

## The European Third Energy Package: A Radical Change in Control and Governance of Energy Networks

### Scope of the Third Energy Package

Following a legislative process initiated by the European Commission ("Commission") in September 2007, the European Parliament endorsed on 22 April 2009 two directives and three regulations that constitute the Third Internal Energy Market Legislative Package (collectively, the "Third Energy Package"). The European Council approved these five documents on 25 June. The Third Energy Package could be published before the end of August 2009. It will enter into force 20 days after its publication. Member states will then have 18 months to implement most of the directives' provisions in their national legislation. The regulations will apply 18 months after the publication.

The Third Energy Package reflects several legislative proposals intended to strengthen competition in the European electricity and natural gas markets. The measures in this package seek mainly to:

- strengthen the separation between energy supply and production and network operation;
- create a certification procedure for European Community- and non-European Community companies;
- initiate an exemption procedure for new investments in the sector;
- enhance regional cooperation; and
- improve regulatory supervision of the energy market.

Traditionally, network operations are divided into (i) transport or transmission (i.e., high-voltage, network backbone for electricity, high-pressure pipelines for natural gas) on the one hand, and (ii) distribution (that which brings gas and electricity from the transport network to the end-customers) on the other. The most radical changes of the Third Package concern transport. Distribution, which is essentially local, is subject to a slightly different, less strict regulatory framework, and will be addressed in a separate *DechertOnPoint*.

### Liquefied Natural Gas (LNG) and Storage Facilities

LNG terminals (i.e., a facility that either liquefies natural gas or offloads and re-gasifies it) are not subject to unbundling and designated storage assets remain subject to the former legal unbundling regime.

In view of their strategic nature, the appointed operators of such facilities are under several obligations: making sure that the assets are operated in a secure, reliable and efficient fashion; treating all users without any discrimination; providing the necessary information to users and operators of interconnected assets; and preserving the confidentiality of commercially sensitive information.

Operators may be enjoined by the regulator to modify their transport terms and conditions, including their tariffs. Unusual contract terms duration (i.e., unusual start dates or contracts lasting less than a year) should not result in "arbitrarily higher tariffs". The maximum capacity must be made available to the market (measures

need to be taken against capacity hoarding). Capacity allocation mechanisms have to be non-discriminatory, transparent and have to “provide appropriate economic signals for the efficient and maximum use of capacity and facilitate investment in new infrastructure”. Capacity must be tradable on a secondary market.

LNG facilities are subject to third-party access on the basis of published tariffs. These tariffs, or their methodologies, must be approved in advance by the regulator.

As to access to storage facilities, Member States have a choice between negotiated access and regulated access. A storage operator has to provide both firm and interruptible third-party access services (with the price of interruptible capacity reflecting the probability of interruption), offer both long and short-term services and offer separately storage space services, injectability and deliverability.

A “combined” operator (i.e., an operator of transmission, LNG facilities, storage and distribution assets, with separate accounts for each) is explicitly allowed, but the discrepancies in the regulation of these different activities may create difficulties.

### **Natural Gas and Electricity Transmission: Three Unbundling Options**

A principal aim of the Third Energy Package is to increase separation, or unbundle, transmission network operations from energy supply and production activities of integrated energy companies in the European Community. From the Commission’s perspective, fair competition can only exist once independent, neutral transmission operations are established. In other words, the European legislature has determined that companies participating in the electricity and natural gas sectors should not be permitted to be vertically integrated. The unbundling requirements of the Third Energy Package apply equally to the electricity and natural gas sectors throughout the European Community and to both Community and non-Community companies.

On 19 September 2007, the Commission proposed two options to achieve unbundling: (i) full ownership unbundling (FOU), whereby integrated energy companies would be required to sell their electricity and natural gas transmission networks and thereby establish separate transmission system operator(s)

(TSO); and (ii) an independent system operator (ISO), pursuant to which integrated energy companies would be permitted to retain ownership of their transmission networks, but would be required to transfer the technical and commercial operation of their transmission networks to a separate body, or ISO (a kind of “hold-separate” trustee), designated by the applicable Member State.

Eight Member States, led by Germany and France, did not agree with the Commission’s proposal regarding the FOU and ISO regulatory models. These Member States proposed an alternative model for the operation of integrated energy companies. On 6 June 2008, the EU Council of Ministers reached a compromise between the Commission and these dissident Member States. Under this consensus approach, Member States can adopt either of the models proposed by the Commission or a third softer option, which has been designated the independent transmission operator (ITO) model. Under the ITO model, integrated energy companies can maintain their existing integrated structure so long as they meet a number of specific conditions to ensure independent operation of transmission infrastructure.

Although the European Parliament was initially reluctant to accept the compromise ITO model for the electricity sector, it decided in April to endorse the EU Council’s position for the natural gas and the electricity sectors. As a result, the Third Energy Package offers Member States three options for the separation of supply and production activities from the transmission networks of integrated energy companies. Once each Member State chooses an appropriate regulatory model, companies organized in that Member State must comply with the provisions of that model and cannot elect another option. Under the terms of the Third Energy Package, each Member State will have one-and-a-half years from the effective date of the Third Energy Package to choose its regulatory model and to adopt a legal framework to implement that model as part of its national law. The following three sections of this update discuss the principal aspects of these alternative models and suggest some of the implications of each.

### **First Option: Full Ownership Unbundling**

FOU requires that each vertically integrated energy company separate legal ownership of its high-voltage (high-pressure for gas) transmission company (the transmission system operator) from

its production and supply interests. This option has the following implications:

- Each entity which owns a transmission system acts as a TSO;
- FOU can be implemented either by (i) divestiture of either the high-voltage/high-pressure network assets or the production and supply assets of an integrated entity, or (ii) by splitting the shares of an integrated entity into shares of a network entity and shares of the remaining supply and production entity so long as, in each case, the surviving entities fully comply with applicable FOU regulations.
- Member States must ensure that the same person or persons are not entitled to:
  - Directly or indirectly exercise control or any right over (in particular, the power to exercise voting rights or to appoint members of the board or other body legally representing, or the holding of a majority share in) a TSO and at the same time exercise control over a production or supply entity. Therefore, a production or supply entity may only hold an interest in a TSO or a transmission system if it complies with these limitations.
  - Be a member of the managing boards of both a TSO and a production or supply entity;
- Subsidiaries of a vertically integrated entity performing production or supply activities may not have a direct or indirect interest in a TSO. Likewise, a TSO may not have a direct or indirect interest in any subsidiary of a vertically integrated entity performing production or supply activities.
- The principle of non-discrimination between public and private sectors must be respected. Accordingly, Member States must demonstrate that they have complied with the applicable unbundling requirements in order for two separate public bodies to control transmission activities on the one hand, and production and supply activities on the other hand.
- Even if a production or supply entity is established in a Member State that has chosen a non-FOU model, that entity cannot control or exercise any rights over an unbundled TSO in a Member State where the FOU model is chosen (i.e., a form of regulatory reciprocity applies).

- Member States that choose to implement ownership unbundling will be granted additional time to apply these provisions to their integrated energy companies. This extension of time recognizes that the restructuring required by entities regulated under the FOU model is more extensive than that required under the other regulatory models.

## Second Option: Independent System Operator

Under this option, a vertically integrated energy company can maintain ownership over its network transmission assets, so long as an unrelated ISO conducts all of the duties of the system operator.

The Third Energy Package requires that specific additional rules be enacted by Member States adopting the ISO model to ensure its effectiveness. These rules include specific organizational measures and measures related to investment in the electricity and natural gas sectors. The ISO model requires implementation of a complex disjunction between (i) the ownership of transmission assets by a former vertically integrated energy company, and (ii) the management of such assets by an ISO entity.

Member States have not shown great interest in adopting this option.

## Third Option: Independent Transmission Operator

Under this model, energy companies can maintain their integrated structures, provided that they meet several conditions, including:

- The TSO must be part of a vertically integrated energy company on the date when the new directives come into force in the applicable Member State;
- The TSO must put in place a supervisory body having decision-making authority over actions that could affect the value of assets allocable to the TSO's shareholders (e.g., the level of the TSO's indebtedness and the amount of dividends distributed to shareholders of the TSO). This supervisory body must include representatives of each of (i) the integrated energy company, (ii) the transmission system operator and (iii) third-party shareholders;
- The TSO must adopt a compliance programme setting forth measures intended

- to prevent discriminatory conduct against market participants;
- The Supervisory Body of the TSO must appoint a compliance officer with responsibility for monitoring the implementation of this compliance programme;
- Management staff may not work for the integrated energy company's supply and production company at any time during the period from three years before through four years after being employed by its transmission business; however, a minority of management may have held such positions, provided any such positions were terminated at the latest six months before appointment with the TSO;
- The TSO must seek the approval of the national regulatory authority ("NRA") for all commercial and financial agreements to be entered into between the integrated company and the TSO;
- A 10-year network development plan based on the existing and forecasted supply and demand of the transmission network must be submitted annually to the NRA by the TSO. This plan is intended to schedule investments in order to guarantee the adequacy of the transmission network and the security of supply.
- The investment must enhance competition in the sources of natural gas supply and enhance the security of gas supplies;
- The risk associated with such investment must be sufficiently high as to conclude that the investment would not take place unless an exemption were granted;
- The exempted infrastructure must be owned by a natural or legal person which is separate, at least in terms of its legal form, from the system operators in whose systems such infrastructure will be built;
- Charges must be levied on users of such infrastructure (i.e., the infrastructure may not be funded by general tariffs);
- The exemption must not detract from (i) the existing level of competition or the effective functioning of the internal natural gas market, or (ii) the efficient functioning of the regulated system to which the infrastructure is or will be connected.

The NRA will be mandated to ensure that each ITO meets its obligations and may impose fines of up to 10% of an ITO's turnover in the event of a breach of these obligations.

## Unbundling: Derogations and Exemptions

The exemption regime has not been significantly changed from the Second Package, except concerning procedures and the exemptions to the unbundling provisions themselves.

The Third Energy Package provides that major new natural gas infrastructure (e.g., interconnectors, LNG facilities and storage facilities) may, upon request, be exempted from the full ownership unbundling, third-party access and/or regulated tariffs rules for a defined period of time. The same exemption provision applies to significant increases in the capacity of existing energy infrastructure as well as to modifications that enable the development of new sources of gas supply.

In each case, the following conditions apply:

The NRA has authority to determine whether an exemption should be granted on a case-by-case basis. An exemption can cover all or part of the infrastructure. In addition, the NRA can condition the grant of an exemption in terms of its duration and on non-discriminatory access to the exempted infrastructure. Where the infrastructure in question is located in the territory of more than one Member State, the Agency for the Cooperation of Energy Regulators (ACER) may submit an advisory opinion to the NRAs concerned. If the involved NRAs cannot reach agreement, or upon a joint request from the relevant NRAs, ACER is authorized to decide upon the exemption request after consulting with all of the parties involved.

The applicable competent authority is directed to notify the Commission immediately of any decision made. Upon receipt of such notice, the Commission may direct the NRA or the ACER, as applicable, to amend or withdraw such exemption determination at any time within a two-month period.

As to electricity, new interconnectors (i.e., high-voltage, cross-border links) may also secure an exemption from certain provisions of the Directive and the Regulation. The conditions and the procedure to secure such an exemption are similar to those mentioned above for new gas infrastructures.

In addition, the Natural Gas Directive and the related regulation provide for specific derogations, at varying degrees, for certain markets, some of which qualify as emergent and isolated (e.g.,

Estonia, Latvia, Finland, Cyprus, Malta, Luxembourg and Greece). Also, the directive and regulation provide for a temporary derogation in connection with take-or-pay contracts, envisaging a situation in which a natural gas entity would encounter serious economic and financial difficulties absent such derogation because of its existing contractual commitments.

As to the Electricity Directive, Cyprus, Luxembourg and Malta benefit from a derogation.

### **Certification Procedure: Equal Treatment for Third Countries**

Regardless of the unbundling option chosen by the Member State, each NRA is required to certify that each TSO regulated by it complies with the requirements set forth in the applicable directives. Once so certified, the Member State must appoint the TSO and provide appropriate notice to the Commission.

Entities from third countries (i.e., countries outside the European Community) who want to control a TSO are not and will not be exempted from these requirements. A so-called “third country clause” will apply under the Third Energy Package. This clause provides that companies organized outside the European Community are subject to the same rules as domestic European investors. Among other things, such companies must: (i) comply with the unbundling requirements that apply inside the European Community; and (ii) request and obtain a certification of compliance from the applicable competent authority.

An NRA will analyse whether a company organized outside of the European Community meets the relevant conditions set forth in the Third Energy Package and will also determine if approval of such person to control a TSO would put at risk the security of the energy supply of the European Community or of the individual Member State affected thereby. For these purposes, such NRA will take into account the rights and obligations of the European Community and of the affected Member States with respect to the relevant third country.

The NRA will adopt a draft decision on the certification of a transmission system operator within four months from the date notice is provided by the transmission system operator. This decision will be furnished to the Commission, which will examine it and deliver its opinion to the NRA within two months after receiving such request. The NRA

will, within a period of two months after the expiry of such two-month period granted to the Commission, adopt a final decision regarding certification.

The conditions placed on non-EU companies will be without prejudice to the international obligations of the European Community and, in particular, WTO rules and possibly Energy Charter Treaty rules on investment protection.

Member States will have three-and-a-half years to implement the provisions of the Third Energy Package concerning third countries.

### **Management of the European Transmission Networks: ENTSOs and ACER**

With regard to the management of transmission networks, the gas and electricity regulations of the Third Energy Package establish two new European associations of transmission system operators (ENTSOs) for the electricity and natural gas sectors and grant such associations specific rule-making powers. The most important tasks delegated to the ENTSOs are (i) the preparation of network codes, (ii) the adoption of common network operation tools to ensure co-ordination of network operation in normal and emergency conditions and (iii) the preparation of a non-binding Community-wide 10-year network development plan.

The Third Energy Package establishes ACER, an EC-level regulator, which will, among other things, monitor the execution of these tasks and report to the European Commission.

These developments will be addressed in a separate *DechertOnPoint*.

### **The Story So Far**

Historically, the electricity and natural gas sectors were vertically integrated from production to transport and customer supply by country or by national subdivision. The first EU liberalization packages broke this mold by mandating third-party access to the parts of this sector that were deemed to be natural monopolies and therefore essential facilities from the viewpoint of competition law—the networks.

The expectation was that, through access to a liberalized network, the production and supply branches would engage in cross-border competition,

with the resulting benefits for the customers and society as a whole.

However, it is clear in retrospect that this policy underestimated the effects of several characteristics intrinsic to the energy sector and was not implemented with coordinated priorities:

- In the electricity sector, existing grids were built on a national (or even sub-national) basis, with limited cross-border connections. They were not intended to serve, and ineffective in serving, a supranational market;
- The natural gas sector was characterized by long-term contracts, which funded significant infrastructure investments; existing grids are subdivided on a sub-national basis and are subject to connection bottlenecks; operators were also tied in “take or pay” contracts justified by the technical characteristics of extraction;
- The energy industry remains capital intensive and is environmentally sensitive, with the result that new investments in production or infrastructure take time before they can affect the market;
- The leeway left by EU legislation to the Member States provoked significant variations in implementation from one Member State to the other; some constraints imposed on the TSOs and their tariff regimes diverged into 27 different national regimes;
- TSOs, most of which are still “controlled” by large shareholders who, in turn, are or control large suppliers or producers, are each subject to varying regulatory regimes and national regulators. They are taking time to implement progressive unified market mechanisms whereas the production sector is reorganizing itself more rapidly on a cross-border basis, subject only to the constraint of competition (antitrust) law;
- Also, tariff regulation is organized on a national basis, with a lack of uniformity and different degrees of maturity and transparency in the regulatory framework. In addition, certain Member States have limited control over the price of gas and electricity, and certain NRAs may be tempted to exercise more pressure on the transport tariffs in order to control changes in energy prices, if only at the margin.

## The Way Forward

Against this background, the Third Package addresses the issue of investments by establishing new rules regarding special tariff regimes for new investments. It also mandates structural reorganization of the transmission sector that will require new shareholders and that may include cross-participations between TSOs. It should be noted that, as a competition law remedy, the Commission has already secured divestments by two German operators of their transmission operations.

The Third Package also favors establishing cross-border market mechanisms among TSOs and exchanges and encourages NRAs to reward TSOs who play an active role as market facilitators—whose incentivization was not done enough in the past—in order to integrate markets further on a cross-border basis.

Effective implementation of the Third Energy Package should accelerate the development of Europe’s internal energy market. At the same time, this wave of legislation poses significant risks and opportunities for participants in the European energy markets. Affected companies will face challenges in complying with new structural and governance requirements and in pursuing significant investments during a period of regulatory transition. Given the scale of the electricity and natural gas sectors in Europe, the Third Energy Package has potentially enormous implications for companies and consumers in the European Community.

Therefore, energy companies, transmission network operators and their shareholders are encouraged to assess carefully the potential impact of these rules on their corporate structure, market position and strategy as soon as they can, and request the necessary guidance to take advantage of business opportunities that should arise from this milestone in the development of the internal European energy market.



Since 2001, Dechert LLP has been involved with the liberalization of the electricity and natural gas sectors in the European Union. Our lawyers have significant experience with unbundling issues, particularly the ITO model, as we have assisted clients in the implementation of anticipated versions of it.

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initiatives as well as in ancillary businesses such as equipment manufacturing.

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