10</sup> COM (1998) 167 final, 16.3.1998.

<sup>11</sup> COM(97)599 Energy for the future - renewable sources of energy: White Paper.

<sup>12</sup> *Ibid.*, p.9.

<sup>13</sup> COM (2000) 297 final, 16.5.2000.

<sup>14</sup> Com (1999) 612, 23.11.99.

Commission, traders, consumers and users – the Madrid Forum, had been set up to identify further harmonisation needs beyond those mentioned in the Gas Directive.

The Commission gave high priority to solving the additional issues of cross-border physical and tariff-based transmission barriers to trade, realising that a true internal market would not be realised if trade were impeded at the borders. However, the Commission also continued its work on the Gas and Electricity Directives, aimed at pushing member states to open up their markets and establish third party access systems stricter than those actually demanded by the directives. An important tool applied in this work was benchmarking reports, openly displaying how member states performed with respect to implementation of the directives and also with respect to additional means applied for removing barriers to the internal energy market. Also part of the benchmarking reports was indicators of competition in the member states, in the form of price levels and rate of switches of suppliers. The first of the benchmarking reports on the implementation of the gas and electricity market came late 2001,<sup>15</sup> and was first dealt with by the European Council in Barcelona in March 2002. The second benchmarking report on the implementation of the directives came in April 2003.<sup>16</sup> A separate benchmarking report on transmission tariffs in the member states was published in October 2002.

### ***2.1.3 Commission request for more power to change the scope and depth of its regulatory competence***

In the 2001 benchmarking report, the Commission concluded that the process of creating a level playing field internal market in energy had run into serious problems, due to asymmetry in implementation of legislation already established as well as new obstacles concerning cross-border transmission systems. The report showed that some member states had not adapted national legislation to the directives. Several countries showed little progress in the rate at which customers were entitled to switch suppliers. For several countries, failure in ensuring fair access to transmission and distribution networks was recorded. Moreover, the reports showed that some member states had not even set deadlines for full market opening. In general, the implementation ‘failures’ and asymmetries were greater for the Gas Directive than for the Electricity Directive. The conclusion drawn by the Commission in its 2001 report was that the asymmetrical implementation of the directives had created different market conditions across member states in Europe, affecting both energy consumers and energy companies. The concerns were no less worrying two years later in the 2003 benchmarking report, where a range of obstacles were identified. One obstacle received particular attention, the *high degree of market concentration*, found in the gas and electricity industries in many member states.

The asymmetries recorded gave the Commission ammunition to target individual member states, as well as requiring more in-depth community level regulation, in order to save the internal market project from falling apart. Already at the Gothenburg Summit in 2001, the European Council agreed that the Gas and Electricity Directives had failed to create

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<sup>15</sup> SEC (2001), 1957, 03.12.01.

<sup>16</sup> SEC (2003 448, 07.04.03.

a true European energy market, and that a second package of measures was needed. The European Commission came up with proposals for amending the directives and additional regulations for matters still unregulated, which were finally adopted by the Council in June 2003. The amended directives required full electricity and gas market opening for non-household consumers by July 2004 and for all consumers by July 2007. The amendments also required *legal unbundling* of network activities, i.e. organisational separation of units operating transmission activities from units operating generation and supply activities. Moreover, it mandated the establishment of a regulator in all member states with well-defined regulatory functions and a requirement that network tariffs be published.

The scope of EU regulations was broadened by additional, separate rules for cross-border trade in gas and electricity. A regulatory committee will decide on guidelines for compensation of transit flows, on harmonisation of national transmission tariffs and on allocation of cross-border interconnection capacity.

The European Commission also sought to reduce the scope of the directive, however, in order to make policies aimed at creating an internal energy market more effective. More specifically, the Commission sought to remove member states' right to demand public service obligations of national firms, something that also enabled governments to favour these firms due to their specific role. Instead, the Commission wanted secondary legislation to provide for environmental protection and security of supply in the Community. The Parliament and Council did not accept this. Instead, public service obligations were reinforced in the amendments, with the introduction of monitoring of security of supply and a mandatory scheme for labelling the fuel mix, emission and waste data for electricity generation.

## **2.2 The general Community Law procedure applied in the process of establishing the internal energy market**

As noted above, the Commission envisioned back in the 1988 Green Paper 'The Internal Energy market'<sup>17</sup> the determined application of already existing European Community Treaties as a powerful tool for ensuring the creation of an internal market in energy. Indeed, the 1988 IEM paper laid out four areas in which the Commission would seek to apply general EC law: free movement of goods, state monopolies of a commercial character, rules of competition and state aids (Lyons, 1992:23). Application of rules of the Treaty (based on Article 90-3) would entail directives directly from the Commission that would *not* have to be adopted by the Council. EU competition rules had been adopted back in 1957 when the European Economic Community was established as part of the Treaty of Rome. The major aim of the rules was to ensure free movement of goods, services, capital and labour in the Community. The rules aimed at modifying both the conduct of players and the structure of markets. They prohibited price fixing agreements and abuse of dominant market position by undertakings. They even went so far so to warn that member states would not be allowed to abuse their privileged position in connection with public undertakings or undertakings to which member states granted special or exclusive rights. Finally, specific rules prohibited aid

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<sup>17</sup> COM/88/238.

granted by a member state or through state resources that distorted or threatened to distort competition by favouring certain undertakings or the production of certain goods. Hence, governments, public and private undertakings are all targets for the EC Treaty rules on competition and state aid. They seek not only to remove public barriers to trade and competition, but also prevent the erection of private barriers once *public* barriers are removed. Current EU competition policy<sup>18</sup> is more or less a blueprint of the rules established in 1957. An additional EC regulation was added in 1990 providing for the legal procedures for notification and treatment of mergers.<sup>19</sup>

The rules of competition and state aid were seen as particularly relevant tools for dismantling dominant market structures present in many national gas and electricity markets, seen by the Commission as fundamental barriers to free and fair competition in a common internal market. Nevertheless, the Commission concluded 15 years later, in the 2003 benchmarking report, that national electricity and gas market structures still functioned as a potential impediment to the realisation of fair competition in the EU.<sup>20</sup> The report even indicated that the restructuring or *mergers* taking place in the energy industries could further aggravate the problem of structural concentration, a conclusion backed also by independent studies.<sup>21</sup>

‘Differential rates of market opening... promote distortion of competition between energy companies by allowing the possibility of cross-subsidies at a time when companies are restructuring themselves into pan-European suppliers’.<sup>22</sup>

The repetition by the Commission in 2003 of the worries voiced 15 years earlier that anti-competitive structures in the gas and electricity markets could impede free and fair competition in the internal energy market indicates that the general EU competition rules and the Directorate-General responsible for competition had not come to play the promised role in the internal energy market process, despite of good intentions to do so in the 1988 Green Paper. Also recent Commission concerns over possible distorting effects of non-harmonised

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<sup>18</sup> articles 81 to 90 in the EC Treaty.

<sup>19</sup> Regulation 4064/89.

<sup>20</sup> The report stated that one of the most significant barriers to the internal electricity market was ‘[t]he high level of market power among existing generating companies associated with a lack of liquidity in wholesale and balancing markets which impedes new entrants’ (p. 4). The conclusion for the gas market was no less explicit. ‘Concentration of gas production and import in a few companies and slow development of gas trading hubs which often means that new entrants find it very difficult to buy wholesale gas on reasonable terms, although this situation could be significantly improved with better arrangements for cross border trade and the creation of a fully integrated single market’ (p. 5).

<sup>21</sup> An independent research report compiled by the German-based Öko-Institut in May 2002, concluded that only the UK and Scandinavian electricity markets could be characterised as unconcentrated markets, whereas in all other regions market concentration and its trends are critical with respect to establishment of a fair and competitive energy market (p. 19). France and Belgium were mentioned as particularly worrying, in that the former centralised state monopolies kept concentration indicators very high. Also with respect to the German market, which historically has enjoyed a certain diversity of power generation, mergers have pushed concentration indicators to levels that are regarded critical (p. 19). A recent IEA working paper has addressed the issue (referanse).

<sup>22</sup> Ibid, p. 3.

national state aid schemes to the energy industry points in the same direction<sup>23</sup> Hence, did the Commission neglect the general competition rules as an instrument to force through change in the member states?

Back in the period immediately after the adoption by the Commission of the 1988 Green Paper on the internal energy market, the competition services, DG IV, under the leadership of Commissioner Sir Leon Brittan actively sought to apply general community law for enforcing member states to dismantle national monopolistic energy structures. In 1991, the Commission allowed Brittan to start proceedings against gas and most electricity import/export monopolies in the member states. The Commission sent letters to member states asking them to justify their *de facto* monopolies, warning that the Commission intended to act more aggressively in order to achieve a single market in energy, (Lyons, 1992:23). In March 1991, an important judgement in the Court of Justice upheld the Commission's use of a generalised Commission directive (i.e. one that did not need to be sanctioned by either the European Parliament or even the Council) to force greater competition in the telecommunications sector (Lyons, 1992:13). This strengthened the case for a similar active use of the procedure in the energy sector. However, towards the end of 1991, after intense lobbying of commissioners by several governments, energy industries and the European Parliament, it became clear that DG IV would not develop any near-term directives to enforce competition in the energy sector based in general competition law (Lyons, 1992:23.). Another factor that contributed to the self-restriction was that the Commission was awaiting the outcome of a 'test case', the so-called Almelo case, which had been brought to the Court of Justice by the Dutch court (Lyons, 1998:34). Local Dutch electricity distributors, led by Gemeente Almelo wanted to import electricity from Germany, but were thwarted by the exclusive import and export rights granted to the generators (Lyons, 1998:34). In its April 1994 judgement, the Court of Justice found that, according to EU competition rules (articles 85 and 86), there had been trade-distorting practices involved, but that Article 90-2 provided some protection from competition rules when a company operated as a necessary general economic interest. The Court of Justice acknowledged that the Dutch generators had some public service obligations, but did not make any judgement on whether the obligations necessitated the monopolistic behaviour<sup>24</sup>. General community law therefore remained part of the Commission's arsenal as a substantive threat if the specific energy directive procedure did not work out properly. The Energy Commissioner Cardoso e Cunha signalled to the Energy Ministers at the 29 October 1991 Council that the Commission would be prepared to use them if progress was not made with the Gas and Electricity Directives (Lyons, 1992:24).

Hence, during the 1990s EU competition law was more a latent than actual instrument to be used in imposing competition onto domestic energy markets in the EU area. This latent

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<sup>23</sup> A 2002 Commission working paper ('Inventory of public aid granted to different energy sources') documented vast asymmetries in subsidies to national energy industries, likely to cause major distortions in competition between companies receiving and not receiving public aid. The EU Commission has acknowledged the competition distorting effects of the large asymmetries in state aid to energy across member countries.

<sup>24</sup> In 1996, the Dutch appeal court, taking the Court of Justice ruling as its base, found that the public service obligations presented by the generators were not sufficient grounds for imposing an import monopoly, and thus the generators had acted contrary to the Treaty's provisions (Lyons, 1998:34).

role was restated in 2001, when the Commission in June announced that if member states were unable or unwilling to adopt the new proposals for the completion of the energy markets, it might make use of the instruments provided for in Article 86(3) of the EC Treaty.<sup>25</sup>

The 2001 European Commission case against Norway requiring the dismantling of the Gas Negotiation Committee constitutes one of a few exceptions in which general competition rules have been used to induce structural changes.<sup>26</sup> The European Commission warned Norwegian gas producers that the joint sale of Norwegian gas carried out through the Gas Negotiation Committee (GFU) was in breach of the European Union competition rules as it fixed, among other things, the price and the quantities sold.<sup>27</sup> This case indicates that the Commission by the turn of the century was more prepared to apply general Community rules to enforce free and fair competition in the internal energy market.

### *2.2.1 The case of general merger control regulation in the European Community*

That EU competition law has mostly functioned as a latent threat to press through free and fair competition in the energy market can also be said of the narrower merger control regulation. The Commission and independent observers have voiced concerns that the many recent mergers seen in the European gas and electricity market may have further concentrated national industry structures. Those fears are borne out by statistics showing that of the 2400 merger cases notified in the period 1990–2003, the Commission cleared 2,235 of them (more than 90%) after only a routine four–six week review. Only 18 mergers were blocked.

Now this relatively lenient merger control may well be a product of the generally positive attitudes towards European-scale industry mergers at office of the Directorate-General responsible for competition (DG IV). We can read, for instance, in a DG VI information brochure on EU Competition Policy published in 2000 that ‘in a market in the process of integration, mergers which create or strengthen a dominant position are, in fact, quite rare’,<sup>28</sup> and adds that

When companies combine via a merger, an acquisition or the creation of a joint venture, this generally has a positive impact on market...In the context of the globalisation of trade coupled with the further development of the single market in the Community, firms are being driven to combine in order to reach a size which will allow them to remain competitive and present on markets that are extending all the time. In recent years, the merger trend in the European Union has gained pace.<sup>29</sup>

<sup>25</sup> XXXIST Report on Competition Policy 2001 – SEC(2002) 462 final: 41.

<sup>26</sup> . The Commission initiated formal proceedings against approximately 30 Norwegian gas companies arguing that the GFU scheme was incompatible with European competition law. Both the gas companies and the Norwegian Government claimed, at a hearing in December 2001, that European competition law should not be applied, since the GFU scheme had been discontinued for sales to the EEA as of June 2001 following the issuance of a Royal decree by the Norwegian Government. They also argued that European competition law could not be applied, since the Norwegian gas producers had been compelled by the Norwegian Government to sell gas through the GFU system established by the Norwegian Government.

<sup>27</sup> Commission Press Release, IP/01/830 Brussels, 13 June 2001

<sup>28</sup> European Commission, 2000, Competition policy in Europe and the citizen, p. 21.

<sup>29</sup> Ibid., p.19.



Gerber (1994, p. 137) concluded that the lenient merger control in the Commission could be symptomatic of a shift in the early 1990s when the Commission turned away from earlier concerns with private conduct and lighted on government barriers to free and fair trade in the Union. In the opinion of Neven et al. (1993) EU merger control is highly politicised, suffused with informal deals that tend to direct decisions in favour rather than against mergers.

A more historical and institutional reason is that merger control is a policy area in which the Commission has still limited competence and experience. Merger control was not included in the 1957 Treaty and only provided for by additional regulation in 1989 after 20 years of political wrangling (Wilks & McGowan, 1995). Merger control had not been an issue when drafting the Treaties because the original six member states simply lacked merger control legislation, and were preoccupied less with market domination than with the creation of ‘Euro champions’- firms large enough to compete with US and Japanese firms. Current EU merger control regulation still applies therefore only to large mergers with a Community dimension. The Community dimension of mergers and acquisitions is assessed on the basis of turnover thresholds applied to the companies involved. The most important are the worldwide threshold (EUR 5000 million of all undertakings combined) and the Community-wide threshold (EUR 250 million of at least two of the undertakings).<sup>30</sup> Below these thresholds, member states are free to enforce their own merger control systems. Unease grew in the 1990s as EU merger control regulation was seen to function below par due to political interference. German authorities and the German Federal Cartel Office, often the strongest exponents of a strict European competition policy, were the most outspoken critics. What they called for was a politically independent European Cartel Office to deal with merger control (Wilks & McGowan, 1995: 260). The idea of an independent European Cartel Office was rejected by subsequent DG IV Commissioners, with the backing of member states with little interest in strengthened cartel regulation at the EU level. When the Commission in 2001 adopted a proposal to increase its competency in the area,<sup>31</sup> the German Federal Cartel Office and other national competition authorities raised objections, fearing that European merger control would become even more lenient than before.<sup>32</sup> First then, the Commission has limited competency in handling concentration cases in the Community and practice is highly lenient; second, the principle of subsidiarity is robust. Both encourage disparate national practices.

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<sup>30</sup> After 1997, a merger has a Community dimension also if it requires ‘filings’ in more than three member countries and the worldwide turnover of the merging undertakings is more than EUR 2500, Community-wide turnover more than EUR 100, with further specification of distribution of turnover in the actual countries.

<sup>31</sup> The Commission proposed to lower the threshold level for cases in which the Commission would have sole competency. This would facilitate the process for European firms, giving them a one-stop-shop procedure, instead of different national legislation and competition authorities.

<sup>32</sup> Reply of the Bundeskartellamt to the Green Paper of the Commission of the Review of Regulation (EEC) No 4064/89 of the Council on the control of concentrations between undertakings, Bundeskartellamt, E/G4 – 3001/93 Bd. 3, Bonn, 21 March 2002. The Federal Cartel Office emphasised in its comment on the Green Paper that the major aim of the Commission seemed to be a speed-up and simplification of the notification process for European industries.

### 2.2.2 Competition legislation and state aid

It is clear that the Commission in the early 1990s saw long-standing state aid to national industries, particularly the massive state aid to European coal industries, as a major obstacle to free and fair competition in the internal market. Restructuring and reduction of coal subsidies were considered major conditions for the creation of a fair internal energy market as asymmetrical levels of state aid would not only favour coal over other energy sources but also the industry of some member states over others. Since state aid to coal was already regulated by special provisions in the 1951 ECSC Treaty<sup>33</sup> and was not included in the wider competition legislation in the EC Treaty with its provisions on State aids, it was not DG IV but DG XVII (the Energy Directorate), that in a 1986 decision required all aid to the coal industry to be re-negotiated in 1995 (see decision no 86/2064/ECSC), (Lyons, 1992:29).

In the 1990s, the Commission, in negotiations with member states, managed to reduce and restructure coal subsidies. The table below sets out the figures from the end of the 1980s to 2001.

**Table 1. Member state aid to the coal industry (million) Ecu, 1988–90 and 1997–2001**

	1988	1989	1990	1997	1998	1999	2000	2001
Aid to production	5 724	11 891	4 996	5 993	5 417	5 394	4 837	3 832
Non-production aid	7 400	10 945	8 838	1 361	1 529	1 362	2 130	2 487
Total	13 124	22 836	13 834	7 354	6 946	6 756	6 967	6 319

It is evident that the Commission did succeed in curtailing state aid to the coal industry as the 1990s progressed, and in changing the structure of the subsidies as well.<sup>34</sup> Nevertheless, vast sums are still poured into the coal industry of certain member countries, notably Germany, which in 2001 stood for about 2/3 of all EU member state aids to coal. Other major national coal industries still heavily subsidised are the Spanish and French industries.<sup>35</sup>

When the ECSC Treaty expired in 2002, EU member states had the chance to reconcile state coal-aid policies with the competition rules dealing with state aid in general.

<sup>33</sup> Provisions in the ECSC Treaty obliged Member States to seek Commission approval of all subsidies and major investments connected with domestic coal mining. Member countries and the EU for security of supply reasons regarded such subsidies legitimate, since domestic coal resources otherwise would be non-competitive to coal imported from outside the region.

<sup>34</sup> In one important respect, the Commission was instrumental in restructuring state aid to coal. In Germany, coal producers and the electricity industry had long entered into two agreements (known as *Jahrhundertvertrag*, 1974 and 1980) which specified the amounts of German coal the power industry should consume for fuel. In return, the electricity industry was allowed to recover the extra fuel costs through the imposition of an extra tax, the *Kohlenpfennig*. Under pressure from the Commission, the German Supreme Court in 1994 deemed the arrangements illegal. The upshot is that although the German electricity industry's coal consumption is still subsidised, subsidies fell dramatically after this decision.

<sup>35</sup> Commission Staff Working paper – Inventory of public aid granted to different energy sources, COM (2002), pp. 23–24

They chose instead a council regulation that kept decisions on state aid to coal outside the realms of the general competition rules.<sup>36</sup> This was when the *security of supply* again had become a major energy policy issue in the Community, a factor that doubtless helped sway the Council and Parliament to widen policies regulating state aid to coal beyond the realms of general competition policy. Hence, the new Regulation states that

As indicated in the Green Paper on a European strategy for the security of energy supply (adopted by the Commission on 29 November 2002), it is therefore necessary, on the basis of the current energy situation, to take measures which will make it possible to guarantee access to coal reserves and hence a potential availability of Community coal. In this connection, the European Parliament adopted a Resolution on 16 October 2002 on the Commission Green Paper on a European strategy for the security of energy supply, which acknowledges the importance of coal as an indigenous source of energy. The European Parliament said that provision should be made for financial support for coal production, whilst recognising the need for more efficiency in this sector and for cutting back subsidies. Strengthening the Union's energy security, which underpins the general precautionary principle, therefore justifies the maintenance of coal-producing capability supported by State aid.

This particular example shows how the dilemma caused by EU-wide and member state supply security requirements affects EU policies aimed at creating an internal energy market based on free and fair competition. It is also but one where we see the principle of free and fair competition in the European energy market being sidestepped in order to solve the more important supply security problem in the EU. In chapter 3 we return to this quandary.

### **2.3 Conclusion – the consistency of EU internal energy market policies with the principle of free and fair competition**

How consistently have EU internal energy market policies fostered the principle of free and fair competition in the Union? The Commission in 1988 identified several major procedures for how it would proceed in its efforts at establishing an internal energy market based on the principle of free and fair competition between companies operating in the market, regardless of national origin. The first of them involved the promulgation of several closely worded energy directives aimed at harmonising government regulations at state level. Policies developed under this procedure increased considerably in scope and depth since the Electricity and Gas Directives were adopted in 1996 and 1998. EU decision-makers recognised that these directives were insufficient instruments for removing major barriers to free and fair competition. Amendments of the directives, adopted by the Council in 2003, should, if implemented by national governments, improve the prospects of free and fair competition for energy enterprises across member states becoming a reality. The amendments sought to rectify asymmetrical implementation problems across member states by reducing discretion in the choice of regulatory approach and introducing clear timetables for a full-scale market opening to be completed by all member states. The amendments also included formerly unregulated factors that impeded free cross-border trade between certain member states, potentially shielding the industry in some member states and impeding foreign

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<sup>36</sup> Council Regulation (EC) No 1407/2002

companies from competing in the market. It is, however, clear that progress in compliance with the principle of free and fair competition will be dependent on symmetrical implementation by member states of the 2003 directive amendments. The high extent of asymmetric implementation in the past does not promise untroubled waters ahead. Despite the amendments, there is growing concern both at the Commission and among independent observers that the energy directive procedure has failed to break up concentrated national industry structures or even managed to prevent the reinforcement of such structures through mergers and acquisitions, which could work against future free and fair competition between energy companies in the Union. The European Commission envisioned in 1988 another procedure to deal with such energy industry structures, the application of general competition legislation. Nevertheless, the procedure remained dormant, and never really applied with determination to prevent increased market concentration in national energy markets, despite the Commission having fully acknowledged the situation as worrying. The Directorate-General responsible for competition (DG IV) has so far intervened only in a few energy industry mergers and acquisition deals. Hence, the two actions available for enforcing free and fair competition are not fully reconciled.

Lack of reconciliation also characterises policies aimed at restructuring state aid to the coal industry. Also here, general competition regulation on state aid was sidestepped and the Directorate-General responsible for energy (DG XVII) took on regulatory competency instead of the DG IV, leading only to incremental and slow progress in bringing state subsidy arrangements in line with internal market principles of free and fair competition. As noted above, whereas the Commission had considerable clout in its early efforts to remove the highly asymmetrical state subsidies to coal production, legitimised as part of the internal market policy, new attention to energy security in recent years seems to have dented the political legitimacy of Commission attempts to remove coal subsidies, seen as a barrier to free and fair competition in the Union. In sum then, insufficient attention to coordinate has not only affected EU-wide general competition rules and internal market directives to promote a free and fair internal market. It has also affected policies established to accomplish other energy policy goals. We return also to this topic in chapter 3.

### **3 Other EU energy policy goals and policies – consistency with the principle of free and fair competition in the internal energy market?**

In this chapter we explore whether EU environmental and energy security policy measures and goals for the European energy system were consistent with the principle of free and fair competition in the internal energy market. In section 3.1 we summarise the effects of EU environmental policy on the energy industry. In section 3.2 we discuss why environmental policies have been at odds with the efforts of the Commission to establish an internal energy market. In section 3.3, we look at Commission initiatives to increase its competency in energy security matters, and the actual policies put in place. This is where we also discuss the compatibility of these measures with the internal energy market principle of free and fair

competition. Section 3.4 summarise our conclusions and discuss further the impacts of the lack of reconciliation of policies on the internal energy market principle of free and fair competition.

### **3.1 EU environmental policy as it affects the energy industry**

Although environmental policy got off to a slow start, steps in the 1970s and 80s had an immediate impact on the energy sector.<sup>37</sup> By the early 1980s, acid rain had become a public issue, and, in Germany especially, public opinion was enflamed as the damage to the Black Forest became apparent and German farmers began to worry about their livelihood (Lyons, 1992:64).<sup>38</sup> The 1988 Large Combustion Plant Directive,<sup>39</sup> which took over four years to negotiate, was a major achievement by the Commission in controlling air pollution (SO<sub>2</sub> and NO<sub>x</sub>) from the electricity industry. Three years on, though, several member states had still not incorporated the directive in national law or communicated their national directive compliance plans to the Commission (Lyons, 1992:66).

At the start of the 1990s, the traditional barriers between energy and environmental sectors in Commission policy-making were crumbling (Lyons, 1992:75), reflecting in no small part the greater clout of environment ministers in some member states than their colleagues heading the energy departments; almost everywhere stronger links were being forged between environment and energy, and in some cases the two departments were being combined. One issue alone, global warming, was seen as the catalyst behind the fusion of environmental and energy interests and the major reason EU energy policy in the 1990s took such serious account of environmental protection. Carbon dioxide emissions, largely from fossil fuels, were and still are considered the main contributory factor to the greenhouse effect.

The 1990s was also the decade the Community widened its powers to deal with environmental issues. The 1987 Single European Act contained explicit references to the environment, including, in article 130-R, the following undertaking:

Action by the Community relating to the environment shall be based on the principles that preventative action should be taken, that environmental damage should as a priority be rectified at source, and that the polluter should pay. Environmental protection requirements shall be a component of the Community's other policies.

The 1993 Maastricht Agreement opened for decision-making by majority rule on environmental issues, apart from when fiscal concerns were involved. This certainly increased the powers of the European Commission to propose and get adopted environmental

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<sup>37</sup> In 1970, the EC adopted Directive 70/220/EEC, which limited car petrol engine emissions of carbon monoxide and unburnt hydrocarbons, and standards were strengthened several times during the 1970s and 80s. An initiative to limit the sulphur content of heavy fuel oil in 1976 had to be withdrawn because of opposition from some Member States, including Germany.

<sup>38</sup> Hence, in 1984, the EU adopted Directive 84/360/EEC set out to limit emissions from industrial plants. The directive settled the principles of Best Available Technology and that Member states can implement more stringent measures under certain conditions.

<sup>39</sup> 88/609/EEC

regulations. As a result, a series of directives and programmes were forthcoming that used administrative and information measures aimed at spurring behavioural change in energy sector and among energy users. On the other hand, the Agreement curtailed the arsenal of means that could effectively be applied by the Commission since the adoption of harmonised tax rules would still need unanimity in the Council.

Although the list of new EU environmental directives on pollution from the energy and transport sectors adopted during the 1990s is long (Wettestad, 2002),<sup>40</sup> it was particularly in the field of climate change that the European Commission's governance ambitions grew during the 1990s. The Commission's thinking on the greenhouse effect moved ahead sharply between the 1988 communication (COM/88/656) and the 1989 communication (COM/89/369) on 'energy and the environment' (Lyons, 1992:75). In the latter, the Commission concluded that additional economic gains resulting from the internal energy market or 'new tax systems' could be used to finance some of the control and saving schemes suggested in the report. Otherwise, the energy and environment communication entailed a considerable degree of compromise between the Commission's energy and environment services (DG XVII and DG XI). One of these compromises was over nuclear energy. The paper's only reference to the subject affirmed that nuclear power could contribute to a limitation of emissions from fossil fuel combustion but that a debate on the safety, transport and waste (including that arising from the decommissioning process) from nuclear energy would have to be launched in a broad political framework.

This compromise statement reflected a wider European retreat, politically speaking, from a positive approach to nuclear power generation. One year earlier, the 1988 communication on the greenhouse effect had mentioned 'the increased use of nuclear power' as a possible action to reduce CO<sub>2</sub> emissions (Lyons, 1992:77).

In October 1990, Italy convened the first-ever joint energy and environment council, where a commitment was forthcoming to stabilise the Community's CO<sub>2</sub> emissions at the 1990 level by the year 2000. Already in August 1990, a draft report on fiscal instruments examining different CO<sub>2</sub> emission stabilizing options was circulating, one of which was the idea of tradable permits (Lyons, 1992:77). By December, the Commission decided to opt for a combined energy and carbon tax, and informed the member states in an unpublished paper on 'policy options in view of the Community's CO<sub>2</sub> emission stabilisation target' (ibid.). In September 1991, the Commission launched its strategy paper in which it described steps to stabilise CO<sub>2</sub> emissions, including a proposed energy/carbon tax. Apart from the section on the energy/carbon tax the strategy paper did not go into much detail, and it appeared to have

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<sup>40</sup> The transport sector (fuel and vehicle manufacturers) was further targeted through the Auto Oil Programmes launched during the 1990s, aimed at prompting vehicle fuel combustion efficiency and fuel qualities. Another target were the emissions from large coal-fired power plants. Amendments in 1994 (COUNCIL DIRECTIVE 94/66 EC) to the LCP Directive set limit values for SO<sub>2</sub> emissions also from smaller combustion plants using solid fuels. Another parallel EU air quality policy initiative targeted both the oil and vehicle manufacturing industry. Air quality policy efforts were further stepped up when the EU launched the Clean Air for Europe (CAFE) programme in 2001. The integrated policy advice from the CAFE programme is planned submitted by the end of 2004 or beginning of 2005. The European Commission will present its thematic strategy on air pollution during the first half year of 2005, outlining the environmental objectives for air quality and measures to be taken to achieve the meet these objectives.

been written around the need to get a Council mandate to prepare a draft directive for such a tax (*ibid.*). Apart from fiscal measures, the strategy paper outlined two other sets of measures: specific measures (R&D programmes, sectoral measures and other types of regulatory and voluntary measures) and complementary national programmes (Lyons, 1992:79).<sup>41</sup>

It was, however, the proposals for an energy/carbon tax that proved particularly controversial. The Commission formulated the proposal as 'a new type of legislative approach providing for an orderly use of fiscal incentives by the member states within the internal market' (Lyons, 1992:84). The proposed combined energy/carbon tax took into account both the energy component and carbon content. The energy component was a 'security of supply' component, aimed at dampening demand for energy. It also took into account environmental disadvantages of nuclear energy and large-scale hydroelectric schemes. Exemption was proposed for renewables (Lyons, 1992:85). While energy and environment commissioners at the Commission promoted the carbon tax proposal, it met with trenchant opposition from other commissioners, notably the Commissioner on Taxation (Skjærseth, 1994:28). There was vociferous lobbying in Brussels by business interests fighting the tax (*ibid.*). Although the proposal was re-written to include the principle of conditionality, which meant that the tax would only be implemented if other OECD countries followed suit, the Council never managed to gather unanimous support for implementing the tax. The UK, France and southern EU countries were strongly opposed. The UK was against transferring fiscal powers to the EU; France was only interested in a carbon tax, not one that could harm its nuclear industry; and the least economically developed EU states feared that a common tax would stump economic growth. The failure of the European Commission to get through a common framework for carbon/energy taxes was caused by strong member state opposition and the lack of power to enforce harmonised fiscal instruments. Despite this failure, the European Commission did not give up, and continued to draft another directive on minimum taxes on energy products. The Commission adopted the draft in 1997, and after difficult and often interrupted negotiations, the Council adopted the directive in October 2003. The numerous compromises required to win the unanimous backing of the fifteen EU states had trimmed it of any near-term consequences for national tax levels, but may have strengthened the longer-term likelihood of upwards harmonisation of tax rates, (Christiansen and Hasselknippe, 2003). The many exemptions allowed in the tax regime led EU Internal Market Commissioner Frits Bolkestein to compare it to a Gruyere cheese, 'too many holes'.<sup>42</sup>

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<sup>41</sup> Specific measures included the ALTENER programme (renewable energy), 'a proposal on least cost planning' and ways of encouraging low pollution/high performance technologies, such as CHP, in the power generation sector. Also among specific measures were 'energy auditing', and energy savings measures in the industrial sector, including the Save programme and energy labelling schemes. Proposals for the household sector were heat metering and certification of buildings. For the transport sector it proposed the use of BAT to reduce exhaust emissions and increased fuel efficiency. The complementary national programmes included proposals for national burden sharing of emission reductions, acknowledging that some Member States would need extra economic growth than others. It also included calls for R&D, fiscal incentives such as house insulation, carbon sinks, etc.

<sup>42</sup> Environment Daily, ISSUE 1540 - TUESDAY 28 OCTOBER 2003

### **3.2 European Commission efforts to reconcile environmental policy measures with internal market principles**

It is clear that the Commission continued to argue for harmonised taxes during the 1990s because they considered it an essential step on the road towards free and fair competition between energy companies regulated by different member state governments. The connection was discussed already in the 1991 strategy paper on meeting the CO<sub>2</sub> emission target. During the 1990s the Commission pointed out with increasing emphasis that the many different environmental standards and state support schemes across member states were not compatible with free and fair competition in the internal market. Member state governments and members of the European Parliament, on the other hand, also noted a reverse connection, i.e., that internal market rules might not be compatible with improving the environmental performance of the European energy system. The likelihood of conflict between environmental goals and internal market rules was surely acknowledged when the Electricity and Gas Directives were drafted as the Commission had to accept provisions in the directives allowing member states to deviate from parts of the directive in case they opted for instructing their national industry to take on particular environmental restructuring obligations (part of what was called public service obligations – PSOs). Article 8 (3) of the Electricity Directive was explicit in allowing deviation from general rules on access to the grid for generators of electricity in favour of those generating electricity from renewable energy sources.<sup>43</sup>

The conflict was further acknowledged when the Commission set out to propose specific climate policy measures beyond the CO<sub>2</sub> tax. One such measure was the 1997 White Paper for a Community Strategy and Action Plan, Energy for the Future: Renewable Sources of Energy, in which the goal of coupling the share of renewable energy in the EU from 6% to 12% in 2010 was formulated.<sup>44</sup> As already noted in chapter 2, the European Commission devoted in this White Paper full attention to its first report to the European Parliament on further harmonisation requirements beyond the Electricity and Gas Directives needed for an internal energy market in Europe to materialise. The Commission voiced concerns that non-harmonised schemes established in member states to promote the use of renewables would result in trade distortions.<sup>45</sup> The report illustrated its point with an example. Given a country paying state aid to renewables (X) and another operating a system of green certificates (Y), ‘[i]f producers from X were permitted by country Y to issue and sell green certificates in Y, they may receive double support. Producers in Y selling in X would, on the other hand, receive not support whatsoever’.<sup>46</sup>

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<sup>43</sup> Article 8 (3) in the directive states: ‘A Member State may require the system operator, when dispatching generating installations, to give priority to generating installations using renewable energy sources or waste or producing combined heat and power.’ The Commission managed, as a compromise, to get the directive text included specifying that ‘such obligations must be clearly defined, transparent, non-discriminatory and verifiable; they, and any revision thereof, shall be published and notified to the Commission by Member States without delay.’

<sup>44</sup> COM (97) 599 final.

<sup>45</sup> Some member states had introduced guaranteed prices for producers of electricity based on renewables, other states operated with tax exemptions, and schemes supporting per kWh produced, etc.

<sup>46</sup> Report to the Council and the European Parliament on Harmonization Requirements, p. 3.



The Commission thereafter gave harmonisation of support schemes top priority in its further work of transforming the White Paper into what became the 2001 Directive on the Promotion of Electricity Produced from Renewable Energy Sources in the Internal Electricity Market.<sup>47</sup> Both a common levy for consumers across the Union and a system of tradable green electricity quotas were seen as funding systems compatible with the general internal market rules. This notwithstanding, no single harmonised system across member states was proposed in the 2001 Report to the Council and Parliament on the implementation of the Community Strategy and Action Plan,<sup>48</sup> and in the 2001 directive, also named the Green Electricity Directive.<sup>49</sup> Explicit reference was instead made in the directive to the 'subsidiarity principle' as valid for member state choice of schemes, and that more time would be needed to evaluate the functioning of the various national renewables support schemes. The directive instructed the Commission to come up with a well-documented report on national experiences by October 2005.

Hence, the Commission did not prevail in its efforts at standardising and harmonising renewable energy support schemes with internal market principles in the directive, entailing continued asymmetries in support given to industry across member states and a breach of the internal energy market principle of free and fair competition. The Commission instead sought to support national initiatives that could function as models for a future harmonised Community system, such as the Renewable Energy Certificate System concept that had been formulated back in 1998 at a workshop hosted by the European Commission in the Netherlands.<sup>50</sup>

In one important exception, the Commission managed to get the Council to adopt a climate policy tool that in principle could be made compatible with the internal energy market principle of free and fair competition, the CO<sub>2</sub> emission trading system, adopted by the Council in 2003. In the 2000 Green paper on greenhouse gas emissions trading within the European Union, the Commission states that

a coherent and co-ordinated framework for implementing emissions trading covering all Member States would provide the best guarantee for a smooth functioning internal emissions market as compared to a set of uncoordinated national emissions trading schemes.... The development of the internal market has been one of the driving forces behind the EU's recent development, and this should be taken into consideration when creating new markets.... The Commission believes that a

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<sup>47</sup> Directive 2001/77/EC

<sup>48</sup> COM (2001) 69(01)

<sup>49</sup> The Directive set the target of 22% of electricity being produced by renewable sources of energy by 2010, against 14% in 2001. It instructed member countries to come up with indicative targets of consumption of renewable electricity in national reports by October 2002.

<sup>50</sup> Based on this concept, a pan-European RECS group was established to investigate whether the system could be extended across Europe. In 1999, An Association of Issuing Bodies, represented by national electricity system operators, was formed, and European governments formed in 2001 a group to follow the test-phase process and for a more close examination of whether national RECs schemes could be defined. The first certificates were issued in Finland in 2001, and by 2003; several European countries had made the system mandatory instead of voluntary. Nevertheless, there are still member countries that oppose that such a system should replace their already established national schemes.

Community approach is necessary to ensure competition is not distorted within the internal market<sup>51</sup>

It is conceivable that the internal market was an important factor when the Council in the late 1990s gave up its scepticism to a system of emissions trading, one of the flexibility mechanisms under the 1997 Kyoto Protocol, heavily inspired by the US, and started instead to work actively to turn the EU into a frontrunner in using emissions trading as an instrument to achieve emission reductions. The Commission had, as noted above, already in 1990 included tradable permits as an instrument compatible with the internal market goal, but as it failed to get the Council to accept other harmonised fiscal instruments during the 1990s, it increasingly pushed tradable permits as an acceptable alternative. When the Commission warned the Council in 2001 that the internal energy market was in great trouble, not least thanks to the wide range of national-specific trade-distorting environmental regulations, it may have impelled the Council to accept the tradable permit system. Nevertheless, the emission trading system is still not up and running, and national governments have considerable leeway in adapting the system to benefit their industrial interests. Whether the final system will actually narrow or widen trade distortions between member states' energy industries will only be seen when the system comes into force in 2005.

### **3.3 EU level initiatives and policies aimed at reaching security of supply in the Union**

*Increased energy security* in Europe has influenced EU co-operation from the start in the 1950s. Two out of three founding European Community Treaties dealt with the issue of co-operation to ensure sufficient supply of energy. The Treaty establishing the European Coal and Steel Community (ECSC Treaty) was signed in 1951, and the Treaty establishing the European Atomic Energy Community (EAEC or EURATOM Treaty) came in 1957. Together with the 1957 Rome Treaty on the European Economic Community (the EEC Treaty), they constitute the founding treaties of the European Community.<sup>52</sup> Early EC energy co-operation revolved around enhancing and improving coal and nuclear supplies in Europe. Extensive R&D resources were channelled through the ECSC and EURATOM Treaties.

Security of supply has remained near top of the EU energy agenda, reflecting the general lack of conventional energy resources and dependency on imports from outside the area, and international events threatening to interrupt the flow of energy into the EU. The political embargos of the Arab oil producers in the 1970s hit many EC countries hard, with energy supply interruptions threatening economic growth and welfare. During the 1970s and 80s, energy policy strategies concentrated fully on the security of supply issue. In 1986, the common objectives established for community energy policy were<sup>53</sup>

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<sup>51</sup> COM (2000) 87, 08.03.2000.

<sup>52</sup> Historically, the ECSC Treaty was the practical follow-up to the Schuman Declaration of 9 May 1950, which proposed placing Franco-German production of coal and steel under a common High Authority within the framework of an organisation open to the participation of the other countries of Europe. The ECSC Treaty expired in 2002, and coal policy matters continued to be governed by special EU regulations.

<sup>53</sup> General objectives set out in the 1986 resolution (OJ/86/C241).

- Maximise security of supply and reduce the risks of sudden fluctuations in energy prices through developing the Community's own energy resources under satisfactory economic conditions;
- Diversify the Community's external sources of supply;
- Improve the flexibility of energy systems and, *inter alia*, develop, as necessary, network link-ups;
- Develop effective crisis measures, particularly in the oil sector;
- Create a vigorous policy for energy saving and the rational use of energy, with diversification between the different forms of energy.

Beyond such general policy guidelines, actual EU-level *legislative tools* aimed at coordinated action on security of supply issues remained scant. One exception was the 1975 directive that restricted the use of natural gas for power generation.<sup>54</sup> The directive was revoked in 1991.

As documented by Lyons (1992), security of supply slipped down the agenda in 1989 and the internal energy market became the main focus of DGXVII's attention, alongside environmental policy. Security of supply and the internal energy market were not considered mutually exclusive, however. In the 1988 Communication on a single energy market, the Commission recognised that 'a more integrated energy market is a significant additional factor as regards the security of supply for all Member States.'<sup>55</sup> Nevertheless, when the Commission started to work out its first internal energy market proposals in 1990 (third party access, attacks on German coal subsidies, etc.), member state fears that competition would interfere negatively with security of supply considerations could not be easily shaken off (Lyons, 1992:42). The Commission responded by recognising that 'the internal energy market cannot be set up until the notion of security of supply has been defined'.<sup>56</sup> In a working paper on the security of energy supply policies proposals were presented aimed at striking a balance between the benefits of security of supply for member states and the potential negative effects of state financial and legal support.<sup>57</sup> The Commission also asked member states to incorporate a new chapter on energy into the Treaty, as a mode of achieving more power to co-ordinate security of supply and internal market issues (Lyons, 1992:43). The draft articles for a new Treaty chapter on energy failed to be adopted by the Council, however, due to a strong blocking alliance, of which the UK, Germany and the Netherlands were important parts (*ibid.*).

After the Iraqi invasion of Kuwait in 1991, causing new oil market turmoil, the Commission sought to widen its capacity to respond to oil market instabilities. A package of

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<sup>54</sup> Directive 75/404/EEC.

<sup>55</sup> COM/88/238.

<sup>56</sup> The Commission first progress report on the Internal Energy Market (COM/90/124).

<sup>57</sup> DG XVII working paper on security of energy supply (SEC/90/1248). In this document, the Commission for the first time specified what share of a Member State's electricity generating capacity could be dedicated to indigenous fuel resources or state-supported for security of supply reasons – 20 per cent, in later communications to be reduced to 15 per cent by 2000.

directive proposals was, however, rejected by the Energy Council.<sup>58</sup> Member state governments also systematically undermined Commission efforts to assume greater power in the coordination of member state security of supply policies.<sup>59</sup> Security of supply continued to interfere with Commission internal market policies when it was added as a public service obligation (PSO) in the Electricity and Gas Directives; the directives allowed member states to deviate from internal market principles if deemed necessary by national security of supply considerations.

From 2000 onwards, energy security gained new topicality in EU energy policy, due in part to fresh energy growth figures showing an increase in import dependencies<sup>60</sup> and other figures showing an aggravation of the situation after the 2000 Nice Summit opened the EU up to new applicant countries from Eastern Europe in 2004. 2002 and 2003 added to the concerns, as massive blackouts caused havoc in California, Italy, Sweden and Denmark. Voices were once again being raised questioning whether liberalised energy systems would bring about more vulnerability and short-term risks of supply distortions than under the former centrally planned systems. A sudden oil price hike at the end of 2000 also fanned energy security concerns. The Commission could no longer deal lightly with the security of supply issue, and published in November 2000 a Green Paper in which it announced the introduction of a broad security of supply strategy.<sup>61</sup>

The Green Paper addressed a range of both long-term and short-term security challenges, and measures that could be taken to reduce the risks. It fully acknowledged that simultaneously reaching environmental and energy security goals would constrain options available.

The evidence of climate change and the demands of sustainable development greatly restrict the possible options in the supply security debate. Yet secure energy supplies and sustainable development share similar aims: reducing energy intensity, improving energy efficiency and increasing clean, indigenous and renewable energy sources simultaneously serve environmental and energy supply objectives.<sup>62</sup>

The Green Paper also acknowledged the likelihood of friction in simultaneously trying to reach internal market goals and energy security.

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<sup>58</sup> Part of the package was a proposal to give the Commission greater power in international negotiations within the IEA framework. Some role was eventually given to the Commission in IEA –negotiations, but far less than proposed by the Commission.

<sup>59</sup> On top of this the Commission were facing new problems with already established security of supply policies directed at increasing the production of nuclear power in the member states. Vast EC and member country government subsidies had been poured into nuclear power programmes, and the lack of transparency characterising these programmes were clearly not compatible with internal market goals. Also the 1986 Chernobyl disaster had rendered further efforts by the Commission to support nuclear power difficult.

<sup>60</sup> In November 2000, the EU Commission published the Green paper ‘Towards a European Strategy for the Security of Energy Supply’, [COM(2000)769]. The Green Paper presented risks of short-term and long-term supply distortions, based on the trends of EU’s ever-widening dependence on energy imports, expected to rise from 50 per cent of its energy requirements to 70 per cent the next 20 to 30 years if no countermeasures were taken. Energy imports represented in 2000 6 per cent of total imports. 45 per cent of oil imports came from the Middle East and 40 per cent of natural gas came from Russia.

<sup>61</sup> Green, (COM (2000) 769).

<sup>62</sup> Ibid, p. 13.

The internal market in electricity ... has had two opposing effects related to security of supply. First, it has improved the overall efficiency of the energy system and created a market for more energy saving electrotechnologies.... Second, however, it has made investments, which require large capital input or which have long pay back periods less attractive. Investment in research, particularly basic research, and development of new energy technologies may be put at risk. An additional issue is the impact of competition. If this brings prices down, as appears to be the case, demand could rise as a result....This combination of factors could work to the disadvantage of supply security and consequently lead to price rises or even interruptions in supply, as has been seen in parts of the US market.<sup>63</sup>

Based on the ensuing debate,<sup>64</sup> the European Commission proposed<sup>65</sup> that the EU

- Rebalance its supply policy by clear action in favour of a demand policy.
- With regard to supply, priority should be given to the action to combat global warming, notably by promoting new renewable energy sources
- Undertake an analysis of the contribution of nuclear energy in the middle term.
- Provide a stronger mechanism to build up strategic stocks and to foresee new import routes for increasing amounts of oil and gas.<sup>66</sup>

By September 2002 the Commission had adopted a Communication and two draft directives seeking to establish a Community-level framework to guarantee joint and coordinated action in increasing oil and gas stocks in member states. It also sought to harmonise security of supply standards and the way national stocks were organised, and finally, to assume more power to coordinate the stocks in case of oil or gas crises, with the establishment of a special Agency<sup>67</sup> The proposals were, however, not accepted by the Council and Parliament. On the contrary, early 2004, the Parliament backed the Council in settling the principle that security of supply standards would be set *nationally* and that oil and gas stocks would continue as

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<sup>63</sup> Ibid, p. 21.

<sup>64</sup> Communication of 26 June 2002 from the Commission to the Council and the European Parliament. Final report on the Green Paper 'Towards a European strategy for the security of energy supply' [COM(2002)321 final - Not published in the Official Journal]. 236 written reactions were received from EU, national and local governments, public energy agencies, industries, NGOs and science. Here, all interest parties presented their solutions, which would simultaneously benefit themselves. Some proposed higher taxes and other lower taxes. Some proposed a halt in liberalisation and other a higher pace. Some opted for increased state support for coal and nuclear, others opted for less state support. Some argued for higher energy prices other for lower. Some wanted stricter environmental standards on fossil fuels to boost investments in indigenous fuels. Others opted for lower standards. Some argued for demand-side investments and others for supply-side investments.

<sup>65</sup> Communication of 26 June 2002 from the Commission to the Council and the European Parliament. Final report on the Green Paper 'Towards a European strategy for the security of energy supply' [COM(2002)321 final. Not published in the Official Journal].

<sup>66</sup> The Green Paper concluded that the margins for manoeuvre were largest in demand-side measures at the Community level, and hence, that an attempt at controlling the growth of demand ought to be made, notably by encouraging a real change in consumer behaviour through taxation measures, as an example. In the field of renewable energy, the Green Paper established that efforts taken by the EU to promote renewable energy sources had so far been too feeble. In the field of nuclear power, the Green Paper established that without action, the contribution of nuclear energy would decrease, and that reconsideration should be made of its future contribution in light of issues such as global warming and security of supply.

<sup>67</sup> *Euractiv*, 13/09/2002, 'Commission wants to improve security of oil and gas supply'

matters of national responsibility without the need for increased coordination competency to the Commission.

After pressure from the Parliament<sup>68</sup>, Director-General Ms de Palacio put energy security issues at the heart of the meeting of EU energy ministers in December 2003<sup>69</sup>. The Commission proposed a range of new directives and sought to speed up the process of adopting proposals already long-time in the pipeline.<sup>70</sup> Some of these addressed the dual aim of energy security and internal market principles, mainly proposals to increase investments in European transmission capacity. Others addressed the dual aim of higher energy security and reduction in greenhouse gas emissions, mainly directive proposals tied to the promotion of energy efficiency. One of the directives, promoting the use of co-generated heat and power (CHP), became ready for adoption after the European parliament ratified a compromise deal struck with the council of ministers. The compromise entailed that the parliament abandoned calls for a single harmonised method for calculating co-generated energy across member states. Alternative calculation methods may now be used until 2010 or even for an unlimited period. However, the Commission will be invited to submit further proposals for harmonisation if this proves necessary.

### **3.4 Summary: EU efforts at sorting out inconsistencies between energy policies aimed at different goals**

The presentation above has outlined the enormous task given the European Commission in reconciling internal energy market policies with policies aimed at improving environmental

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<sup>68</sup> Environment Daily, Friday 10 October 2003, issue 1528

<sup>69</sup> The rapporteur on electricity liberalisation in the EU, MEP Mr Turmes essentially alleged a plot by Ms de Palacio and her most senior civil servant François Lamoureux. Together with Europe's big utilities, they would create a highly integrated electricity market with few, very large companies, and based on large-scale nuclear and coal power generation. Building the necessary extra capacity and upgrading grid systems would be fantastically expensive, Mr Turmes complained. It would carry its own risks such as those experienced this summer when nuclear and coal stations had to be wound down in several countries due to lack of cooling water. The MEP set out an alternative strategy, starting with radical energy efficiency measures to restrain demand, urging the European Commission to come forward quickly with a long-promised EU directive on energy services, promotion of decentralised generation powered by gas, biomass or other RES to ensure supply security and Europe's ability to meet its Kyoto climate gas emission commitments. Europe's controversial electricity market liberalisation should be continued, but strengthened through re-regulation, he continues. Grid activities and production, retail and trading of electricity should be split, or unbundled in the jargon. Far from building a vast new European grid network, there should be a moratorium on new EU-sponsored transmission lines and a focus instead on regional markets.

<sup>70</sup> A legislative package to promote investment in the European energy sector was aimed at strengthening competition and preventing blackouts in the energy system. The package comprised a directive on electricity infrastructure and security of supply, a decision revising guidelines for trans-European electricity and gas networks, and a regulation on gas transmission networks. Under the directive member states would have to develop policies on how to satisfy electricity demand and define standards to ensure secure transmission and distribution. Transmission system operators and national energy regulators would play a bigger role than now in producing and monitoring investment strategies. Member states would be required to 'take into account' the need to develop renewables. The decision on trans-European energy networks would introduce fast-track approval procedure for projects of 'European interest'. Another draft directive on energy efficiency and energy services issued, proposes binding targets on member states to save 1% per year of all energy supplied between 2006 and 2012 compared with business-as-usual. Another 'energy savings' draft directive on energy saving in buildings; draft directives on eco-design of energy using products (EUP), regulatory and fiscal proposals to promote biofuels and a transport policy White Paper to improve management of this sector.

performance and security of supply in Europe. The Commission has increasingly acknowledged that EU policy goals and measures are far from fully reconciled, entailing that the internal energy market principle of free and fair competition between energy companies residing in different member states is being compromised. The Commission has acknowledged that some of EU's energy policy goals are hard but not impossible to reconcile by a coordination of policy instruments. As an example, the goal that EU consumers should enjoy lower energy prices in a free market is not necessarily compatible with reduction in environmental stress, since lower prices will increase demand for additional energy to be produced. Increased demand will also potentially compromise the security of supply goal. The three goals can be made more compatible, but probably not fully so, by a reconciliation of policy instruments.

However, the Commission has faced great problems in convincing member state governments to equip them with proper instruments. The instruments applied at the EU-level today seem to create incompatibilities between the goals. Hence, the large asymmetric rates of state aid for national industries across member states (legitimised out of concerns for the environment or/and security of supply) is surely compromising the internal market principle of free and fair competition. Large sums of state aid is still poured into the European coal industry, notably in Germany, Spain and France, as a measure to save employment in areas dependent on coal mining jobs and as a measure to apply national resources in order not to increase import dependency. With respect to nuclear power, the Commission concluded in 2002 that "information currently available" did not indicate any substantial amounts of illegal state aid<sup>71</sup>. Nevertheless, public aid to nuclear power has always been shrouded in secrecy due to the connection found in several countries between nuclear power used for civil and military purposes. Moreover, large amounts of state aid is also poured into national renewable energy production schemes, aimed at restructuring the national industries in order to reach national obligations for reduction of climate gases. The level of state aid aimed at environmental restructuring is heavily asymmetric across member states, estimated in 2001 to range from 0.4 eurocents/kWh in Finland to 6.2 eurocents/kWh in Germany<sup>72</sup>. The many recently failed efforts of the Commission to standardise and coordinate security of supply policies across member states is another potential source of asymmetric pressure and support of the energy industry in different member countries. In sum, the EU seems still far away from equipping the executive, the Commission, with power to coordinate national energy policies, and as such to ensure that the principle of free and fair competition will characterise the future internal energy market.

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<sup>71</sup> Commission Staff working paper 2002, *Inventory of public aid granted to different energy sources*.

<sup>72</sup> 'Renewable Energy "must be reviewed"', *Environment Daily*, issue 1604, 6 February 2004.

## **4 Explaining deviations from the principle of free and fair competition**

In chapter 2 and 3 we discussed different sources of inconsistencies with the principle of free and fair competition in the internal energy market. They included asymmetrical implementation in member states of internal energy market policies, lack of reconciliation of different internal energy market policies and lack of reconciliation of internal energy market policies with policies adopted for reaching other energy policy goals. In this chapter, we briefly discuss why these sources of inconsistency were allowed to develop. In section 4.1 we discuss EU-level explanations, and in section 4.2 we examine more closely member country interests as an explanatory factor.

### **4.1 Lack of regulatory capacity and coordination problems at the EU level**

In general, the problems encountered by the Commission in establishing an internal energy market characterised by free and fair competition is partly tied to the dilemma arising partly from conflicting goals and partly from poorly reconciled measures to accomplish them. The European Commission fully acknowledged this policy dilemma in the 2000 Green Paper on energy security.

*At first sight, the aims of energy supply security are not always fully compatible with those of competitiveness, environment protection and liberalisation. Enlargement will bring its own challenges. The task for policy makers will be to reconcile wider objectives with energy supply and to seek instruments which can serve common objectives. (p. 23)*

The Commission, in an effort to dilute the problem of conflicting goals, called upon the Council and Parliament to provide it with a goal priority list. Recently, this took place in the political process where amendments to the Electricity and Gas Directives were drafted. The Commission called for environmental and consumer protection provisions to be left out of the directive text, in order for measures to be focused more clearly on complete liberalisation. The Commission instead opted for secondary legislation to deal with consumer protection and environmental issues. This proposal was, however, rejected by the Parliament and Council, who actually responded by strengthening such public service obligations in the new amended directives.

Efforts to bring about harmonization where poorly reconciled policy instruments prevail were expended by the Commission when it called upon the Council and Parliament to provide it with more regulatory capacity or empower it to extend the range of policy tools available at the Community level, thus enabling it to pursue environmental and security of supply goals with a minimum distortion of the internal energy market principle of free and fair competition. Such a call was made in no ambiguous terms in the 2000 Green Paper on energy security where the Commission evaluated current options for intervention, especially related to equal internal market conditions, harmonisation, environment and taxation as insufficient. Lack of regulatory capacity was clearly in evidence with respect to harmonisation



of energy and environmental taxation, where the Commission largely failed in its many efforts at convincing member states that such harmonisation was essential for the internal energy market to adhere to the principles of free and fair competition

Limited EU-level regulatory capacity affects, however, more than the taxation instrument. The Single European Act and the Maastricht Treaty gave the Commission more political power with one hand by opening for majority voting on environmental legislation, but took with other when the Single European Act settled the principle of subsidiarity in environmental legislation, allowing member states to implement stricter environmental standards than the Community. This surely limited the power of the Commission to ensure harmonisation and similar conditions for member countries' industrial sectors. The recent failure of the Commission to standardise security of supply measures across member states is another example.

However, not only lack of EU level regulatory capacity but also coordination problems within the Commission seem to explain some of the difficulties encountered in the internal energy market process. For instance, whereas the Commission, represented by DG XVII, in 2002 evaluated current market concentration as a likely impediment to a free and fair competitive internal market, it has hardly made use of the merger control instruments in the hands of DGIV to prevent market concentration becoming even more problematic. It seems that the Commission is not a unitary agent but a collective of Directorates whose separate stockpiles of goals and instruments are not necessarily fully harmonized. Hence, when the Directorate-General responsible for competition policy considered the emergence of ever stronger and larger European companies as positive for Europe's global competitiveness, it is not necessarily consistent with competition in regional energy markets in Europe, which continue to labour under unfair competition conditions.

Nevertheless, the competition rules are still part of the arsenal of Commission instruments, and there are clear indications that the Commission is quietly building up a case-based competition policy approach to liberalisation of the energy sector, implying that in the long-term, the Court of Justice will be used more actively to force member states and undertakings to break up regulatory and market barriers to free and fair competition.

## **4.2 National interests curtailing the EU internal energy market project**

EU-level explanations notwithstanding, the European Commission opined in the Green Paper on energy security that a lack of political consensus between member states was the underlying cause of the lack of regulatory power provided for the Commission. Member states have simply not been ready to endow the European Commission with the necessary regulatory capacity. Lack of consensus derives from the continued painful co-existence of national energy policy interests with Community goals. Such national interests vary between member states. In chapter 2, asymmetries between member states in implementation of the Gas and Electricity Directives was discussed as one of the impediments to free and fair competition in the internal energy market. A closer look at implementation data collected by the European Commission in its 2003 Benchmarking Report on the implementation of the

internal markets in electricity and gas reveals some interesting patterns about these member state asymmetries. The data are included in Annex I of the report. A summary of the data is presented in table 2 below.

**Table 2. Member state implementation by 2002 of internal electricity and gas market measures (number of deviations from ideal implementation (16 deviations possible, 7 for electricity and 9 for gas)**

	UK	Fin	Spa	Swe	Ita	Aus	Den	Net	Bel	Gre	Irl	Por	Ger	Fra	Lux
El	0	0	1	1	1	2	2	2	3	3	3	3	3	4	5*
Gas	0	n.a.	1	6*	1	1*	3	4	2*	n.a.	3*	n.a.	7	7	5
Tot	0	0#	2	7*	2	3*	5	6	5*	3#	6*	3#	10	11	10*

Source: The Commission, 2003 Benchmarking report

The table shows that, at one end of the spectrum, the European Commission had no concerns regarding implementation of electricity and market reforms in the UK and Finland, although gas market information is lacking for Finland. According to the Commission, also Spain, Sweden, Italy, Austria, Denmark and the Netherlands performed well in implementation of the gas and electricity markets, although Sweden and, less so, the Netherlands, were lagging behind with respect to the latter. At the other end of the scale are France, Luxembourg and Germany, all with high scores on defections from ideal internal market implementation. The asymmetric levels of ambitions recorded in the table largely reflect more stable underlying national interests that have also shown up in positions taken in policy processes aimed at transferring decision-making power from national governments to EU institutions.

The UK's wide compatibility with internal market conditions is one token of the country's early liberalisation of the energy market. The UK championed neo-liberal thinking in Europe, during the various Thatcher administrations from 1979 onwards. The electricity and gas markets were made subject to competition regulation in the UK already in the 1980s. Mrs Thatcher became renowned for her fight against state subsidies to the coal industries, leading to massive strikes and lay-offs. UK politicians were central when the Commission drafted its first internal market directives (Lyons, 1992). Germany and France were among the sceptics in the early 1990s. Germany had just started its unification programme, which involved a massive restructuring of East German industry, not least the energy industry, where the coal industry was massively subsidized, as indeed it was in West Germany, a symptom of the country's lack of alternative indigenous energy sources. In order to avoid immediate and massive unemployment and likely social turmoil, Germany found itself in no position to accept EU energy policies that put an end to coal subsidies. As noted above, German coal industry is still subsidized far more generously than any other energy industry in Europe. France was sceptic because the new liberal governance ideas were far from the French tradition of state-planned industry policies. Under this regime, France had embarked on a massively subsidised nuclear power programme as a way of curtailing its import dependency (alongside Germany and several other member states). The nuclear industry had

become an important export industry and a matter of national pride. France could not accept EU policies that threatened the nuclear industry.

France and Germany both saw environmental regulation by harmonisation of fiscal measures as a threat. For the French it was their subsidised nuclear industry that was imperilled, and for the Germans their coal industry. The UK rallied round as a general Euro-sceptic, refusing to countenance any transfer of rights to the EU that could possibly force the country to raise taxes. The UK was also instrumental together with Germany and the Netherlands in clipping Commission wings in security of supply matters. They all feared a scenario with greater EU control over management of domestic hydrocarbon resources. The resultant lack of EU competency over security of supply policy caused other member countries to fear that the EU would be unable to address their supply security problems, which, in effect, would put the damper on their internal market project aspirations, (Lyons, 1992). The European Commission failed therefore to inspire widespread enthusiasm for its internal energy market project. Member states, among them France and Germany, managed to change original non-discretionary regulations proposed by the Commission in the electricity and gas directives into a highly discretionary framework programme for national liberalisation. The asymmetries in implementation of internal market principles are therefore not all that surprising.

The energy industry structure asymmetries among member states emanate from different national industry-regulatory styles. Some member countries, notably the UK, have since the 1980s pursued stringent policies to de-merge monopoly structures and merger control regulation to curtail the establishment of monopoly positions, whereas other countries, notably France, have pursued industry policy based on national state monopolies, without any stringent competition policy. Germany, the traditional defender of strict merger controls, has, on the other hand, been less active in preventing national industry concentration. Member states have pared down European Commission plans for greater supra-national power in European competition policy in general, and merger control in particular, arguing that such control should be a national preserve, where information on market conditions is deemed to be superior. And since competition policy is a typical case of regulation by discretion, member states feared that transferring more rights to the EU could lead to regulatory capture beyond their control. Nevertheless, regulatory capture could still be a potential problem at the national level. The tendency towards concentration in the energy industries in most member states during the 1990s should probably be interpreted as such national regulatory capture. National competition authorities are compelled by the energy sector to accept national anti-competitive structures (dominant positions, state subsidies, etc.) that will strengthen the position of national firms since competition authorities in other countries accept such structures. The end result is a high degree of strategic regulation by member states to protect national industries from competition.

Another factor lurking behind asymmetrical market openings and structural developments in member states' energy systems is asymmetries in exposure to security of supply measures. It should be obvious that energy surplus countries in Europe have been

more eager to install competition in their energy systems than energy deficit countries. Slow market opening and concentrated industry structures may still be interpreted as measures applied by governments to reduce energy security exposure. As long as member states do not trust the Commission with wider responsibility in the security of supply policy area, we should expect asymmetries in member states implementation of internal market principles to continue.

### **4.3 Concluding remarks – explaining barriers to internal market implementation**

This study has shown that the EU executive, the European Commission, has vigorously sought to minimise deviations from *ideal* solutions in the political process of establishing an internal energy market adhering to the principle free and fair competition. The Commission has sought to increase the scope and depth of policies to coordinate and standardise national policies across member states deemed necessary to achieve free and fair competition in the internal energy market. It has succeeded in some cases, such as the 2003 amendments of the Gas and Electricity Directives, which extended the scope of the directives to include measures to remove barriers to cross-border trade in electricity and gas in the Union. But in other important areas the Commission has failed. The discretionary features of the Electricity and Gas Directives meant that the Commission would be unable to prevent highly asymmetrical implementation of gas and electricity market measures in the member countries. Vociferous opposition from member states, industry and the EU parliament forced the Commission to abandon general community competition law as a means to press forward the internal energy market. Court of Justice rulings, implying that competition rules could be overruled in cases of general economic interests, further restricted the Commission from applying general competition rules in the process. The disinclination to enforce competition rules has facilitated increasing market concentration since the Electricity and Gas Directives were adopted, likely to aggravate barriers to free and fair competition in the Union. *In this perspective*, the general competition rules have not been fully reconciled with the internal market goals. The Commission has neither managed to reconcile environmental and supply security policies in the energy sector with the internal market principle of free and fair competition. EU energy policy inconsistencies reflect underlying interests of EU member states more than conditions at the EU centre. Member states have not been interested in handing over policy instruments to the EU executive with which it might have had a chance to iron out inconsistencies. The coordination and enforcement capacity of the European Commission is therefore limited.

Although the European Commission has noted considerable success in opening up European energy markets to competition, member states can still apply various forms of protective measures (strategic regulation) to shield their national industries from competitive pressure. The arguments used by governments to legitimise protective measures vary, but transformation of national energy industries to become more environmentally friendly is widely used. Even subsidies of coal production are legitimised as a means of improving environmental performance. On the other hand, weak environmental standards can constitute

yet another measure to shield national industry. There is little doubt that harmonization deficits between member country's environmental regulations are a barrier to fair competition in the Union. Governmental acceptance of concentration in national industry structures (potentially leading to abuse of dominant position) and long lead-times in implementation of EU directives) are other mechanisms with the effect that national industries are favoured in the energy market.

An effect of asymmetries developing between member states concerning regulatory and competitive pressure installed on industries is the reduction of the efficiency and legitimacy of EU energy policy. This deficit may in the next round lead to even more scepticism in member countries towards EU's capacity to ensure a level playing field and to prevent security of supply crises and/or environmental degradation. Member states may also increasingly resist enforcement of internal market principles by pointing first to the fact that environmental and/or security of supply problems necessitate deviation from the principle and second to examples of greater deviations by other member states. The room of manoeuvre will widen for member states in future negotiations with the Commission, something that could leave the Common Energy Policy project in a vicious circle. It remains to be seen whether the amendments to the Electricity and Gas Directives in 2003 will help create the virtuous circle needed by the Commission. In the immediate future, other problems are looming. In May 2004 10 new member countries join the Union, many of them with energy policies and energy industry structures far out of compliance with internal market principles. This could open for new stratagems also from incumbent member states.



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## **Annex I National asymmetries recorded in the European Commission 2002 Benchmarking report on the implementation of the Electricity and Gas Directives**

### *Asymmetries in electricity and gas market opening*

The 2002 Benchmarking report recorded large asymmetries in deadlines set by national governments for implementing full-scale electricity and gas market opening<sup>73</sup>. Compared to the highly modest requirement set by the directives, the implementation rate is not bad. However, in terms of Commission efforts to urge member states to go ahead faster than these minimum requirements, the result is less comforting. With respect to electricity market opening, Sweden, Finland, the UK and Germany had granted a 100% opening of the market by 1999. Austria followed suit in 2001, Denmark and Spain in 2003. By early 2002, the planned full-scale opening deadlines for the rest of the countries varied considerably. Ireland planned full-scale opening for 2005, Belgium for 2007 whereas three countries had still not managed to set a final opening date (France, Italy, Greece and Portugal). By April 2003, France and Greece still operated with only 34% of national customers eligible to choose suppliers. Portugal operated with 45%, Belgium with 52%, Ireland 56%, Luxembourg 57%, the Netherlands 63% and Italy 70%.

With respect to gas market opening, 5 countries declared by 2003 100% opening of the gas market (Austria, Germany, Italy, Spain and UK). At the other end of the scale were France (20%), Denmark (35%), and Sweden (47%). In-between, we find Belgium (59%), the Netherlands (60%), Luxembourg (72%), and Ireland (82%). Greece, Portugal and Finland were not included on the list.

### *Asymmetries in national efforts at ensuring transparency and non-discriminatory use of energy networks.*

The Directives set as minimum requirement that transmission system operator should unbundle its management/accounting of transmission system operations from other commercial operations, in order to increase transparency and prevent cross-subsidisation. The same was demanded for distribution system operators. Nevertheless, the Directives urged for a full organisational or even ownership split as a solutions that would better increase transparency and prevent cross-subsidisation. This Directive furthermore gave national regulators the choice of either implementing an open and transparent system in which power suppliers were given access to grids on tariff terms regulated ex-ante or the less transparent system where access were given only after case-by-case negotiations. Again, the Directive

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<sup>73</sup> The Electricity Directive operated with minimum targets for the opening of the electricity and gas markets, urging member countries to go ahead faster than this. The minimum targets set by the Electricity Directive was that 30% of consumption should be opened up in 2000 and 35% in 2003. The targets set in the Gas Directive was an absolute minimum of 20% by 10 August 2000 increasing to 33% by 2008.

was the outcome reflecting the least ambitious, and the Commission urged member countries to opt for the most transparent solution.

With respect to the Electricity Directive, 6 countries had chosen a full ownership split of transmission activities and other commercial activities (Finland, Italy, the Netherlands, Spain, Sweden and the UK). Another 7 countries had chosen a model of legal (organisational) split, where the transmission company still were engaged in other commercial activities (Austria, Belgium, Denmark, Germany, Greece, Ireland, Portugal). Only France and Luxembourg had chosen the least ambitious solution of separation of management of the transmission system from that of other commercial activities. With respect to local electricity distribution systems, no countries had implemented ownership split of distribution and other commercial activities. Six countries chose organisational split (legal unbundling), (Belgium, Denmark, Italy, Spain, Sweden and the UK). The rest had only chosen the less ambitious unbundling of management/accounting. Concerning terms of access, Germany were the only country that had chosen the less ambitious negotiated access model. Denmark had chosen a model in which access terms were made transparent after the deal was carried out, through ex-post control.

With respect to the Gas Directive, only two countries had chosen full ownership split model for the transmission system (Spain and the UK). Another 4 countries had chosen the organisational split model (Austria, Belgium, Denmark and Italy). The rest had chosen unbundling of management or accounts (France, Germany, Ireland, Luxembourg, the Netherlands and Sweden). Identical systems had been chosen for the distribution systems, except for Spain, which here had chosen the less ambitious 'organisational split' system. As to regulator transparency, Germany again was the only country that had chosen negotiated rather than open regulated access. Sweden and Denmark had chosen a model of ex-post control by the regulator.

#### *Asymmetries concerning national market concentration in electricity and gas markets*

In the 2003 Benchmarking report, the European Commission evaluated that 8 out of 14 member countries had electricity industry structures 'which are likely to have negative consequences for the development of the internal market', due to concentration in the generation of electricity (data for Luxembourg was not made available). 5 countries operated with an industry structure where three or less companies were in control of more than 90% of generating capacity (Greece, Ireland, Belgium, France and Sweden). In three more countries (Denmark, Portugal and Spain), the corresponding figures varied between 78 and 83%. On the other end of the scale came the UK with a highly fragmented structure (36%). Other countries evaluated with an industry structure beneficial to competition were Austria, Finland, Italy and the Netherlands. Also for the gas market, 8 countries were evaluated with high concentration in the wholesale market, two countries were unknown (Belgium and Ireland) and only two had moderate concentration (Germany and the UK). Recent merger and acquisition trends in Europe point in the direction of even larger market concentrations.

As sufficient import capacities (transmission capacity) between member states may have the effect of reducing potential negative effects of national market concentration, the

Commission made in its 2003 Benchmarking Report a separate investigation of member countries transboundary transmission capacity and plans to increase the capacity. Import capacity showed great variation EU member countries. In electricity Luxembourg had an import capacity of 100% of installed domestic capacity. Also the Nordic countries as well as Austria and Belgium had import capacities of more than 20%. At the other end of the scale, UK (3%), Spain (4%), Ireland (5%), Italy and Portugal (8%), France (9%), Greece (11%) and Germany (12%) have modest import capacities as share of domestic installed capacity. Greece and Ireland had, however plans in 2003 for large increments in transmission capacity. Also Denmark, Italy, Spain and Portugal had plans for substantial increase in capacity. France had no plans for additional capacity and Germany had plans for a small 1% increase in capacity. Hence, whereas abundant import capacity in some member countries had a balancing effect on high levels of industry concentration, notably in Sweden, other countries were characterised by a combination of industry concentration and lack of import capacity, notably France. France had neither any plans for increasing the import capacity.