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MANUFACTURING THE EU ENERGY MARKETS:  
THE CURRENT DYNAMICS OF REGULATORY PRACTICE

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## **Abstract**

This chapter aims to analysis the new dynamics at work in EU energy regulation. Since the publication of the European Commission's 'Sector Inquiry Report' in January 2007, European energy companies have felt the cold wind of competition law - many for the first time. In addition, national competition authorities (NCAs) have been actively pursuing abusive market practices - sometimes making innovative use of competition law in the process. Certain energy giants have agreed to unbundle their transmission networks - even when their national governments opposed the inclusion of ownership unbundling in the draft 'Third Package' of electricity and gas legislation. In parallel, the Third Package envisages the creation of a new regulatory agency - ACER - to co-ordinate technical cross-border regulatory issues in the internal market. So who will be in the driving seat in the next decade - and will co-ordinated regulatory powers be the preferred approach to market design? Will regulatory rules co-exist alongside competition based controls or will the latter gradually supersede the former? This chapter will examine these critical issues.

## **Keywords**

Antitrust, Third Legislative Package, ACER, European Union



## 1. Introduction

Until the late 1970s, the traditional organization of energy markets was based on the full horizontal and vertical integration of supply and transport activities, in general completed by a monopoly in retail supply at the local or regional level with regulated prices. The shift of regulatory regimes towards market-based competition has been widely discussed (e.g. Armstrong, Cowan and Vickers, 1994; Crew and Kleindorfer, 1986) and largely implies, if not a retreat, at least a redefinition of the role of the state and its tools for action (Jamassb, 2006). In the European Union, regulation was traditionally based on sector-specific rules rooted in the theory of natural monopoly and justified the grant of exclusive rights. The liberalization of electricity and gas markets really started in the mid 1990s,<sup>1</sup> following the 1987 Single European Act, with a view to breaking national and regional boundaries and achieving a competitive single market. The first legislation defining common community rules for the implementation of a competitive retail model was enacted in 1996 for electricity<sup>2</sup> and 1998 for gas,<sup>3</sup> and was subsequently repealed in 2003.<sup>4</sup> While the second package of Directives in 2003 was to go a step further in the harmonization of Member states' market designs and ensure stronger *ex ante* regulation at the national level, the main innovation of the third legislative package (thereafter Third Package) officially published the 14<sup>th</sup> of August 2009,<sup>5</sup> is the creation of a new Agency for the Cooperation of Energy Regulators (thereafter ACER), representing an effort to strengthen *ex ante* regulation at the Union level.

However, more than ten years after the enactment of the first liberalization Directive, the completion of a truly competitive retail market integrated at the level of the European Union remains at best a work-in-progress (Haas et al., 2006). The Sector Inquiry of 2007 showed not only that continued vertical and horizontal integrations remain a key feature of energy markets but also that there is still a wide diversity of situations among Member States.<sup>6</sup> European markets have been restructured around a more competitive wholesale market but a *quasi*-monopoly or a vertically-integrated oligopoly continues to dominate. Contrary to the US, retail competition is a key aspect of European market design, but the intensity of retail competition remains unsatisfactory in most cases. The push to complete the single EU energy market may be stalling, despite the major improvements introduced since the mid 1990s.

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<sup>1</sup> Directive 90/377/EC of 29 June 1990 concerning a community procedure to improve the transparency of gas and electricity prices charged to industrial customers, O.J. 17.7.1990, L185/16; Directive 90/547/EC of 29 October 1990 on the transit of electricity through transmission grids, O.J. 13.11.1990, L 313/30.

<sup>2</sup> Directive 96/92/EC of 19 December 1996 concerning common rules for the internal market in electricity, O.J. 30.1.1997, L 27/20.

<sup>3</sup> Directive 98/30/EC of 22 June 1998 concerning common rules for the internal market in natural gas , O.J. 21.7.1998, L 204/1.

<sup>4</sup> Directive 2003/54/EC of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC, O.J. 15.7.2003, L 176/37; Directive 2003/55/EC of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC, O.J. 15.7.2003, L 176/57.

<sup>5</sup> Directive 2009/72 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, O.J. 14.8.2009, L 211/55; Directive of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, O.J. 14.8.2009, L 211/94; Regulation 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators, O.J. 14.8.2009, L 211/1; Regulation 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation 1228/2003, O.J. 14.8.2009, L. 211/15; Regulation 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation 1775/2005, O.J. 14.8.2009, L. 211/36.

<sup>6</sup> DG Competition, Report on Energy Sector Inquiry, SEC(2006) 1724 final of 10.1.2007.

For a variety of reasons, Member States have had very different views on the advantages of the new market organization. The ten year negotiation process which led to the enactment of the first liberalization Directive already evidenced the difficulties of getting a consensus (Hancher, 1997) and many of the problems which would impair the reform process in the next period, in particular the lack of a clear legal basis for energy in the EC Treaty. Indeed, apart from coal with the late European Coal and Steel Community Treaty (expired on 23 July 2002) and nuclear with the European Atomic Energy Treaty, energy has never had any specific legal basis in primary EC law. General EC law therefore applies, in particular competition and internal market rules. The project of the European Union with the liberalization and the integration of energy markets is indeed not only unique in scale, but it is also unique in the vertical overlaps of competences between Member States and the Union level, which constrain the process of reform and the legal and regulatory tools available to support it. In retrospect, this long and on-going legislative process has been nothing but a quest to better harmonize 27 separate national market designs and implement stronger *ex ante* regulation, both at the national and the European levels, *given* the constraints of the European institutional structure for decision-making in energy and the underlying vested interests of Member States.

Another important part of energy regulatory oversight which should not be overlooked in Europe is the enforcement of the antitrust laws. In theory, antitrust policy should be used to monitor conduct *ex post* and be optimally articulated with *ex ante* regulation (Newbery, 2006). It should be noted that the use of antitrust and regulatory policy as a combined instrument in the EU energy sector has differed significantly from their application in other network industries. In the telecommunications sector for example, the liberalization process started with antitrust measures and was then followed by harmonization rules at the level of *ex ante* regulation. Unlike the telecoms sector, it took over seven more years after the first Directive of 1996 before the antitrust laws were applied in energy and even then only in rare cases. Following the Sector Inquiry, the Commission has resorted to a much more determined approach often relying on the commitment procedure. Overall, in the face of the long-lasting shortcomings of the liberalization process, both *ex ante* and *ex post* regulatory oversight have been continuously evolving within the boundaries of the European institutional structure.

This chapter thus aims to analysis the new dynamics at work in EU energy regulation and set out the consequences of the institutional constraints on the efficiency of the initiatives currently pursued, especially for market design. It also aims to investigate how *ex ante* and *ex post* approaches are articulated in EU energy regulation and the potential problems it raises. For reasons of clarity, this chapter will be structured around this dichotomy.

## 2. Ex Ante: The Creation of ACER - Strengthening Regulatory Convergence?

ACER is the outcome of a long process of more than 10 years of informal co-operation among regulators. The Florence (electricity) and Madrid (gas) Forums were instituted in 1996 on the initiative of the Commission and gathered delegates from the Member States (plus Switzerland and Norway), national regulatory authorities, the industry (essentially producers, power exchanges, traders and industrial customers), the European Parliament and other non-governmental stakeholders (e.g. associations of consumers) under the authority of the Commission. The Council of European Energy Regulators (thereafter CEER) was then created the 7<sup>th</sup> of March 2000 to foster the dialogue among national regulatory authorities and between them and the Commission. A further step towards a deeper cooperation of European energy regulators was accomplished with the adoption of the decision 2003/796/EC of the 11<sup>th</sup> of November 2003 instituting ERGEG.<sup>7</sup> To an extent, ERGEG formalized the regulatory role played by the CEER in the Forum process (Eberlein, 2003).

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<sup>7</sup> COMMISSION DECISION 2003/796/EC OF 11.11.2003 ON ESTABLISHING THE EUROPEAN REGULATORS GROUP FOR ELECTRICITY AND GAS, O.J. 14.11.2003, L 296/34.

ERGEG's role is to advise the Commission on possible improvement of community legislation and help harmonize regulatory practice among Member States. Its action has been particularly noticeable in the field of cross-border exchange and trade. In the late 1990s, Member States each had different export, import and transit electricity tariffs which led to so-called 'pancaking', namely cross-border trade was subjected to as many tariffs as Member States involved, and did not reflect the actual costs incurred. Different methodologies also existed for the allocation of cross-border capacities (Jones, 2006). ERGEG's conclusions on these issues became legally binding in the form of Regulation 1228/2003 on cross-border exchanges, recently repealed by the Regulation 714/2009. Even if ERGEG is effective in gathering data and making regulatory proposals, it cannot adopt legally-binding decisions and has no enforcement powers. As such this informal approach permitted neither the development of interconnection capacities nor the coordination of Member States' energy policies (Eberlein, 2003).<sup>8</sup> ERGEG's decisions are also taken purely by consensus. The acknowledgment of these shortcomings became the basis for the creation of ACER.

### **2.1 – ACER as a European Network Agency**

The creation of ACER must be viewed within the wider context of the creation of several new authorities at the European level, in particular in the telecommunication sector. In late 2007 the Commission proposed to formalise and strengthen the existing regulatory networks both in the energy and electronic communications sectors by conferring on them a status of independent agency: it has thus proposed the creation of ACER and a European Electronic Communications Market Authority (EECMA). The originality of the ACER and the EECMA compared to other agencies in the EU regulatory landscape is that they are in reality "*network agencies*" (Lavrijssen and Hancher, 2008). The existing networks, such as ERGEG in energy, are incorporated into the agencies as Boards of Regulators which will, together with the Directors and Administrative Boards, cooperate with the Commission and the NRAs to further the completion of the internal market. These agencies are also intended to provide a greater political and legal independence for the members of the networks - the NRAs - from their national governments. In the opinion of the Commission, inadequate political independence at national level indeed hampers an effective and impartial application of European law, and this is one of the reasons why ACER was created as a network agency.

The re-framing of the regulatory networks as network agencies raises particular accountability issues as the role of European regulatory networks moves beyond formal co-ordination of procedures and the exchange of information or best practices towards fostering closer regulatory convergence.<sup>9</sup> The gradual emergence of these network agencies represents a new stage in European sectoral regulation and involves a multi-level situation with different lines of responsibility running between the Commission, the regulatory network agency, the Member States and their NRAs. Necessarily, this structure complicates the allocation of responsibility and the accountability of these different actors from a political as well as a legal perspective. Much of the legal and political science literature has focussed on the accountability deficits of the networks themselves (e.g. Hofmann and Turk, 2007; Curtin, 2007; Papadopoulos, 2007), but in the light of the repositioning of the regulatory networks as European network agencies, it remains equally important to consider their position *vis a vis* the Commission in the future, and the division of competences between these new agencies and the Commission itself. The next section takes a closer look at these issues for ACER whose powers have recently been defined in the Third Package which entered into force the 3<sup>rd</sup> of September 2009.

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<sup>8</sup> For an interesting discussion of forums as regulation devices in the modern economy, see Brousseau and Glachant (*forthcoming*).

<sup>9</sup> For a complete analysis of these issues, see Lavrijssen and Hancher (2008).

## 2.2 – ACER: Revolution or Evolution?

In terms of internal governance, ACER will broadly follow the principles of the Draft Inter-institutional Agreement on the Operating Framework for the European Regulatory Agencies<sup>10</sup> and will be composed of four different bodies. An Administrative Board composed of 9 members (2 appointed by the Commission, 2 by the European Parliament<sup>11</sup> and 5 by the Council) will establish the budget (mainly financed by the European budget), check its implementation, set the work program, adopt financial regulations and appoint the Director. Even though the European Parliament obtained the two seats it claimed during the negotiations, the Administrative Board remains the body of the Council as a two third majority voting rule applies and hence the four appointees of the European Parliament and the Commission would need to coalesce to veto decisions of the Council's. This is important as the only body where the decisions of ACER can concretely be contested, the Board of Appeal, is appointed by the Administrative Board. The decisions of the Board of Appeal can in turn be contested before the European Courts but given the nature of the competences of ACER, it is likely that the Board of Appeal will be the most important (if not the unique) institution where dispute settlement will take place. The Director will then manage and represent the agency. He/she shall be appointed by the Administrative Board but only following a positive opinion from the Board of Regulators. The Board of Regulators will in practice be the central body of the agency and perform the regulatory functions. It will also approve the work program. It will be constituted by no more than one representative per Member States and one non-voting representative of the Commission. A two third majority rule, with each member having one vote, will be used to reach a decision. Despite initial fears, the functions of the Board of Regulators are relatively clearly delimited and include most of the substantive powers of the new ACER.

As laid down in the Third Package, ACER is “to assist the regulatory authorities [...] in exercising, at Community level, the regulatory tasks performed in the Member States and where necessary, to coordinate their action”. Its objectives are thus to provide a framework for the cooperation of NRAs, complement their actions at EU level to address regulatory gaps on cross-border issues and provide greater regulatory certainty. Concretely, ACER will primarily have an advisory role in relation to national Transportation System Operators (thereafter TSOs), national regulators, the European Commission, the Council and the European Parliament, as well as a monitoring role on behalf of the Commission. Its opinions and recommendations should contribute to ensuring more coordination among TSOs and among regulators of the different Member States, spread good practices and in particular contribute to the implementation of the new (non-binding) Community-wide ten-year network development plan, i.e. monitoring the work entrusted by the new legislation to the new European Network of Transmission System Operators (thereafter ENTSOs) for electricity and gas.<sup>12</sup>

The first main area of competence for ACER will concern the monitoring of TSOs and their cooperation at the regional or at the community level through the new ENTSOs. The ENTSOs are also new bodies intended to formalize and unify through forced membership the existing networks of European TSOs. ACER will provide an opinion to the Commission on draft statutes, list of members, draft rules of procedure and the annual work program of the ENTSOs, as well as on the certification of national TSOs. However, the ENTSOs will not be bound by the opinions of ACER and the Commission. ACER will then advise the ENTSOs on their ten-year network development plans<sup>13</sup> as

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<sup>10</sup> COMMISSION DRAFT INTER-INSTITUTIONAL AGREEMENT ON THE OPERATING FRAMEWORK FOR THE EUROPEAN REGULATORY AGENCIES, COM (2005) 59 FINAL OF 25.2.2005.

<sup>11</sup> But no member of the European Parliament can seat.

<sup>12</sup> The ENTSO for electricity already exists and was voluntarily created in the end of 2008 (gas will soon follow).

<sup>13</sup> The ten years network development plans is composed of three reference documents: an annual generation outlook, a transmission adequacy analysis and a review of transmission infrastructures needs/projects. This is intended to foster the emergence of a longer-term vision of the EU energy network, give a new tool for market participants (especially

well as monitor completion on behalf of the Commission. ACER will also have a duty to follow progress on the implementation of projects to create new interconnector capacity, check the security of the network and importantly approve the compliance program of vertically-integrated TSOs cooperating within a joint undertaking covering two or more Member States for capacity allocation. Last, ACER will have the obligation to submit to the Commission draft framework guidelines which set out clear and objective principles for the new network codes to be prepared by the ENTSOs.<sup>14</sup> The Commission will define priorities for network codes and ACER will only act on its request.<sup>15</sup> After satisfactory review of the content of network codes by ACER, the Commission may obtain approval via the regulatory procedure (comitology).<sup>16</sup> ACER will then monitor implementation of the codes and eventually submit recommendations to the Commission, the European Parliament and the Council when it deems it unsatisfactory.

We note that the powers of the Commission to adopt general binding measures on technical and operational cross-border issues is extended considerably when compared to the Second Package. Originally limited to congestion management principles, inter-transmission system operator compensation mechanisms and harmonization of principles underlying the setting of charges applied to producers and consumers, the Commission's powers now extend to establishing cross-border network code areas and the certification of TSOs, as well as powers to require the provision of information, powers to determine the rules for the trading of electricity and lastly to determine details of investment incentive rules for interconnector capacity including locational signals. As with ERGEG before, ACER will have an advisory role only in these instances. We note that contrary to ACER, the ENTSOs can initiate the process of formulation of new network codes beyond the agenda preliminary set by the Commission (even though the process for review and adoption remains the same). Despite a proposed amendment by the European Parliament, ACER cannot enact binding guidelines for network codes.

The second main area of competence for advisory and monitoring functions is targeted at the NRAs. ACER may indeed formulate opinions to the Commission and/or the NRAs (on their request) on how the latter should exercise their powers to adopt binding decisions in a specific case or whether a particular decision complies with the legislation. In case of a negative opinion in the later case, ACER has a duty to inform the Commission which will ask the NRA to withdraw or amend its decision. However, no binding enforcement mechanism is provided, and the Commission remains free to propose guidelines on dispute settlement procedures via the regulatory procedure. ACER will also promote harmonization in the transposition of the new Directive and Regulation.<sup>17</sup> ACER can provide a framework for the cooperation of NRAs and then provide recommendations to the Commission to

(Contd.) \_\_\_\_\_

generators) and enable a wider consultation on this issue with relevant stakeholders. However, the financing issue is not addressed.

<sup>14</sup> We note that the Third Package does not provide a clear definition of what draft framework guidelines should include and that there are also no clear provisions as to the binding effect of network codes. It is interesting to see that the ENTSO for electricity has already launched a pilot network code project on wind generation connection. The list of network areas covered by the Regulation 714/2009 is very extensive and no priorities are provided in the legislation.

<sup>15</sup> When the Commission is dissatisfied with the work of ACER, it can require a review of the draft framework guidelines submitted. When ACER fails to proceed, or when the ENTSOs fail to complete the requested draft network codes, the Commission can take the lead each step of the way.

<sup>16</sup> Under comitology, before the reforms introduced by the Lisbon Treaty, the Commission is assisted by a committee of Member States representatives and decisions are taken according to different procedures defined in EC law. In the case of the regulatory procedure, the Commission submits its proposal to the Council only when the committee disagrees. The European Parliament must be informed and gives an opinion to the Council. The Council finally acts by qualified majority on the proposal. If the proposal is rejected, the Commission may resubmit or present a legislative proposal on the basis of the EC Treaty.

<sup>17</sup> Even though less institutionalized and without a clear duty to provide opinion on request, ERGEG had the same role through the adoption of common positions and benchmark of best practices which contributed to peer-reviewing and informal pressure.

make them binding via the regulatory procedure. ACER can also, in accordance with its work program or on request of the Commission, make recommendations to assist regulatory authorities and market players in sharing good practices.

ACER will have certain autonomous powers to take specific binding decisions on technical issues in relation to cross-border energy networks. This may include terms and conditions for access and operational security of cross-border infrastructure, in particular the procedure and time frame for capacity allocation, and the sharing of congestion revenues. ACER will have competence on these issues upon a joint request of NRAs or when they cannot agree after a period of 6 months. It will gain the power to grant an exemption for new infrastructures from the rules on third party access and/or the use of congestion rent. This involves balancing the interest of ensuring free competition in the short term with the interest of safeguarding sufficient investments in infrastructure that will enhance competition in the energy sector in the long term. Until the enactment of the Third Package, the national regulatory authorities of the Member States directly involved had jurisdiction to grant individual exemptions for their own territories. The Member States or the national regulatory authorities had thus to cooperate and find common grounds for the grant of these exemptions. In the case of a sustained disagreement between them, the project could not proceed. If all the Member States involved had adopted a positive decision for their own jurisdictions, the Commission retained the right to propose amendments or request a complete withdrawal of the exemption.

With the new Regulation 714/2009 on cross-border exchanges, the allocation of decision powers is somewhat modified, introducing a new policy dimension.<sup>18</sup> National regulatory authorities remain in charge of the examination of applications but can jointly decide to delegate their power to the new ACER. The major innovation lies in the fact that ACER is to take a decision, subject to Commission veto powers, in case of sustained national disagreement. ACER thus constitutes an additional forum to settle dispute among national regulators on exemptions in the common interest of the European Union. Within ACER, decisions on exemptions will be effectively taken by the Board of Regulator. However, as with the former Regulation 1228/2003, Member States may provide for the national regulators or ACER to submit, for formal decision, to the relevant body in the Member States its opinion on the application. The final decision can thus be retained by national governments. When the NRAs or ACER reach a positive decision, the European Commission may request them to amend or withdraw it and the notifying entities are required to comply. In the case where a Member State would have provided for ACER or the NRA to submit their opinion for formal decision to the relevant body in the Member States and that the formal opinion would differ from that of the Commission, a mechanism of dispute resolution is missing. However, it is explicitly stated that the Commission may adopt guidelines under the regulatory procedure on the procedure for decision-making on exemption. The Commission is still not granted the power to overrule Member States and NRAs in case they cannot agree, even after ACER mediation. This might amount to a marginal loss of power for the Commission even though the allocation of decision powers on this issue does not seem clearly settled.

Overall, ACER will not dispose of any true decision or veto powers on the action of TSOs and NRAs. ACER is rather intended to create an institutionalized forum for cooperation on cross-border issues, and will be vested only with a limited degree of discretionary power which will essentially limit its action to 'sunshine' regulation (Henry, 1997; Henry et al., 2001). ACER may however gain significant influence (as distinct from formal powers), if the Commission generally complies with its opinions, which resorts to a sort of 'soft law' approach. Far from a regulatory revolution, ACER will thus in essence continue the current tasks of ERGEG, albeit with a formal basis in the European Directives and Regulations.

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<sup>18</sup> For a complete analysis of the regulatory and legal challenges raised by merchant transmission investment in the electricity sector, see Hauteclocque and Rious (2009).

### **2.3 - Why Are the Powers of ACER Limited - Legal Constraints or Vested Interests?**

In EU institutional law, these limitations can be analyzed on the basis of the so-called *Meroni*<sup>19</sup> doctrine which postulates that an institution like the Commission cannot delegate to an agency powers it itself does not possess. The powers delegated can be neither greater nor different than those granted in the first place by primary or secondary EC law. Delegation thus cannot lead to the creation of new powers since this would upset the so-called institutional balance. Only strictly defined executive powers can be delegated, but not political or decision making powers. This implies that the delegating entity must conserve the ultimate decision power and strictly monitor implementation by the agency. The problem then becomes to differentiate between technical and truly political powers. The doctrine last postulates that a decision of such an agency can only be case-specific and will not have a more general value on which firms could rely in other contexts.<sup>20</sup> From a legal point of view, the current powers of ACER *a priori* reflect a strict application of the *Meroni* doctrine, as interpreted above. Its powers to define the terms and conditions for access and operational security of cross-border infrastructure are inherently technical and case specific and its decision powers on exemptions are subject to approval by the Commission and Member States themselves. A breach of the institutional balance could indeed probably be invoked only when ACER is not politically and legally accountable to the same extent as the delegating entity (Lavrijssen and Hancher, 2008).

However, the self-interest of the different actors involved seems to better explain the limitations of ACER. Drawing on the recommendations of the regulatory networks themselves, the Commission considered three possible options to strengthen regulatory convergence: to expand its own monitoring powers vis-à-vis the national authorities, to create an independent European Regulatory Agency and lastly, to strengthen the role and powers of the existing European regulatory networks. The NRAs and the Member States took a sceptical stance on the first two options, mainly because they would lose some of their powers to the Commission and/or to an EU independent agency. Similarly, Member States opposed strengthening of NRAs' decision powers and independence. However, there was guarded support among the national authorities themselves for the further development of the role and powers of European regulatory networks, in the form of a sort of 'European network plus' which would give them more independence and a way to share responsibility.

### **2.4 - Conclusion**

The dividing lines between the competences of the Commission and ACER on the one hand, and between ACER and the NRAs on the other hand, are likely to evolve following continuous interactions. Establishing and then addressing the problems raised by the interactions with the ENTSOs, the NRAs and the Commission will indeed constitute one of the main challenges for the new ACER. As concerns the relationships with NRAs, procedures for joint cooperation need to be defined, in particular in respect of its monitoring duties (Community and national network development plans, implementation of network codes), when ACER is to take a final decision, or for settling problems regarding the exchange of confidential information. Furthermore, concrete monitoring of the harmonized application of European law by NRAs is not an easy issue and the procedures for the consultation of relevant stakeholders by ACER (and the ENTSOs for that matter) will also have to be clarified.

Even though the regulatory gaps on cross-border issues should be incrementally reduced thanks to more harmonization and cooperation at the EU level, it would be wrong to believe that a definitive shift towards centralised powers for the adoption of binding technical decisions and a general

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<sup>19</sup> Case 9/56, *Meroni & Co Industrie Metallurgiche SpA v High Authority of the European Coal and Steel Community*, [1958] ECR 11.

<sup>20</sup> For a complete analysis of the *Meroni* doctrine and subsequent cases, see Craig (2006), Geradin (2004/2005), Lenaerts and Verhoeven (2002) and Griller and Orator (2007).

strengthening of regulatory convergence has occurred with the creation of ACER. Economic regulation will to a large extent remain a national competence, albeit that the NRAs should respect the European interest when regulating on matters such as tariffs or access conditions. European *ex ante* regulation remains weak and the process leading to creation of ACER reflected the underlying problem: until now there has been no legal basis for the Commission to act on a number of cross-border issues, and no consensus among the various regulatory stakeholders on how to resolve such matters. As a result, the Commission does not have any concrete power or indeed experience of regulation, for instance on interconnection or generation licensing, and hence has to rely on TSOs and NRAs. The formalization of ERGEG within ACER also results from this need for the Commission to gather and consolidate expertise. Importantly, the Commission retains full competence for the exercise of competition related matters, as we will see in the next section.

### 3. Ex Post: A Quasi Ex Ante Regulatory Role for Antitrust in the EU Energy Markets – From Antitrust Law to Antitrust Policy?

Given that the results of *ex ante* regulation have appeared weak and ineffective, the Commission announced it would use its antitrust powers with more vigour in the coming years. The will to intensify the use of the antitrust laws was demonstrated by the decision to mount the Sector Inquiry (2007) and has been confirmed on several occasions by officials of the Commission (e.g. Monti, 2003). As a general rule, antitrust rules apply to all aspects of the energy sector, as confirmed by the European Court of Justice in *Costa/Enel* as long ago as 1964.<sup>21</sup> Having their base in the EC Treaty, the fact that sector-specific rules exist does not limit their application. With the *Deutsche Telekom* case<sup>22</sup> in 2003, the Commission indeed confirmed that the EC antitrust laws had to be enforced when a previous decision of a national regulator still left room for abuses of dominance, hence raising fears of jurisdictional confusion and loss of legal certainty for market players.<sup>23</sup>

The intensified use of the rules on cartel and most importantly, abuse of dominance (and in another field, state aid rule) is an important change in the dynamics of European regulatory practice. Since the beginning of the liberalization process, EC antitrust laws have been intended to be used to support the efforts of the sector-specific legislation (Cameron, 2005). As many features of market structures and conduct are beyond the scope of liberalization Directives, the EC antitrust laws are indeed rightly being used to support the transition. However, the recent developments in the practice of the European Commission, in particular the development of the commitment procedure<sup>24</sup> coupled with an increased willingness to impose sanction, show that using the antitrust laws as a tool to build markets raises several problems in the European institutional context.

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<sup>21</sup> Case 6/64 *Costa v Enel*, [1964] ECR 585.

<sup>22</sup> Case COMP/C-1/37.451, 37.578, 37.579, *Deutsche Telekom AG*, O.J. 14.10.2003, L 263/9. The Judgment has been confirmed on appeal by the Court of First Instance (Case T-271/03 *Deutsche Telekom AG v. Commission of the European Communities*, [2008] ECR II-00477).

<sup>23</sup> The *Deutsche Telekom* case concerned the prices charged by Deutsche Telekom to competitors for accessing the local loop. As these prices exceeded those charged to Deutsche Telekom subscribers on the retail market, the Commission considered that the Deutsche Telekom pricing strategy could be analysed as a margin squeeze. The German incumbent argued that its prices to competitors could not be in breach of Art 82 EC due to the previous acceptance by the German regulator. The Commission however dismissed this argument and considered that the responsibility of Deutsche Telekom was engaged in view of the superiority of Art 82 EC over secondary EC law in the hierarchy of community rules. For a complete analysis of the issues raised by the *Deutsche Telekom* case, see Monti (2008).

<sup>24</sup> Art. 9 of Regulation 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in article 81 and 82 of the treaty, O.J. 4.1.2003, L 1/1.

### 3.1- Enforcing the Antitrust Laws the Regulatory Way in the EU Energy Markets

The use of the antitrust laws in the liberalization process in most countries is spearheaded by two main instruments: the application of pure, behavioural antitrust rules (Art 82 EC included) and the imposition of *quasi*-regulatory, structural measures, such as forced ownership unbundling, splitting up entities, forced divestitures or forced auctions (the so called VPPs auctions and gas release programs), which often involve long-term monitoring and thus involvement by the antitrust authorities. As the use of the latter type of remedies is becoming more prominent, especially at the Community level, it does not seem illegitimate to argue that the use of the antitrust laws is increasingly going beyond the *ex post* control of market conduct.

The role of the Commission in the promotion of competition in the liberalized energy markets has indeed evolved over time. Increasingly, the Commission is resorting to *quasi*-regulatory measures to foster competition under the antitrust interventions. Unilateral commitments by the parties involved have also, since 1996, become part of the tools used by the Commission to restructure the market and promote competition. The commitment procedure gives the power to the Commission to accept and make legally binding commitments offered by defendants in the course of a proceeding when it judges that they sufficiently address the underlying competition problem. This procedure has been created in order to accentuate procedural economy and speed. Confirmation and approval of that strategy in the context of merger review was given by the Court of First Instance (thereafter CFI) in the *EDP/Commission*<sup>25</sup> case. Further examples can be found in the *EDF/EnBW*<sup>26</sup> and *GDF/SUEZ*<sup>27</sup> merger cases. Commitments should in theory, be suitable, necessary and proportional to the underlying competition law problem to be lawful.

The Commission also started in 2008 to accept commitments of divestiture in the context of Art 82 EC cases. This happened recently in the German market where first E.ON<sup>28</sup> and then RWE<sup>29</sup> accepted to divest their transmission networks to avoid further antitrust scrutiny whereas the German government was still strongly opposing ownership unbundling during the discussions around the enactment of the Third Package.<sup>30</sup> We note that it is the first time that monopolization cases result in the divestiture of the essential facility considered,<sup>31</sup> thereby demonstrating both the willingness of the Commission to address the shortcomings of the sector-specific legislation through antitrust and the ability of the commitment procedure to create rapid changes in the market structure. Even though the Commission may be gradually replacing unilateral commitments by the parties involved and binding obligations by more formal decisions, the use of the commitment procedure continues apace. The commitment procedure thus allows the Commission to bargain liberalization outcomes directly with the incumbent, without going through the interface of NRAs and Member States.<sup>32</sup>

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<sup>25</sup> Case T-87/05 *EDP - Energias de Portugal, SA v. Commission*, [2005] ECR II-03745.

<sup>26</sup> Case M.1853 *EDF/EnBW*, IP/01/175 of 7.2.2001.

<sup>27</sup> Case M.4180 *GDF/Suez*, O.J. 29.3.2007, L 88/47.

<sup>28</sup> Case COMP 39.388 *E.ON*, O.J. 13.2.2009, C36/8.

<sup>29</sup> Case COMP 39.402 *RWE*, O.J. 5.12.2008, C 310/23; IP/09/410 of 18.3.2009.

<sup>30</sup> For a complete analysis of these cases and the fulfillment of the necessity, suitability and proportionality tests, see Rosenberg (2009).

<sup>31</sup> We note here that divestiture of essential facilities had previously been imposed in energy merger proceedings, e.g. in *Dong/Elsam/Energi2* (Case M.3868, IP/06/313 of 14.3.2006), *E.ON/MOL* (Case M.3696, O.J. 16.9.2006, L 253/20; IP/05/1658 of 21.12.2005) and *GDF/Suez* (Case M.4180, O.J. 29.3.2007, L 88/47).

<sup>32</sup> On the importance for the Commission to get direct access to firms during the liberalization of network industries, see Salerno (2008).

### 3.2 – Manufacturing the EU Energy Markets through EC Antitrust Policy – A Sceptical Viewpoint

Even if the Commission is using its powers under antitrust policy to impose *quasi*-regulatory measures, several arguments may be raised to discourage this approach. They mainly revolve around (i) their ability to deliver efficient decisions given legal and judicial constraints and (ii) the lack of predictability of antitrust proceedings and the related impact on the necessary clarification of rules.

Questioning the ability of competition authorities to enforce efficient decisions from an economic point of view is legitimate. Confronted with novel types of anti-competitive conduct, some of the main difficulties of antitrust authorities indeed arise from the fact that the instrument used to bring about more competition is a law which may only issue prohibitions based on economic concepts, such as the ‘relevant market’ or ‘market power’, and whose application is constrained by judicial review. These economic concepts became embodied in legal rules and must be applied in completely new market settings, and antitrust authorities must tackle anti-competitive practices without always being able to firmly rely on past case law, an intimate knowledge of the market or even definite insights from economic theory.

The problem raised by the definition of the relevant market is only example. The Commission relies heavily on the definition of a relevant market when assessing the abuse of a dominant position. The definition of the relevant geographic market is complicated by the fact that these markets may be rapidly evolving in the new liberalized context, for instance because of the development of regional exchanges and market coupling initiatives in electricity or a structural reduction in long-term reservations of gas import capacity. The problem is even more acute for the definition of the relevant product market. The centrality of this definition criterion causes several problems for antitrust authorities, for instance, in the generation market where market power might be exercised by non-dominant pivotal suppliers or by the dominant incumbent through portfolio effects.<sup>33</sup> In the case of abuse by a generator with a market share falling below the threshold of dominance under Art 82 EC (in general 40%), EC antitrust law can only be applied exceptionally in the case of coordinated behaviour leading to *collective* abuse of dominance. Although this could probably be one way forward for antitrust on this issue, the alleged occurrence must be backed by solid evidence before the Courts.

The case of the abuse of dominance in generation markets is a good example of the limitations of economic theory itself for antitrust purposes. If there is a general consensus on the fact that market structures should not be too concentrated (e.g. Green and Newbery, 1997; Newbery et al., 2003), economic analysis gives few useful insights for the application of Art 82 EC in individual cases, as the different strategies used to exercise market power are complex and even “*the researcher rarely knows the strategic variables that firms use to influence market prices or often even the details of how market prices are set*” (McRae and Wolak, 2009). Tracking abuse of market power in the generation market requires highly assumption-specific oligopoly modelling yielding results which are too uncertain to firmly ground policy actions (Bonasina et al., 2007). Smeers (2009) similarly argues that the insights derived from these models on how market power is (or will be) exercised are too approximate to order contract or asset divestiture and might even be counterproductive in terms of efficiency compared to other possible solutions such as promoting single market integration. From a practical point of view, it will indeed be difficult for antitrust authorities to differentiate between the exercise of market power and legitimate scarcity rents (Fraser, 2003). It is also likely that the standard of proof used in court would in any way be too high to use these sorts of reasoning.

Overall, the main problem primarily lies in the speculative nature of economic analysis which might not provide straightforward answers to novel questions. Economic analysis suggests that antitrust enforcement is complex and requires a careful consideration of the market context in which the practices examined occur. A strong willingness to use the antitrust laws to fix the shortcomings of

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<sup>33</sup> For an insightful discussion of the different problems raised by the definition of the relevant market in generation, see Perrot-Voisard and Zachmann (2009).

liberalization might thus lead the Commission and NCAs to impose remedies whose real impact on market are questionable. This is for instance the case of VPPs.

From an economic point of view, the main problem with VPPs lies in our limited understanding of the different patterns of entry in generation. From that perspective, the frequent imposition of VPPs (or gas release) is, it is submitted, a source of concern.<sup>34</sup> VPPs are primarily intended to remedy horizontal concentration at the generation level and increase liquidity in the wholesale market. They force dominant firms to make capacity options available for a pre-determined time horizon, which amounts to a virtual divestiture of capacity. As such, VPPs are a way to tackle concentrated market structures in merger and antitrust proceedings when physical asset divestiture is not feasible. VPPs are thus hybrid remedies, between structural and behavioural, which should facilitate entry by cancelling the need to invest in generation. In the Commission's view, VPPs are part of a two-stage strategy where a first wave of entry in retail must create new outlets which will attract entry in production by independent power producers or at least enable resellers to build a sufficiently stable customer base to subsequently integrate backward. As with any long-term supply contract, VPPs might also have mitigation effects on abuse of market power by dominant firms in the spot market but there are few studies attempting to quantify these effects on firms' strategic bidding and equilibrium prices (Boisseleau and Giesbertz, 2006).

There is to date no convincing evidence of positive effects of VPPs on competition. This can be explained by the fact that the efficiency-enhancing effects of VPPs will depend on many factors such as auction design,<sup>35</sup> contract durations or the investment climate, which have not been systemically analyzed, neither theoretically nor empirically (Boisseleau and Giesbertz, 2006). The main effect of VPPs might well be to deter investment in new capacity, which goes counter to the objective of long-term generation adequacy. In balancing the contradictory incentives for entry in retail and production, the length of the VPPs is thus important and implementing VPPs for periods longer than the period of decision and construction of a new power station does not seem necessary (Léveque, 2008). We can thus seriously doubt that the suitability, necessity and proportionality tests defined by Regulation 1/2003 are met in the case of VPPs. In addition, the monitoring of remedies over many years is not costless. If long-term VPPs or gas releases are imposed, or if antitrust authorities must monitor portfolios of contracts over a long period of time, antitrust authorities would be intricately involved in the day-to-day monitoring of deregulated energy industries, taking up a *quasi-ex ante* regulatory role for which they might not be prepared. Finally, the question is raised if antitrust authorities have the necessary resources and time to invest into the monitoring of *quasi*-regulatory antitrust remedy. One could argue that antitrust authorities could work together with sector regulators, who would manage all technical aspects. This is now possible under the Third Package. This in turn, however, raises questions about the exchange of sensitive information between antitrust authorities and sector-specific regulators.

The problem of assessing the economic efficiency of the decision, in particular the remedies imposed, is even more complicated given that short and long-term efficiency criteria conflict, e.g. entry and investment, or when efficiency criteria must be weighted with non-economic goals, a likely occurrence in both cases in liberalized energy markets (Hauteclouque and Glachant, 2009). National and European antitrust authorities are inevitably required to 'balance' competition maximization with other objectives of energy market regulation, such as the impact of energy market liberalization on the environment, the need to ensure security of supply, the need to guarantee the public service obligations and the certainty that reasonable price levels will be maintained in the market. In these cases, quantification of efficiencies and the process of balancing these efficiencies and anti-

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<sup>34</sup> VPPs HAVE FOR INSTANCE BEEN IMPLEMENTED AS REMEDY IN *EDF/ENBW, SYNERGEN* (REPORT ON COMPETITION POLICY 2002, IP/02/792 OF 31.5.2002) AND *DIRECT ENERGY* (CONSEIL DE LA CONCURRENCE, DECISION N°07-MC-04 OF 28.6.2007 AND DECISION N°07-D-43 OF 10.12.2007).

<sup>35</sup> In most cases, VPPs define base and peak load rights with different durations.

competitive effects will be even more difficult. Generally, if the competition analysis of business conduct necessitates taking into account non-economic variables or requires solving trade-offs for which economic analysis is ill-equipped or ambiguous, the economic accuracy of decisions becomes uncertain, and so does the eventual outcome of judicial review.

In view of this, it is submitted that if a market building exercise necessitates a fairly high level of discretion which antitrust authorities do not usually enjoy due to procedural constraints and judicial control, it is not obvious whether granting more discretion would necessarily be welfare improving. In this regard, the so-called ‘enhanced economic’ approach and the generalization of the commitment procedure are sources of concern. The modernization of EC antitrust enforcement, largely unrelated to the liberalisation of network industries, indeed aimed at implementing an ‘enhanced economic’ approach based on long-term consumer welfare. This meant gradually shifting to a more ‘effect-based’ approach where the real economic effects of competitive behaviours are more important than formal legal categories. In the EU, this is expressed by the regular statements of the Commission on the fact that it will take a ‘case by case’ approach in energy cases. Applying a sort of *rule of reason* is already a challenge for antitrust authorities in most sectors, but applying it in newly liberalized energy markets where the rate of technical change is too slow to allow a rapid development of competition, as in the telecommunication sector, could soon appear intractable in practice. In any case it may well undermine the predictability of antitrust enforcement. Overall, the already uncertain gains in terms of efficiency should not be offset by the welfare loss arising from the consequences of legal uncertainty (Hauteclocque, 2009).

Another argument against the use of *quasi*-regulatory interventions by the Commission under the antitrust laws is indeed the lack of predictability of antitrust enforcement. If restructuring is increasingly completed through *ex post* interventions, based on individual cases, and sometimes leading to semi-structural measures, it creates an unpredictable regulatory framework for other players in the market. Legal certainty and more generally the clarification of rules is a particularly important goal of regulation in newly liberalized markets as it facilitates both the entry of new competitors who already suffer from asymmetries of information and investment in some high fixed-cost technologies necessary for long-term security of supply. Legal certainty thus has a positive impact both on short and long-term efficiency criteria. Lastly, the deterrence potential of the antitrust laws is largely associated with the predictability of enforcement, and this predictability may itself be correlated with its simplicity.

The development of commitment decisions under Art 9 of Regulation 1/2003 is in this regard unlikely to effectively contribute to the clarification of rules as the Commission does not have an obligation to fully justify its competition analysis under this procedure. As put by Schweitzer (2008): “*The Commission may be biased in favor of administrative flexibility and underestimate the value of binding precedent and the evolution of legal doctrine.*” This is arguably even truer in newly-opened markets. The recent *Alrosa* judgment,<sup>36</sup> if upheld on appeal, may however limit the use of Art 9 commitments by imposing an obligation onto the Commission to clearly formulate the competition problem, justify the proportionality of commitments with the alleged infringement and respect the procedural rights of defendants (and third parties with an interest in the outcome of the proceeding). This first ruling by the CFI has already had consequences as the Commission in *Distrigaz*, following *Alrosa*, made an effort to substantiate the fulfilment of the proportionality criterion (Schweitzer, 2008; DG Comp, 2009). However, in view of the opinion of the Advocate General Kokott (September 2009) who rather surprisingly supported the position of the Commission, the outcome of the appeal before the European Court of Justice will be eagerly awaited.

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<sup>36</sup> Case T-170/06, *Alrosa v. Commission*, [2007] ECR II-0260. In this case, De Beers (no 1 buyer and trader of diamonds worldwide) unilaterally committed to stop business relationships with the 2<sup>nd</sup> world producer, Alrosa, to avoid being convicted for an abuse of a dominant position. Alrosa subsequently appealed before the Court of First Instance judging that this decision was disproportionate and that his right to be heard was not respected.

This is an important judgment also because the use of the commitment procedure raises the problem of the political legitimacy of the Commission in negotiating remedies such as forced divestiture, elsewhere rejected by Member States. In a context of continued opposition at the Member State level, reliance on a case-by-case approach and negotiating commitments has obvious advantages for the Commission. Retaining some flexibility for future bargaining with the former incumbents may understandably be seen by the Commission as the only way forward at the present time. Bargaining through antitrust indeed has the advantage to bring large improvements in the competitive structure without waiting for the slow development of EC electricity law and without risking being overturned by Community Courts. It is also a unique occasion for the Commission to get direct access to firms as opposed to mediating its objectives through national regulators. Using Art 9 commitments may also have advantages for the firms themselves which avoid costly fines and court trials, as well as risks of private law suits before national courts. On the other hand, this also comes at an unknown cost insofar as the Commission may use its bargaining power to extract more far reaching commitments than what it could have obtained under an infringement procedure. In addition, the European Commission can and does impose heavy fines,<sup>37</sup> up to 10% of a company's total revenues, a factor which may consequently strengthen the Commission's position during the settlement negotiations.

#### **4. General Conclusion**

This chapter has attempted to analyze the dynamics of regulatory practice currently at work in the EU energy markets. The main conclusion is that the initial institutional architecture (in particular the lack of formal legal basis in the EC Treaty) together with vested interests continue until today to determine the quality and the dynamics of regulatory practice, in particular the legal tools we use to manufacture markets - and how we use them - often no matter whether they are adapted or not to the task at hand. As a result of the relative weakness of *ex ante* regulation, *ex post* regulation through antitrust is increasingly taking the lead, probably shifting the current allocation of regulatory powers away from an optimal balance which remains to be determined.

The Commission is indeed increasingly taking a *quasi-ex ante* regulatory role through antitrust even if it might neither be a suitable nor a legitimate approach. The process of bargaining liberalization outcomes with the former incumbents through antitrust commitment has particularly evidenced its willingness to pursue liberalization despite the opposition of several Member States. The use of the antitrust laws in this case is thus far from being limited to the traditional *ex post* tool kit and has become an on-going process of 'trial-and-error' which hardly clarifies the new rules of the game in the liberalized market context. If manufacturing markets through antitrust has obvious advantages for the Commission, we see that this strategy largely immunizes it from judicial review and hence raises problems of political and indeed legal accountability. From an economic point of view, using antitrust also necessarily leads the Commission to focus on market structure and conduct, rather than on market design. This is a risky choice as our knowledge of competition dynamics in these sectors remains too limited to propose very robust and efficient remedies.

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<sup>37</sup> Highly representative of this was when the European Commission imposed a fine of EUR 38 Mns on E.ON for the breach of a seal in E.ON's premises during an inspection.

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