

A first measure needed, if the proposed Efficiency Directive should come, and in addition to fixing the other issues addressed above, would be to tighten the cap: The emission reduction target needs to be raised to properly reflect the emission reductions achieved through renewable energy deployment and the decreased emissions due to the economic slowdown in the context of the financial crisis. Then the number of emission allowances needs to be reduced accordingly. And as the three-fold approach with the Renewables Directive, the proposed Efficiency Directive and the Emission Trade Directive in place should work to facilitate further savings, one should adapt the linear reduction rate as well and make it more demanding.¹⁰² This would put ETS incentives back in place and it would show that the EU has not only committed to some numbers, but rather truly is willing to move towards the almost zero emission society it seems to envision for the future.

An additional measure to reconsider might be the introduction of a binding targets and a penalty system for Member States who lack ambition or motivation to live up to their obligations. Proposals have been made in the past,¹⁰³ but unsurprisingly met fierce Member States' resistance. The main counter-argument was the cost of a (then necessary) control system, and, of course, hardly any Member State was willing to commit to more than the minimum. However, with the Renewables Directive and the proposed Efficiency Directive, Member States should now have all the "tools" at their hand and understand that through careful but determined coordination of energy efficiency, renewable energy and emission reduction measures achievement of the EU 2020 targets will be a hopeful kick-off for the 2050 future low carbon society.

VI. Conclusion

After the debate in the Council in November 2011, the Turmes Draft Report on the proposed Efficiency Directive is scheduled for adoption end of February 2012, with plenary meeting of the European Parliament in

April 2012. So a final version of the Energy Efficiency Directive can be expected only mid-2012, and one will have to see what eventually remains of the Commission's Proposal.

Still, the proposed Efficiency Directive is an important step into the right direction: the Commission has correctly identified the EU's need to step up its ambitions in this area and make use of its great potential to shape the energy supply of the future. Unfortunately, the Commission's Proposal is not sufficiently ambitious (e.g. lacking binding national targets), not clear enough (e.g. double priority) and creates a serious danger to the Emission Trade system. The additions and amendments introduced by the Rapporteur Claude Turmes particularly address and improve the first two issues and thereby significantly upgrade the Proposal. However, as argued above, provisions dedicated renewable heating and cooling as well as renewable electricity would add to its overall value and stress the bigger picture of EU energy supply: energy efficiency, renewable energy deployment and emission reductions all need to go together. Similarly, the Renewables Directive could include a reference, when next revised in 2012.

Even with those amendments, as the last – and maybe most urgent – concern, the problems of the Emission Trade System will still need to be addressed: what is needed is an increased emission target to better reflect the reality, the number of emission allowances needs to be reduced and the linear reduction rate should be raised. Otherwise, the ETS will be almost doomed to fail.

¹⁰² On what would be possible, see e.g. EREC "RE-Thinking – A 100% Renewable Energy Vision for the European Union", p. 21f, available for download at: http://www.erec.org/fileadmin/erec_docs/Documents/Publications/ReThinking2050_full%20version_final.pdf.

¹⁰³ E.g. Fouquet, „Towards a Better Compliance Structure for the European Emission Reduction Policies until 2020“, Friends of the Earth Europe, March 2008.

Understanding the Public Service Obligation in the Electricity Sector:

Lessons for the Contracting Parties of the Energy Community Treaty

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Abstract

The paper underlines that the EU energy *acquis* does not simply require the Contracting Parties to the Energy Community Treaty to liberalize their electricity markets, but it also provides for a "safety net" to ensure the available of public services through the imposition of Public Service Obligations (PSO). Nevertheless, the paper points out that the present understanding of the PSOs in the Contracting Parties is not in compliance with the conditions provided by Article 3 of the Electricity Directive. Therefore, it includes some policy recommendations and a proposal for introducing a duty of notification, which should be instructive for the Contracting Parties to improve their understanding of PSO in line with EU law, by thus effectively safeguarding the availability of public services in the electricity sector to their citizens without jeopardizing the effective electricity market liberalization.

1. Introduction

The goal of the electricity market reforms that have been taking place in Europe over the last couple of decades is to open electricity markets and give consumers a choice of supplier by introducing competition where possible, and by complementing it with regulation of the parts of the electricity markets that remain monopolistic. Even though the introduction of competition within national markets was a precondition to establishing a common electricity market in the EU, the design of the liberalization process took into account additional non-economic objectives, such as the universal availability of electricity supply.¹ According to the European Commission, in a competitive environment the market will normally ensure the best provision of services of general economic interest (SGEI).² However, regulatory intervention is sometimes necessary due to market failures in providing such services, and to the need of satisfying a number of socially desirable objectives.

The provisions on PSO included in the EU energy

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¹ For an overview of the impact of the liberalization of the energy market on consumers, such as impact on prices and other aspects of services see an article from the early days of the liberalization: F. McGowan, "Consumers and Energy Liberalization", *Journal of Network Industries*, 1 (2000), 353-373.

² Commission of the European Communities, Green Paper on Services of General Interest, COM(2003) 270 final, Brussels, 21 May 2003, Section 1.2.

liberalization Directives are an example of regulatory intervention, which tries to reconcile the EU internal market and competition rules with the effective provision of the SGEI. The possibility granted to the public authorities of the EU Member States to impose a PSO on selected undertakings is a regulatory tool that, if properly used, aims at counteracting the adverse effects that the liberalization of electricity markets might have on the supply of electricity.

Through the conclusion of the Energy Community Treaty in 2005,³ the countries from South-East Europe (SEE), as well as the new Contracting Parties - Ukraine and Moldova,⁴ accepted to implement the EU *acquis* in the field of energy. On the one hand the Contracting Parties are required to liberalize their electricity markets in accordance with the EU rules, but due to the importance of the provision of public services on the other hand, these countries can rely on PSO to ensure the provision of public services.

Due to the importance of the concept of PSO for the Contracting Parties, the paper aims at clarifying the scope of application of this concept within the electricity sector. In particular, after an overview of the concept of PSO, the paper will assess the provisions on PSO included in the EU *acquis* on electricity, and afterwards it will analyze the current understanding of the PSO in the Contracting Parties of the Energy Community Treaty.⁵ Finally, in its conclusions the paper will elaborate a number of recommendations addressed to the Contracting Parties, in order to help them to align their understanding of the PSO in compliance with the EU *acquis*.

2. Defining the Concept

During the last two decades the manner in which public services are provided in Europe has radically changed. While in the past these services were primarily provided by the State and by its entities, more

recently an increasing number of private undertakings have been entrusted by the State to provide such services through the imposition of PSO. The concept of PSO was not present in the EC Treaty, but it has been developed as a "side effect of the liberalization process"⁶ in the EU liberalization legislation.

According to Jones, PSO means "[g]uaranteeing, through regulatory standards, measures or requirements, of levels of consumer or environmental protection that might otherwise not be maintained through the simple operation of the market mechanism".⁷ While private and academic authors provide quite clear definition of PSO that has not been the case with the European institutions. The European Commission included this expression in a number of policy documents, but it did not clarify its meaning. In its 2001 Communication, and the Report to the Leaken Council, the European Commission relied on the terms "Public Service" and "Universal Service", but it did not provide a definition of PSO.⁸ The first definition of PSO by the European Commission was provided in the 2003 Green Paper, and later in the 2004 White Paper.⁹ This concept, according to the Commission, refers to the specific requirements that are imposed by public authorities on the provider of the service in order to ensure that certain public interest objectives are met, and these obligations could be applied at Community, national or regional levels. However, in the Interpretative Note on PSO provided by the Commission in 2004 after the adoption of the second Electricity Directive, the Commission stated that PSOs are "[o]bligations which the undertaking ..., if they were considering its own commercial interests, would not assume or would not assume to the same extent or under the same conditions."¹⁰ In addition,

6 I. Houben, Public Service Obligations: Moral Counterbalance of Technical Liberalization Legislation?, *European Review of Private Law*, Vol. 1, 2008, p. 7-27 at 9.

7 C. Jones, *EU Energy Law: Volume I: The Internal Energy Markets* (Imprint Leuven, Belgium: Claeys & Casteels, 2nd ed, 2006), 224.

8 Commission of the European Communities, Report to the Leaken European Council: Services of General Interest, COM(2001) 598 final, Brussels, 17 October 2001.

9 Commission of the European Communities, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: White Paper on Services of General Interest, COM(2004) 374 final, Brussels, 12 May 2004.

10 European Commission, Directorate General for Energy and Transport, Note on Directives 2003/54/EC and 2003/55/EC on the Internal Market in Electricity and Natural Gas: Public Service Obligation, issued on 16 January 2004, at 2.

3 Treaty establishing the Energy Community for South East Europe, signed on 25 October 2005, OJ 2006 L 198/18.

4 The countries of the SEE are: the Republic of Albania, Bosnia and Herzegovina, the Republic of Croatia, the Republic of Macedonia, the Republic of Montenegro and the Republic of Serbia, as adhering parties, and, Kosovo through the United Nations Interim Administration Mission in Kosovo (UNMIK), pursuant to the United Nations Security Council 1244. From 01.05.2010 Moldova and from 01.02.2011 Ukraine became full members of the Energy Community.

5 The paper is limited to the analysis of the PSO in the Contracting Parties signatories to the Energy Community Treaty and does not include Moldova and Ukraine.

the European Commission pointed out that when the Member States impose a PSO, the following conditions should be satisfied: *firstly*, the obligations imposed should be related to the supply of the SGEI in question; *secondly*, the measure should contribute directly to satisfying this general economic interest; and *thirdly*, the measure should be imposed in such a way that it did not affect the intra-Community trade.

The PSO is dealt with by the sectoral EU liberalization legislation. The Electricity Directive provides a number of categories of PSOs which can be imposed on electricity companies. They concern universal service, security issues (including the security of supply), the regularity of the service, the quality and price of the supply, and other issues such as environment protection, energy efficiency and climate protection.

3. Conditions for PSO Assessment under the EU Electricity Acquis

The liberalization legislation has never been limited to the mere introduction of competition, but it has always provided for safeguards to ensure that services continue to meet defined quality standards.¹¹ The safeguards in the electricity sector provided in the Electricity Directive are to be found in Article 3, which establishes the rules concerning PSO. The Electricity Directive provides for a minimum harmonization; on the other hand, the identification of specific PSO is left to the Member States, which can adopt measures on a case-by-case basis in accordance with the subsidiarity principle.¹² The European Commission monitors that the PSOs imposed by the Member States do not affect the intra-community trade and hamper the liberalization process. In the following sections the minimum rules stipulated in Article 3 through the different generations of Electricity Directive will be analyzed.

3.1. Transparency of PSO

The first Electricity Directive of 1996 contained an explicit requirement in Article 3(2) for the publication

11 European Commission, Report to the Leaken European Council, COM (2001) 598 final, 18.

12 Para. 26 of the Preamble of the Electricity Directive reads: "The respect of the public service requirements is a fundamental requirement of this Directive, and it is important that common minimum standards, respected by all Member States, are specified in this Directive, which take into account the objectives of common protection, security of supply, environmental protection and equivalent levels of competition in all Member States."

of the PSO measures adopted by the Member States¹³. However, this provision has been deleted in the second Electricity Directive of 2003,¹⁴ and is now not present in the third Electricity Directive adopted in 2009.¹⁵ Under Article 3(2) of the second and third Electricity Directives, the PSOs "[s]hall be clearly defined, transparent, non-discriminatory and verifiable, and shall guarantee equality of access for EU electricity companies to national consumers." This Article now simply provides a reference to the "transparency requirement". However, there is an expectation that the Member States will publish the measures adopted as PSOs on their website,¹⁶ even though that rarely happens in practice. The Interpretative Note of the European Commission issued after the second Electricity Directive was adopted, analyses separately each requirement provided by Article 3(2). Due to the same wording of Article 3(2) in the second and third Electricity Directive, the Interpretative Note is valid also in relation to the latest EU legislation.

*PSO must be clearly defined.*¹⁷ The Commission referred to *Almelo* judgement of the Court of Justice,¹⁸ where a number of activities came under the category of PSO: the obligation to supply all consumers throughout the territory (supplier of last resort); ensuring continuity of supply; ensuring equal treatment of consumers; ensuring the operation of the national electricity supply system at the lowest possible cost. This is just an indicative and non-exhaustive list of possible PSOs. However, the discretion of the Member States is much broader, as the respective PSOs need to reflect the specific needs of the country in question.

*PSO must be transparent.*¹⁹ The Commission considered that the public service task must be assigned by way of an official public instrument such as legislation.

13 Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity, OJ 1996/L 27, 30 January 1997.

14 Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 Concerning Common Rules for the Internal Market in Electricity and Repealing Directive 96/92/EC, OJ 2003/L 176/37, 15 July 2003.

15 Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 Concerning Common Rules for the Internal Market in Electricity and Repealing Directive 2003/54/EC, OJ 2009/L 211/55, 14 August 2009.

16 C. Jones, *EU Energy Law: Volume I: The Internal Energy Markets*, 355.

17 DG TREN, Interpretative Note: PSO, 2004, at 2.

18 Case C-393/92 *Gemeente Almelo and others v Energiebedrijf IJsselmij* [1994] ECR I-01477.

19 DG TREN, Interpretative Note: PSO, 2004, at 5.

Regulatory act or contract. The instrument has to specify the nature of the PSO, the undertakings and the territory concerned, the responsibility for determining the undertaking's selling prices and the conditions for reviewing such prices, the nature of any exclusive or special rights assigned to the undertaking, the amount of any compensation granted to the undertaking and the period covered by the PSO. However, the act entrusting the undertakings to provide PSOs does not need to be of legislative nature; it could also be done through licenses or concession instruments.

PSO must be non-discriminatory.²⁰ According to Article 3(1) Electricity Directive, the "Member States shall ensure...that...electricity undertakings are operated in accordance with the principles of this Directive...and shall not discriminate between the undertakings..." This is a reaffirmation of the general principle of EU law and it does not provide for specific rights and obligations for the Member States.

PSO must be verifiable.²¹ The test applied by the European Commission is that the measure chosen by the Member State is the least restrictive one on the level of competition in the market. The measure has to be proportionate to the goals achieved. In particular, the Commission shall assess whether the measure is one of the PSOs listed in Article 3(2), whether the measure is appropriate, and it will evaluate the need and the scope of the measure (availability of alternative measures).

3.2. Notification of PSO

Article 3(15) Electricity Directive 2009 requires the Member States to notify PSOs to the European Commission. Unlike the first Electricity Directive, the notification of the implementing measures adopted by the Member States is required irrespective of whether or not the PSO derogates from the Electricity Directive. According to the Interpretative Note of the European Commission, when notifying the measures adopted as PSO to the European Commission, the Member States need to submit the following information: a copy of the official instrument(s) imposing the PSO; an impact assessment of the PSOs on the application of the Directive, as well information on the intentions of the Member State to derogate from provisions of the Directive, and a reference to the national legal provi-

ons concerned and the method of calculating possible financial compensations for the PSO provision. This shows that in order to satisfy the notification requirement, it will not be enough that the Member States notify the legislation implementing the Directives but also additional information is required.

In addition, Article 3(8) includes the same notification requirement in relation to the measures adopted by Member State to protect vulnerable consumers. In particular, under Article 3(8) Member State are required to notify even the measures taken within the general social security system if they are intended to protect the vulnerable energy consumers.

The Directive does not specify how the Commission should proceed after the notification takes place. The Commission shall in theory verify whether the measures adopted by the Member State are in compliance with Article 106(2) TFEU.²²

3.3. PSO as a Justification for Derogations from the Electricity Directive

Under Article 3(14) Electricity Directive 2009, the Member States may decide not to apply Articles 6, 7, 20 or 22 of the Electricity Directive if their application would obstruct the performance of a SGEI and would affect intra-Community trade. The derogations concern the mechanism to authorize the construction of new generation plants (Article 6), the tendering procedure to build new generation plants (Article 7), the provisions on third party access (Article 20) and direct lines (Article 22). Article 3(14) is applied taking in consideration Article 106(2) TFEU. Article 3(14) limits the margin of manoeuvre of the Member States to be able to derogate from the four Articles of the Directive on the ground of a public service if a legitimate objective from Article 3 could not reasonably be achieved through an alternative method. Therefore, Article 106(2) TFEU cannot be relied on by the Member States to derogate from other provisions of the Electricity Directive.

The Commission has clarified the test for applying the derogation provided in the former Article 3(8) in the Note to the first Gas Directive in 1999, and in 2004 in the Note on the PSO issued after the second Electricity

22 There are views that the Commission should also verify whether the notified PSO is in compliance with standards laid down in the Court of Justice case-law related to this article of the Treaty. See: SLOT, P.J., Case law, Court of Justice, *Common Market Law Review*, Vol. 35, pp.1183-1203, 1998, at 1200.

Directive. The Commission has identified two conditions to verify the legitimacy of the derogations, that is: a) the measure has to pursue one of the PSOs identified in Article 3(2) and b) it needs to represent the measure which has the least restrictive effects for trade and competition.

However, Jones in 2006 has rightly argued that it would be unlikely that the Member States will ever derogate from the provisions of the Electricity Directive by relying on Article 3(8), due to the fact that every PSO may be achieved by placing obligations in the licensing conditions.²³ This argument seems still to be valid under the 2009 Electricity Directive, and applications for derogations are hard to be expected.

3.4. Financial Compensation to the Undertaking Entrusted of a PSO

The PSO may represent a burden for the private undertaking entrusted by the Member State to provide the public service. This is the reason why the Electricity Directive allows the Member State to guarantee a financial compensation to the private undertaking or to grant exclusive rights to the undertaking. Compensation may be carried out in a number of different manners. In particular, compensation for provision of public services could be done through direct or indirect subsidies from the government. Alternatively a special fund might be established where the industry's undertakings would contribute, or cross-subsidies between the competitive and non-competitive activities or between different groups of customers could exist.

Compensation, if not proportional to the public service provided, may represent a State aid; a subsidy that would distort the competition in the market by favouring the undertaking entrusted to provide the public service.²⁴ The relationship between State aid rules and compensation for providing a PSO was clarified by the Court of Justice in 2003 in the well known *Altmark* judgement.²⁵ In this judgement the Court of Justice accepted the compensation approach and stated that the compensation for providing a PSO is not a State aid if

four conditions are satisfied.²⁶ In that case, the national compensation scheme shall not be notified to the European Commission, since it does not fall under the scope of Article 107(1) TFEU.

In the case of the electricity industry, PSOs are sometimes imposed on the Transmission System Operator (TSO) and on the Distribution System Operator (DSO). However, due to the (natural) monopoly features, which characterize these segments of the electricity market chain, the companies entrusted of PSOs cannot be chosen through a public procurement procedure.²⁷ Consequently, the last *Altmark* condition can be satisfied only by referring to the typical costs incurred by a well-run undertaking in discharging the public service. Obviously, this condition is not easy to satisfy, since there is a lot of uncertainty about the typical costs faced by a hypothetical company due to the monopoly features of the transmission and distribution sectors. In addition, PSO could be imposed on the generators and/or suppliers as well. In that case, particular importance shall be given to fair conditions for participation in the selection procedure between the incumbent company and the new entrants.

Probably aware of the difficulties faced by national authorities in complying with the four *Altmark* conditions, in 2008 the EU General Court broadened the scope of their application in its BUPA judgement.²⁸ In particu-

26 The four *Altmark* conditions are: a) the recipient undertaking is required by the public authority to discharge PSOs and those obligations have been clearly defined; b) the parameters on the basis of which the compensation is calculated have been established beforehand in an objective and transparent manner; c) the compensation does not exceed what is necessary to cover all or part of the costs incurred in discharging the PSOs, taking into account the relevant receipts and a reasonable profit return for discharging those obligations; and d) when the undertaking which is required to discharge the PSO is not chosen through a public procurement procedure, the level of compensation needed has to be determined on the basis of an analysis of the costs which an hypothetical well-run undertaking would have incurred in discharging those obligations, taking into account a reasonable rate of profit. See: *Altmark* case, para.95

27 This is more the case in the Contracting Parties where one DSO exists. However, it is not unusual that there is more than one DSO in place, in which case tender could be organised.

28 T-289/03, *British United Provident Association Ltd (BUPA), BUPA Insurance Ltd, BUPA Ireland Ltd v Commission of the European Communities*. In relation to more detailed analysis of the BUPA case see: W. Sauter, T-289/03, *British United Provident Association Ltd (BUPA), BUPA Insurance Ltd, BUPA Ireland Ltd v Commission of the European Communities Judgement of the Court of First Instance 02 12 February 2008*, 269-289. M. Ross, "A Healthy Approach to Services of General Economic Interest? The BUPA Judgement of the Court of First Instance", *European*

23 C. Jones, *EU Energy Law: Volume 1: The Internal Energy Markets*, 233.

24 For a discussion on this see: W. Sauter, "T-289/03, *British United Provident Association Ltd (BUPA), BUPA Insurance Ltd, BUPA Ireland Ltd v Commission of the European Communities Judgement of the Court of First Instance 02 12 February 2008*", *Common Market Law Review*, 46 (2009): 270.

25 Case C-280/00 *Altmark-Trans* [2003] ECR I-7747.

20 DG TREN, Interpretative Note: PSO, 2004, at 6.

21 DG TREN, Interpretative Note: PSO, 2004, at 6.

lar, in the later judgement the Court pointed out that in lack of a clear definition in Community law of the concept of SGEI, the Member States could define which cases fall within this category.²⁹ The Court also broadened the scope of the second, third and fourth *Altmark* conditions. In fact, it recognized that the compensation scheme granted by Ireland to the private insurers did not constitute a State aid even though the amount of this compensation was not predetermined, but was decided by the public authority on a case-by-case basis depending by the average risk taken by the private insurer.³⁰ Furthermore, the compensation satisfied the third *Altmark* condition in so far as it was calculated on the basis of "[s]pecific, clearly identifiable and capable of being controlled" criteria.³¹ Finally, the Court held that the fourth *Altmark* condition could not be "strictly applied" in that case. In fact, the compensation scheme established by the Irish Government was not intended to compensate for an identified cost, but rather in relation to the risk profile of the insurance company which received the compensation.³² Therefore, the calculation of the compensation in relation to the costs faced by an efficient operator could not be carried out in this case.³³ Due to the fact that this is the first ruling of an European Court that modifies the application of the *Altmark* criteria, it still unclear at the moment whether the Court of Justice will share this interpretation in its future case-law.

4. Understanding of the PSO in the Contracting Parties of the Energy Community

The SEE countries which are Contracting Parties of the Energy Community Treaty have accepted to transpose and implement the EU electricity *acquis*, including the provisions concerning PSO. This section of the paper aims at analysing the understanding of the PSO in the Contracting Parties, in order to verify whether this provision is implemented and understood in these countries as a tool for addressing the impact of electri-

city market liberalization or whether its improper use could be an excuse for postponing the reforms of the electricity markets in the countries of the region.

4.1. Assessment of PSOs in the Contracting Parties under Article 3 Electricity Directive

In relation to the notification requirement, it should be noted that for the moment the Contracting Parties are not yet required to notify the PSO either to the European Commission or to the Energy Community Secretariat.³⁴ The notification requirement, in fact, was introduced only in 2009 within the third Electricity Directive, and this Directive was only recently introduced in the Energy Community by a decision of the Ministerial Council,³⁵ and it needs to be implemented in the Contracting Parties by 1 January 2015. Another issue closely related to the notification requirement is the possibility for derogation from the provisions of the Electricity Directive. However, no information on this question is available about the Contracting Parties. As these countries do not notify the PSO measures adopted, they also do not inform the Energy Community Secretariat whether their measures require derogation from the Electricity Directive provisions.

Finally, in relation to the financial compensation for provision of PSOs, detailed information is also not available for the Contracting Parties. Some Contracting Parties, such as Macedonia³⁶ and UNMIK³⁷, have introduced provisions in their energy legislation on providing financial compensation to the companies entrusted of

34 The Energy Community Secretariat is an institution established under the Energy Community Treaty.

35 Ministerial Council, Decision on the implementation of Directive 2009/172/EC, Directive 2009/173/EC, Regulation (EC) No 714/2009 and Regulation (EC) No 715/2009 and amending Articles 11 and 59 of the Energy Community Treaty, D/2011/O2/MC-EnC, 06.10.2011.

36 Articles 12(7) and Article 18, Energy Law, Official Gazette of RM, No. 63/2006, 36/07 and 106/08

37 The Rule on Calculation of tariffs states that the decisions about PSO adopted by ERO shall define how the costs of that obligation are to be determined. The energy enterprises shall be entitled to recover the costs for a PSO determined in accordance with the respective decision. The Rule explains that the PSO may either be a charge applied to some or all customers within the same category as those benefiting from its provision, or a levy or similar charge applied to all electricity customers, and it shall be separately identified on all bills and invoices. See: Article 23, ERO, Rule on Principles of Calculation of Tariffs in the Electricity Sector; The document is available on the ERO website without a date and reference number.

28 *Law Review*, 34, 1 (2009), 127-140.

In relation to the importance of the BUPA case for the clarification of the scope of the universal services see: H. Micklitz, *Universal Services: Nucleus for a Social European Private Law*, EUI Working Papers Law 2009/12, 19-22.

29 *BUPA* judgement, para. 167.

30 *BUPA* judgement, para. 214.

31 *BUPA* judgement, para. 237.

32 *BUPA* judgement, para. 246.

33 *BUPA* judgement, para. 252.

PSO, while Albania has introduced similar provisions in its electricity tariff methodology.³⁸ However, because the measures adopted as PSOs are not notified to a central institution, there is no authority that verifies whether the financial compensation granted to the providers of PSOs is in line with the EU *acquis*.

4.2. Defining the PSOs in the Contracting Parties - Are They "Clearly Defined, Transparent, Non-discriminatory and Verifiable"?

Article 3(2) of the second and third Electricity Directives required the PSOs to be "clearly defined, transparent, non-discriminatory and verifiable, and shall guarantee equality of access for EU electricity companies to national consumers." Provided that these general principles are complied with, the Contracting Parties would be free to adopt a number of PSOs in the electricity sector, in order to guarantee security of supply, regularity, quality prices of electricity supply, as well as for achieving environmental protection goals, including energy efficiency and climate protection. The following paragraphs shall provide an empirical analysis of the state of play in the Contracting Parties.

4.2.1. PSO in the Contracting Parties of the Energy Community

The Power Sector Law of Albania defines *all energy activities, except supply to eligible customers*, as public service. In particular, the activities of electricity generation, electricity transmission, electricity distribution, and supply of electricity to tariff (captive) customers, organisation of the electricity market and operation of electricity system are to be carried out as public services.³⁹ In imposing and enforcing licensees' PSO,

38 Para.5.1.2. ERE, Wholesale public supplier tariff calculation methodology, Nr.78, 26 June 2008 and para. 4.1.5, ERE, Retail sales to regulated tariff customers tariff calculation methodology, Nr.80, 26.06.2008.

39 Article 25 Albanian Law on Power Sector, No. 9072, dated 22 May 2003. Some amendments and additions according to Law Nr. 9512 dated 10 April 2006; On some amendments and additions on Law No. 9072 dated 22 May 2003; "On Power Sector", Law 9226, dated 16 October 2006; On some amendments and additions on Law No. 9072 date 22 May 2003; "On Power Sector" amended, Law Nr. 9750 dated 4 June 2007 2003; "On Power Sector" amended, Law Nr. 9750 dated 4 June 2007 "On some amendments and additions on Law No. 9072 dated 22 May 2003 "On Power Sector" amended, Law Nr. 9776 dated 12 July 2007 "On some amendments and additions on Law No. 9072 dated 22 May 2003 "On Power Sector" amended, Law Nr. 9913 dated 5 May 2008 "On some amendments and additions on Law No. 9072 dated 22 May 2003 "On Power Sector" amended, and Law No. 9997 dated 22 September 2008.

the Regulatory authority may consider obligations in relation to: security of supply; regularity, quality and price of supplies; use of indigenous energy sources; efficient utilisation of fuels and energy; environmental protection, and protection of citizens' health, life and property.

In *Bosnia and Herzegovina*, there is no definition of PSO at state level, but at entities levels. According to the Law on Electricity of *Federation Bosnia and Herzegovina*, public service means "the obligation of power companies to perform certain electric power sector activities in the form of public services."⁴⁰ In particular, the electric power sector activities of generation of electric power for non-eligible (tariff) buyers and distribution of electric power and supply of electric power to non-eligible (tariff) buyers shall be performed as public services.⁴¹ Also the existing electricity companies active in the Federation could continue to provide services to non-eligible customers after being licensed by FERC to provide electric power supply as a PSO,⁴² at prices from the tariff system for the sale of electric power.⁴³ In the Rulebook on tariff methodology,⁴⁴ PSO is defined as an "obligation of power companies to perform power activities as public services, regarding the safety, regularity, quality, prices of supply and protection of the environment in accordance with the Law and EU Directives." Moreover, the Decision on tariffs for users of distribution system⁴⁵ states that all regulated companies that have a PSO need to work in the most efficient way, with this obligation being stated in the licence where the licensee is obliged to carry out the distribution of electricity as a public service in accordance with the laws, by-laws, as well as with the EU directives and international agreements.

The Law on energy of *Republika Srpska* (RS) from 2009 defines public service as "the service available to all customers and energy undertakings at certain area at the prescribed price and following the regulated terms and conditions for access and use of the service, in compliance with safety, including the safety of supply, regularity and quality of service,

40 Article 3, Law on Electricity of FBiH, Official Gazette FBiH 41/02, 24/05, 38/05 and 61/09

41 Article 9(2), Law on Electricity of F BiH, *supra*

42 Article 46 (i) (2), Law on Electricity of F BiH, *supra*

43 Article 50(i) Law on Electricity of F BiH, *supra*

44 Article 4, Rulebook on tariff methodologies and tariff proceedings in F BiH, No. 07-07-471-02/05, 8 July 2005

45 Decision on tariffs for users of distribution system of Elektroprivreda Hrvatske zajednice Herceg Bosne, No.07-02-7-58/1/08, 29 January 2008, Mostar

energy use efficiency, protection of environment and prevention of climate changes, which is being carried out following the principles of transparency of work and supervised by the law-established bodies."⁴⁶ It also refers to the PSO as "an obligation of energy structures to carry out certain energy activities as public services."⁴⁷ The Law on energy of RS defines the energy activities that are of general interest and that are carried out as PSO, including the activities related to electricity such as: generation of electricity for supply of tariff customers, distribution of electricity and supply of tariff customers with electricity.⁴⁸ Moreover, the amendments of the Law on Electricity of RS from 2009 state that the public companies in the first place provide SGEI as an obligation in the system of public services because of supplying non-eligible customers as well as eligible customers which are supplied as non-eligible, generating electricity because of supplying non-eligible customers as well as the eligible customers which are supplied as non-eligible, as well as distribution of electricity for all customers.⁴⁹ This obligation could be also granted to other companies that have a contract for concession in relation to the generation of electricity and that shall also be stated in the licence conditions. The companies that perform electric power activities may be required to perform public services and the obligation to perform public services shall be determined by the operation licence issued by FERC.⁵⁰

In Croatia, the PSO extends by definition over all regulated functions in the system.⁵¹ The PSO was defined in the Energy Act of 2001,⁵² but more detailed definition of public service is provided in Article 3(14) of its amendments of 2004, as a "service available at all times to all customers and energy undertakings according to a regulated price and regulated access and use of service conditions, taking into account security, regularity and quality of service, environmental protection, energy use efficiency and climate

protection, all performed according to the principles of transparency of work and supervision of the bodies as prescribed by law." The Energy Act of 2001 as well as the Electricity Market Act of 2004 defines the following activities as public services: electricity generation for tariff customers, electricity transmission, electricity distribution, organisation of the electricity market, supply of electricity to tariff customers.⁵³ A new Electricity Law that aims transposing the Electricity Directive from 2009 is being developed in Croatia, and is pending adoption. The Macedonian Energy Law defined the public service too widely, including all energy activities except trade and supply to eligible customers. Moreover, the Customer Protection Law from 2004 defines the sale of electricity in a distribution network as a public service.⁵⁴ Article 6 of the Energy Law defines the PSO imposed on the undertakings by which the following activities are considered to be public services: generation of electricity for tariff consumers; transmission of electricity; management of a system for the distribution of electricity, and distribution of electricity; operation of the electricity transmission system; organisation and operation of the electricity market; and retail supply of electricity for tariff customers. In the Energy Law from 2006, wholesale supply of electricity to tariff customers was also considered to be a PSO, but with the changes to the law in 2008 it is no longer considered as a separate energy activity and therefore is not addressed as a PSO either. The new Energy Law from 2011 defines the PSO as "one or more obligations imposed to the entities performing regulated energy activities for the purpose of public interest realization pursuant to the present law, and related to safety, including the reliability of supply, service affordability for users at all times, energy or energy fuel quality and price, services, as well as environmental protection, including energy efficiency and climate change protection."⁵⁵ Until recently the PSO was defined in broad terms in the 2003 Energy Law of Montenegro by considering all energy activities as public services.⁵⁶ The Energy Law 2010 still defines energy activities as activities of public interest, but it also provides a definition of

46 Article 3 (aa) Law on Energy of RS, No.01-794/09, 14 May 2009

47 Article 3(bb) Law on Energy of RS, 2009 *supra*

48 Article 11 Law on Energy of RS, 2009 *supra*

49 Article 1 amendments to the Law on electricity, Official Bulletin RS 34/09, 16 October 2009

50 Article 6(2)(3) Law on Electricity of FBiH, *supra*

51 ECS, Report on the Implementation of the *Acquis* Under the Treaty Establishing the Energy Community, Ref: 6th MC/26/06/09-Annex 12/15.05.2009, May 2009 at 43

52 Article 3(12) Energy Act, Croatian Official Gazette 68/01: "Public Service Obligation" - an obligation imposed on energy undertakings to carry out certain activities as public services.

53 Article 20(2) Croatian Energy Act, 2001 *supra*; Articles 3(4) and 3(5) Electricity Market Act, Croatian Official Gazette 177/04

54 ECS, May report 2009, *supra* at 47

55 Article 3(58) Macedonian Energy Law, Official Gazette 16/2011, 10.02.2011

56 Article 1(3) and Article 24(2) Montenegro Energy Law 2003

PSO.⁵⁷ Under Article 67 of the Montenegro Energy Law 2010, the regulatory agency may include in the licence conditions of the energy undertaking the following PSOs: ensuring security of supply; ensuring quality of service; safeguarding environmental protection; protecting citizens' health, life and property; and adopting measures for protection of energy consumers. The law stipulates moreover that the PSO should be clearly defined, non-discriminatory, transparent, easily verifiable and published.

In Serbia, PSOs are defined in the Energy Law of 2004 as activities conducted in the general interest.⁵⁸ The act specifies a number of PSOs in other articles as well. For instance, Article 42 considered PSO the wholesale trade for tariff customers; Article 81 referred to the generation for tariff customers; Articles 104 and 105 addressed the retail trade (supply) of tariff customers. Overall, the provisions concerning the PSO definition were not very clear until recently.⁵⁹ The new Energy law from 2011 does not contain a separate definition of PSO, and it extensively deals only with public supply - understanding it as a PSO defined in the primary legislation.⁶⁰

In UNMIK, the term PSO is defined in the Law on Energy from 2010 as "duty imposed upon energy enterprises entrusted with the provision of SGEI, which may relate to security including security of supply, regularity, quality and price of supplies, and environmental protection, and which takes into account general social, economic and environmental factors."⁶¹ Article 16(3) of the same legislation states that the Energy Regulatory Office may impose the specific PSOs on the energy enterprises, and they may be related to the aforementioned issues. The costs and expenses incurred by energy enterprises shall, subject to review by ERO, be acknowledged as justified costs and expenses for the purposes of setting tariffs.⁶² The Rule on calculation of tariff in UNMIK imposes an obligation on the regulatory authority to issue decisions determining the existence of a PSO; the nature, scope

57 Article 68 Montenegro Law on Energy, No. 01-70/25, adopted 22.4.2010

58 Article 41 Energy Law, Official Gazette of the Republic of Serbia, No.84/2004, 24 August 2004

59 CARDS Project 2005, Facilitating and Implementing the Energy Community in South East Europe: Report on the Implementation of the Treaty Establishing the Energy Community, May 2007 at 257.

60 Article 25 Serbian Energy Law, Official Gazette, 57/2011 adopted on 14.07.2011

61 Article 2 (1.25) UNMIK Law on energy, No.03/L -184, November 2010

62 Article 16(4) UNMIK Law on Energy 2010

and duration of the PSO and the energy enterprises to which the PSO applies.⁶³ However, this is an obligation to be fulfilled "from time to time", and it is not a clear obligation for all the PSOs to be published when they are imposed. So far, this type of decision has not been published.

General remarks on the PSO in the Contracting Parties This empirical analysis conducted in the paragraphs above, shows that until recently the energy laws of the Contracting Parties usually defined the PSO in a broad manner, without taking in consideration the four conditions mentioned by Article 3(2). Progress could be noted with the adoption of the new generation of energy legislations in the Contracting Parties that aim transposing completely the 2003 Electricity Directive. Even though few Contracting Parties have recently adopted new energy legislation, their implementation in practice has not been initiated yet. Therefore, the findings of the study hereby presented are still very much relevant.

The PSOs imposed in these countries usually covers all energy activities, except supply of electricity to eligible customers. Moreover, the PSO is usually imposed on all energy undertakings in the country, rather than on specific undertakings selected in a transparent and non discriminatory manner through a tendering procedure. Even the new legislation adopted in some of the Contracting Parties recently entrusts the incumbent undertakings with a PSO for providing supply to tariff customers (so-called public supply) for a predefined period. This period is usually extended until 2014 when according to the Energy Community Treaty the electricity markets shall be completely opened also for the household customers. This is related to the fact that the PSO is broadly understood only as a tool for protection of (at least) households and guaranteeing security of supply for this category of customers. The PSO is not understood in the Contracting Parties as an exception to general rule requiring that public service should normally be guaranteed by the free competition in the market, but rather as the general rule [emphasis added] relied on by the Contracting Parties to postpone the liberalization of their electricity markets. In particular,

63 Article 22, ERO, Rule on Principles of Calculation of Tariffs in the Electricity Sector

this study found that at the moment the understanding of the PSO in the Contracting Parties (even though noting progress) still differs from the understanding that this provision is supposed to have under Electricity Directive, since the four conditions mentioned by Article 3(2) are not fulfilled in the manner in which the PSO is imposed in the energy laws of the SEE countries. Consequently, the definition of PSO in the energy laws of the Contracting Parties needs to be improved in terms of the content of the obligation (in terms of security of supply, quality of service, regularity, fair pricing, and environmental protection), as well as in relation to the procedures for selection of undertakings that would be entrusted with the PSO in a transparent and non-discriminatory manner. Particular importance has to be paid to the mechanisms for the financial compensation and granting exclusive rights, and to verification whether the proportionality is satisfied and whether it goes beyond what is necessary for ensuring provision of the public service in question.

5. Conclusion: How the Contracting Parties of the Energy Community Can Adopt PSOs in Compliance with Article 3 Electricity Directive

As underlined in the previous pages, although the PSO provision in the EU law was strengthened and became more detailed through the different generations of electricity liberalization Directives, the Member States have a large amount of discretion in implementing this provision at national level. Within the enlargement process, the EU could not provide the SEE countries with anything more than the broad and general provisions from the *acquis* adopted for the needs of the developed economies of the Member States that the SEE countries are expected to adopt as Energy Community law. As it is the case of the EU Member State, the Contracting Parties enjoy also a broad margin of discretion in adopting PSOs in the electricity sector. However, at the moment the understanding of the PSO in the Contracting Parties differs from the understanding that this provision is meant to have in the Electricity Directive. In many instances, this provision is not seen as a tool to tackle the negative consequences of the liberalization process of the energy markets, but rather as an excuse for postponing the reforms. Understanding the PSO in this manner derives from the culture, history and importance of the electricity system in the Contracting

Parties before the process of liberalization of this industry started.⁶⁴

In conclusion, this paper would propose few recommendations that the Contracting Parties should follow in future, in order to implement the PSO in compliance with Article 3 Electricity Directive.

Firstly, in order to fulfil the transparency requirement, the national regulatory authorities of the Contracting Parties or the other public authorities should adopt specific measures imposing PSO in a form of a regulatory decision, as part of the license granted to the energy undertaking or secondary legislation, instead of including the PSO in the national energy law.

Secondly, in relation to its content, the decisions could cover different PSOs and not only PSO for securing supply of electricity to tariff customers, as the current understanding of PSO in the Contracting Parties is. The PSO could be measures related to ensuring continuity of supply, equal treatment of consumers, and the operation of the national electricity supply system at the lowest possible cost. They could be related to energy efficiency, environmental protection and climate change, as well as to regularity and quality of the service. What is important is that the decision imposing the PSO clearly defines the measure in question. In particular, the decision should indicate the geographic scope and the duration of the PSO.

Thirdly, the public authority should define the energy undertakings entrusted to provide PSO, rather than including in the energy law a general obligation on all energy undertakings to provide public services. The undertakings should therefore be selected in an open, transparent and non-discriminatory procedure, and it shall not always be the State-owned incumbent by default. The Contracting Parties shall take into account that PSOs could be imposed even on the new entrants in the supply (or even the generation) market.

Fourthly, the measure imposing PSO should also comply with the requirement of being verifiable. For this reason, the public authority should face the burden of proof that the measure is the least restrictive one of the competition in the market, and that the measure is proportionate. The measure should not go beyond what

⁶⁴ For a detailed analysis of the liberalization of the electricity markets and the implementation of the PSO in the SEE Contracting Parties, see: R. Karova, *Liberalization of Electricity Markets and the Public Service Obligation in the Energy Community*, forthcoming by Kluwer Law International

is necessary for ensuring the provision of the public service in question.

Finally, the public authorities should not discriminate between the undertakings present in the country. In particular, they should clearly identify the mechanisms to calculate the amount of the compensation that the undertakings entrusted of the PSO will receive in accordance with the *Altmark* conditions. Furthermore, the benefits granted in return for providing PSOs, such as special or exclusive rights shall be also made very transparent.

As mentioned in the previous section, Article 3(15) Electricity Directive 2009 imposes an obligation on the Member States to notify to the European Commission the adoption of national measures as PSOs. No notification requirement existed for the Contracting Parties in relation to the transposition of the 2003 Electricity Directive. However, taking in consideration the difficulties that the Contracting Parties are likely to face in modifying their understanding of the PSO in compliance with Article 3 Electricity Directive in future, the paper argues in favour of the extension of the notification duty to the Contracting Parties. Similarly to Article 3(15), the Contracting Parties are now required to notify the PSOs present in their electricity sector to the Energy Community Secretariat as of 1 January 2015. This paper invites the Contracting Parties to do so even in advance of the official deadline set by the decision of the Ministerial Council. This procedure would allow and improve the ability of the Secretariat to monitor the implementation of the PSOs by the Contracting Parties. Additionally, the notified PSOs could be made public, in order to increase transparency and to allow the identification of best practice solutions in the region.

As informally confirmed by an official of the European Commission, at the moment few Member State comply with the notification requirement under Article 3(15).⁶⁵ However, it is important to point out that the Contracting Parties, being candidate countries for membership of the EU, are already familiar with reporting requirements and are less reluctant than the Member States to comply with them. From this perspective, the notification requirement would not be seen as

anything unusual, and it would even be beneficial if the Contracting Parties became accustomed to reporting the PSOs to the ECS before becoming EU Member States and having the obligation to notify the European Commission on this issue.

In conclusion, the paper underlines that the EU energy *acquis* does not simply require the Contracting Parties to the Energy Community Treaty to liberalize their electricity markets, but it also provides for a *safety net* to ensure availability of public services through the imposition of PSO. Nevertheless, the paper has pointed out that the present understanding of the PSO in the Contracting Parties is not yet fully in compliance with the conditions provided by Article 3 of the Electricity Directive. By implementing the recommendations mentioned above and by introducing a duty of notification, the Contracting Parties can improve understanding of PSO in line with EU law, by thus effectively safeguarding the availability of public services in the electricity sector to their citizens, without jeopardizing the effective electricity market liberalization.

⁶⁵ Telephone conversation between the author and an official of DG ENERGY European Commission, who prefers to remain anonymous, on 9.12.2010.