The "f-o-u-l-s" approach to unbundling in the electricity sector: pitfalls and legal risks of structural regulatory intervention

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Abstract

In order to address shortcomings of the energy market, it is essential to apply both competition law and regulatory-based remedies. Any regulatory intervention is to be proportionate and avoid premature imposition of burdens upon operators.

At present, however, EC Commission is strongly supporting a full ownership unbundling legislation strategy ("f-o-u-l-s") and is keen to promote "fouls" unbundling with the EU Council.

A number of legal issues may, however, arise out of a possible EC Law provision imposing ownership separation of the network grid from other activities of the value chain. In this respect, the possibility of legal challenges to the latter should be considered carefully. At a preliminary review ownership unbundling seems to lack of a strong legal basis.

In terms of identification of possible means to implement transmission network unbundling one may look at the Italian case. Italy is a rare example of a Member State which achieved a major target in the liberalisation process, by actually enacting a law that: implemented a mandatory reduction of the market share of the State owned incumbent (i.e. Enel); and unbundled the vertical integrated monopoly (i.e. Enel), by forcing it to sell the network system.

It is difficult, however, to predict whether the Italian experience may be successfully replicated in other Member States where the monopoly or incumbent is a private company.

1. The electricity transmission system and the internal market

1.1. Introduction

Energy cannot be stored economically once produced. Furthermore, an electricity network is often a natural monopoly that cannot be duplicated in an economic manner and/or in a reasonably short time frame. Electricity may only be sold and acquired through a transmission system (which is an essential facility).

It is self-evident that to create a real European electricity internal market there must be adequate interconnection capacity among Member States. At present, adequate capacity does not exist between many areas and at almost all European borders the interconnectors are congested. Therefore, several separate national energy markets currently exist (with few exceptions) within the European territory.

As a consequence, ownership structure and management of the electricity transmission grid are now at the centre scene of the European energy policy for a sustainable, secure and competitive energy supply.

This paper will, therefore, briefly analyse the reasons for the European debate oriented on a full ownership unbundling legislation strategy ("*f-o-u-l-s*"), the main legal issues coming with any such f-o-u-l-s unbundling and an example of unbundling of the electricity transmission activity as it was implemented in Italy, between 1999 and 2005.

1.2. Transition from monopoly to liberalisation

Prior to the liberalisation, in almost all the Member States electricity and gas were historically supplied by monopolies, which were often owned or controlled by the State and had exclusive rights under the national law. These companies were vertically integrated, as they owned the networks and generation facilities and were involved in the supply phase.

Starting from mid 1990's the two liberalisation Directives (i.e. the first liberalisation Directive 1996/92 and the second liberalisation Directive

2003/54) set an important path towards the creation of a European electricity internal market, by removing legal monopolies. Common rules were then introduced for generation, transmission, distribution and supply of electricity[1].

It is noteworthy that achieving a single European electricity market, necessarily requires a transition phase. Both competition and regulatory based-remedies, therefore, are essential to promote effective competition.

1.3. Inadequacy of competition law to govern alone energy markets with vertical foreclosure

The European liberalisation process introduced competition in the energy market, although former monopolies still retain large market shares, due to their historical strength. The mere removal of a legal monopoly (a level playing field) is not per se sufficient to "dismantle" a long time established structural market concentration and vertical integration[2].

Furthermore, in the energy sectors, market dynamic is characterised of highly volatile spot prices in the day-ahead market, which may occur due to the inelasticity of demand in the wholesale market, the non-storable property of electricity, uncertainty regarding demand that varies by time of year, week and day, available production and transmission capacity, bottlenecks and possible exercise of market power.

As to the existing situation, competition law enforcement can make a significant contribution, but cannot by itself open markets and resolve all the shortcomings of the energy market[3].

Competition law (Article 81 and 82 EC Treaty) is largely designed to prevent collusive and/or abusive conducts, which take place on the markets. In this respect, competition law serves as an *ex-post* instrument aimed at preventing anti-competitive restraints of competition (e.g. foreclosure or

[1] On this paragraph see C. W. Jones, EU Energy Law, Volume I, The Internal Energy Market, Leuven, Belgium, 2006, pag. 5 ff.
[2]. On this paragraph see P. Ranci, La promozione della concorrenza nel campo dell'energia: profili economici, Convegno Cesifin "Il nuovo diritto dell'energia tra regolazione e concorrenza", Firenze, 2006, pag. 2 ff.
[3] See European Commission, DG Competition Energy Sector Enquiry, SEC(2006)1724, www.europa.eu., pag 12 ff.

exploitative effects).

In itself, however, competition law is unequipped to modify existing structural models present in the market (save for the case where further concentration may be prevented by means of merger control provisions).

This explains why, in the energy sector competition law remedy cannot intervene so as to reduce incumbents market power. It could, possibly, govern how market power is exercised (e.g. through the application of Article 82 EC Treaty on abuse of dominant position).

Yet, antitrust enforcement is strictly linked to a case by case assessment which, also for practical and timing reasons risks not affording the immediate and concrete protection which new entrants need to be assured, if incumbents position is to be eroded.

The experience observed in the utilities sectors confirms that incumbent still maintain their supra-dominant positions years after market liberalisation has been introduced.

In connection hereof, regulation is the exceptional but necessary complement to the energy market liberalisation.

1.4. The need for regulatory intervention

By definition, any form of pro-competitive regulation restricts freedom of enterprise. Scope and modalities of regulatory interventions, therefore, require proper analysis and assessment of potential consequences.

In particular, *ex-ante* regulation is required to ensure that undertakings cannot use their market power to restrict or distort competition on the relevant market. A regulator may then need to ensure that resources are available on equal basis to competitors, thus eliminating a barrier to entry into the market.

Regulation promotes competition with a view to a future assessment of the market and with respect to medium and long time framework. A regulatory framework needs stability, as investments in transmission capacity incur in huge costs and require a long term strategy that calls for long term predictability.

As to "how" regulation achieves its tasks, regulatory intervention is to be appropriate and proportionate to comply with EC Law principle of proportionality.

In this respect, a thorough analysis of possible "competition models" and clear economic assessment of any new proposed regulation for the energy sector would be beneficial to tailor and assess better regulatory intervention.

Regulatory tasks may be accomplished through various degrees of intervention: (i) "soft", such as regulating to ensure access to market information or threat of further regulation; (ii)"hard", such as regulating over the conduct of market operators (e.g. in Italy, no one may generate or import more than 50% of the overall amount of electricity generated or imported); or (iii) "structural", such as regulating the form of organisation of the operator (e.g. unbundling)[4].

Furthermore, regulation should refer to previous liberalisation experiences in similar network industry sectors. The telecommunications, for example, started a liberalisation earlier in time. There is no need to lament because "the grass of the neighbour's garden is always greener on their side", however, the telecommunication sector currently presents some "cutting edge" rules which may provide a secure path for the energy sector regulators action.

With respect to telecommunication EC Commission stated that "premature imposition of *ex-ante* regulation may unduly influence the competitive conditions taking shape within a new emerging market" (see EC Commission guidelines 2002/C 165/03).

In a recent speech, EU Commissioner for Information Society and Media, Viviane Reding gave a clear view of the prospected horizon of regulatory by stating that "the goal is to have sustained effective competition without on-going regulatory intervention" (see Speech/05/515).

Finally, the relationship between regulation and competition law remedies is quite debated, although a combined action is necessary. Ultimately, *ex-ante* regulation relies on competition law principles and methodologies for market analysis, assessment of incentives and competition policies.

[4] See B. Barton, et al., Regulating Energy and Natural Resources, Oxford, United Kingdom, 2006, pag. 11 ff.; P. D. Cameron, Competition in Energy Markets, Oxford, United Kingdom, 2007, pag. 95 ff.

1.5. Balanced approach to regulation

Under a dynamic regulation approach, it is the degree of market power that determines priorities and method of intervention. Balancing different market powers to promote competition, however, maybe a sort of a "juggling act", due to the number of variables which are involved.

The main purpose of forcing companies' conduct is to improve the competitive situation in the market. However, investment incentives may also be influenced, both negatively and positively. The knowledge that companies may have a duty to behave against their will might lead companies not to invest in the first place or to invest less. Other companies may be tempted to "free ride" on the investment made by the dominant company instead of investing themselves[5].

However, access to the network may also lead other firms to increase investment in, for instance, follow-on research and development that would otherwise not be possible or profitable. Enforcement policy towards third party access has to take into account both the effect of having more short-run competition and the possible long-run effects on investment incentives.

As an example, existing infrastructures are to be made available to new entrants under the third party access regime. On the other side, however, if new entrants do not engage in developing new infrastructures, competition (and technology innovation) would be negatively affected as well.

In light of the above, regulation needs to consider whether mandatory behaviour upon energy operator is to apply indistinctly to all market actors or in an asymmetric way to the sole detriment of the incumbent (i.e. different rules for different powers). Whilst any asymmetric form of regulatory could easily be discriminatory, an indistinctly applicable measure may be insufficient to promote competition.

[5] On this paragraph see M. Monti, Antitrust e regolamentazione nell'industria delle comunicazioni elettroniche principi e prospettive, (Speech/04/144) ,http://europa.eu., pag. 1 ff.

2. Unbundling as instrument of regulation

2.1. Purpose of unbundling

As mentioned above, electricity network is often a natural monopoly that cannot be duplicated in an economic manner and/or in a reasonably short time frame.

Therefore, in network industries, such as the energy sector, the liberalisation process generally aims at achieving three main results with respect to the vertically integrated incumbent: (i) ensure a non discriminatory access to the network (i.e. third party access); (ii) separate the networks from the commercial activities of the vertically integrated companies owning them; (iii) promote competition by *ex-ante* regulation.

In a recent speech at the High-Level Workshop on Energy, Competition Commissioner Neelie Kroes summarised how an excessive "vertical foreclosure" may impact on the electricity transmission system: "the network company knows that it should develop the networks and facilitate third party access, but it also knows that this would be bad for its supply business. Vertically integrated companies therefore have no incentive to enable third party access to the network or to integrate national or local energy markets. This conflict of interest has depressed investment in interconnection capacity....threatening both competition and security of supply"[6].

In fact, a network company which is also active in the supply or generation phase may find itself in an objective conflict of interest situation. It may have an interest in benefiting from "cross-subsidies": by ensuring high prices for transmission and distribution (a market where no competition exists), it could reduce margins on their generation and sales activities (a market where competition exists). By doing so it would maintain overall group profitability.

Network users require transparent, reliable and timely information on the availability of the network. In this respect, there is a risk of information asymmetry between the vertically integrated incumbents and their

[6] See N. Kroes, More competition and greater energy security in the Single Union European Market for electricity and gas, (Speech/07/212) , http://europa.eu.

competitors.

For all the above reasons, separating the activity of the transmission system operator from other activities of the value chain is the main subject to debates on remedies for ensuring a truly independent management of the electricity grid.

However, it just takes a quick "glance" into the telecommunications field to find that EU Commissioner for Information Society and Media, Viviane Reding suggests that "functional separation, which is a specific form of separation, could indeed serve to make competition more effective in a service-based competition environment were infrastructure-based competition is not expected to develop in a reasonable period. It is certainly not a panacea. It has to be looked at on a case by case basis. And it would have to be done well, in ways that do not distort competition, neither at home nor in neighbouring markets"[7].

Management unbundling has been implemented in telecommunication sector, by UK BT group. BT created it "Opeanreach Division" on a functional unbundling basis. So far, the experiment is proving to be successful.

2.2. Various models available for "unbundling"

There are different forms and degrees of separation of the transmission activities from energy generation and supply activities which may be implemented:

- *Accounting unbundling*: the vertically integrated company may freely operate its activities within the value chain, although separate accounts for the transmission/distribution company need to be prepared.

- *Management unbundling*: this is additional to the accounting unbundling. It requires that the management of the network business be separate from the management of the remainder businesses of the energy company.

- *Legal unbundling or independent system operator approach* (as provided under EC Directive 2003/54): a separate legal entity is established in which all

[7] See V. Reding, Connecting up the Global Village: a European View on Telecommunications Policy, Speech/06/772), http://europa.eu.

activities of the network system operator are transferred to. A clear and detailed regulation is required to effectively implement this form of unbundling.

- *Ownership unbundling*: the vertically integrated company is mandated to sell its network assets to third parties whom are not active in the generation or sale of energy[8].

2.3. The "*fouls*" unbundling approach

Under a foremost unbundling approach – ownership unbundling- the network company would be obliged to sell the network to a third party, so that a clear cut separation is made between energy generators and suppliers on one side and transmission operators on the other.

As of today, however, a detailed description of "how" full ownership unbundling legislation strategy ("f-o-u-l-s") would actually be implemented is yet to be disclosed by EC Commission.

At present, ownership unbundling appears to be conceived as a "point of no-return" measure.

In its broad terms, "fouls" unbundling would remove incentives for discrimination with respect to network access and network cross subsidies of commercial activities. Network companies would become pure network companies able to operate independently, concentrate better on their core business and thus (should) become more efficient.

On the other hand, "fouls" unbundling approach should deal with the risk that the exclusion of electricity suppliers as shareholders' of the network company could cut-off the network from innovation deriving from an integrated company. In the long run this could put them at an efficiency disadvantage as technological innovations might be introduced later than possible and at a higher cost.

As to the legal regime of the network company eventually owning the network, it could be either a private or public owned company.

[8] On this paragraph see C. W. Jones, EU Energy Law, Volume I, The Internal Energy Market, Leuven, Belgium, 2006, pag. 5 and pag. 69 ff.

3. The EC Commission and EU Council position on "*fouls*" unbundling

3.1. The European Commission energy sector inquiry

On 10 January 2007, the EC Commission presented the results of its inquiry into the European gas and electricity sectors (aimed to assess the competition conditions on the European gas and electricity market) and proposed an integrated energy and climate change package to establish a new Energy Policy for Europe "to boost European Union's energy security and competitiveness and to combat climate change". Subsequently, on 9 March 2007, the Council of Europe adopted a comprehensive Energy Action Plan for the period 2007-2009, based on the above European Commission's proposal.[9]

According to the EC Commission's energy sector inquiry, three major structural reasons lead to a competition which is not "functioning properly" in the electricity and gas markets. All of these malfunctions concern the ownership and management of the grid and are deemed to negatively affect a secure, affordable and sustainable energy supply for European consumers:

- *national energy markets are too highly concentrated and lack liquidity*: according to the inquiry at the wholesale level, gas and electricity markets remain national in scope and highly concentrated (whether in terms of ownership of generation assets or in terms of trade in a given product). This gives scope for exercising market power.

- *there is an absence of cross border competition:* insufficient or unavailable cross-border capacity and different market designs hamper market integration. Insufficient interconnector capacity and a lack of adequate incentives to invest in additional capacity to eliminate long-established bottlenecks.

- *there is insufficient unbundling of network and supply activities*: the current level of unbundling of network and supply interest has negative repercussions on market functioning and on incentives to invest in

[9] See Commission of the European Communities, Communication from the Commission to the European Council and the European Parliament, Brussels 10 January 2007, http://europa.eu.; see also European Commission, DG Competition Energy Sector Enquiry, SEC(2006)1724, www.europa.eu..

networks (thus also constituting an obstacle to new entrants and security of supply).

Currently, the second electricity market liberalisation Directive (i.e. Directive 2003/54/EC) strengthens the non discriminatory rules introduced by the first electricity market Directive with respect to vertically integrated companies conducts and provides for legal unbundling of transmission system operators, according to which "where the transmission system operator is part of a vertically integrated undertaking, it shall be independent at least in terms of its legal form, organisation and decision making from other activities not relating to transmission" (Article 10). A similar provision applies for unbundling of distribution system operator, although with possible exemptions (Article 15).

3.2. The EC Commission "*fouls*" unbundling and EU Council Action Plan

On 9 March 2007, the European Council adopted the "Energy Action Plan 2007-2009" stating that it "agrees on the need for [i] effective separation of supply and production activities from the network operations (unbundling), based on independently run and adequately regulated network operation systems which guarantee equal and open access to transport infrastructures and independence of decision on investment of infrastructures.... [ii] the establishment of an independent mechanism for national regulators to cooperate and take decisions on important cross border issues... [iii] the creation of a new Community mechanism for Transmission System Operators to improve coordination of network operation and grid security".

The Energy Action Plan is based on the European Commission's proposal (of 10 January 2007) for an integrated energy and climate change package to establish a new Energy Policy for Europe.

Many commentators from specialised press noticed that EU Council failed to agree on the EC Commission proposal for ownership unbundling (i.e. sale of network assets), by instead focusing on an independent system operator approach (i.e. a vertically integrated company remains owner of the network assets, but is not responsible for their operation, maintenance and operation).

The wording in the European Council Action Plan (i.e. not a piece of legislation) tends to confirm the above impression, although it does not expressly exclude "ownership unbundling", still leaving room for further discussions and, ultimately, the possible adoption of new European legislation endorsing European Commission's proposal.

In its proposal, the European Commission considers both legal unbundling and ownership unbundling, but expressly suggests that ownership unbundling is the most effective means to promote competition in the energy sector, by ensuring freedom of choice for energy users and encouraging investments in new generation capacity.

4. A preliminary legal analysis of a EU scale "*fouls*" unbundling

4.1. Introduction

As to implementing "fouls" unbundling, several legal issues may arise out of any future EC Law provision imposing ownership separation of the network grid from other activities of the electricity market value chain.

As of today a thorough legal analysis in this respect is yet to be made, although the possibility of legal challenges to any such provision should be carefully considered.

What follows, therefore, is a preliminary review of the matter. No reference is made herein to possible stranded costs recovery regime connected to ownership unbundling or to ownership unbundling remedies imposed under EC competition law merger control.

4.2. The legal basis and EC Treaty constraints

At European level, the lack of a specific Treaty basis for the energy sector (as instead, for example, for agriculture) implies that the principal liberalisation rules are laid down by means of secondary legislation (i.e.

Directives and Regulations)[10].

Generally, reference is made to the EC Treaty provisions on the approximation of laws (i.e. Article 94 and 95 EC Treaty) when adopting a Directive for the energy sector. Yet, General Principles (i.e. Articles 4 and 5) and Final Provisions (i.e. Article 295) of the EC Treaty would most likely apply as a constraint to any "fouls" unbundling.

In fact, any provision imposing a restriction or an obligation on a network company concerning the management or ownership regime of its network asset, directly affects the fundamental legal freedoms of the company owning the network. The higher the degree of unbundling, the lesser the freedom of enterprise and the freedom of choice upon the company owning the network.

It is noteworthy, that very essence of "ownership" of a thing refers to the right of excluding the others from the benefits that this thing provides (*ius excludendi alios).*

Furthermore, protecting freedom of enterprise as a fundamental right fulfils a general interest, which goes beyond the protection of mere individual rights. In fact, the operation of free competition (i.e. not regulated) carries a number of advantages for the community including efficient allocation of resources in the direction preferred by consumers and innovation by investing in research and development. Ultimately, competition may lead to progress and raising of the standard of living.

These considerations are reflected in the general principles of EU Law, as Article 4 of the EC Treaty provides that "the activities of the Member States and the Community shall include....the adoption of an economic policy which is ...conducted in accordance with the principle of an open market economy with free competition".

The different degrees of unbundling imply for different degrees of restrictions on freedom of choice of the network company: legal unbundling restricts freedom of organization whilst ownership unbundling is in fact a form of expropriation or seizure of the network asset.

[10] On this paragraph see E. Bruti Liberati, La regolazione pro-concorrenziale dei servizi pubblici a rete, Milano, Italy, 2006, pag. 83 ff; see also P. D. Cameron, Competition in Energy Markets, Oxford, United Kingdom, 2007, pag. 138 ff.; see also A. Accardo, et al., Commentario al Testo Unico sull'espropriazione per pubblica utilità, Santarcangelo di Romagna, Italy, 2003, pag. 43 ff.

According to Article 295 EC Treaty "this Treaty shall in no way prejudice the rules in Member States governing the system of property ownership".

As a preliminary consideration on Article 295 EC Treaty, the mere fact, therefore, that certain activities are undertaken by a public entity or a private company appears to be not in itself contrary to the EC Treaty. In this respect, the EC Law should not be concerned whether the ownership of an energy network is retained by the State or a private company (save for the applicability of any EC Treaty competition rules).

By referring to this principle, for example, a network company falling under the definition of "body governed by public law" as per Directive 2004/18/EC on public procurement, or having similar nature, might raise reasonable objections to a legislative provision imposing upon it ownership unbundling through privatisation. In fact, many network companies are owned by local authorities (e.g. distribution system operators), which often have a different view on energy related topics from the central Government.

Some commentator raised the question whether ownership unbundling falls within the competence of the EC Treaty. In fact, Article 5(1) EC Treaty provides that "The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to in therein", whilst Article 5(2) provides that "in areas which do no fall within its exclusive competence, the Community shall take action in accordance with the principle of subsidiarity, only and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore by reason of the scale or the effects of the proposed action, be better achieved by the Community".

EC Community does not have an exclusive competence in the energy sector. Therefore -as a preliminary comment- it should be evaluated whether ownership unbundling "can therefore by reason of the scale or the effects of the proposed action, be better achieved by the Community". This assessment is required especially for those Member States whose national energy market (i) does not currently present an incumbent operator with an absolute dominant position or (ii) would not present any such incumbent once the liberalisation directives packaged have been fully implemented.

4.3. The principle of proportionality

Clearly, the liberalisation energy policies adopted in the European Union starting from mid 1990's pursue a general interest, such as introducing competition, whenever possible, promoting an open and decentralised production with network access and remuneration on the basis of market prices, not costs.

However, it is self evident that a thorough legal and economic analysis of the hierarchy of objectives and effects on the energy industries of any provision restricting freedom of choice or freedom of enterprise should be carried out prior to adopt any new legislation[11].

In this respect, case-law of the European Court of Justice may be of some help, as it provides for a mandatory criterion, against which to test the legality of both Member State or EU action: the principle of proportionality.

Proportionality is now well established as a general principle of EC Law. Proportionality involves the evaluation of three factors: (i) suitability of the measure for the attainment of the desired objective; (ii) the necessity of the disputed measure; (iii) the proportionality of the measure to the restrictions which are thereby involved.

The European Court of Justice stated that "the Court has consistently held that the principle of proportionality is one of the fundamental principles of Community Law. By virtue of that principle, the lawfulness or the prohibition of an economic activity is subject to the condition that the prohibitory measures are appropriate and necessary in order to achieve the objectives legitimately pursued by the legislation in question; where there is a choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued" (see C-331/88 *Fisheries and Food*).

An additional remark may also be made: EC Commission attitude towards similar network industry seems to differ greatly. In the telecommunication sector, for example, EC Commission considers management unbundling as a measure potentially excessive. In the energy sector, instead, it considers

[11] On this paragraph see E. Bruti Liberati, La regolazione pro-concorrenziale dei servizi pubblici a rete, Milano, Italy, 2006, pag. 74 ff; see also A. Accardo, et al., Commentario al Testo Unico sull'espropriazione per pubblica utilità, Santarcangelo di Romagna, Italy, 2003, pag. 43 ff.

ownership unbundling as a necessity.

Clearly, based on past case law the European Court of Justice tends not to substitute its judgement for that of a EU or Member State Legislator which makes policy choices, merely because it believes that thing could have been done differently. Still, it enforces the principle of proportionality.

The relative intensity of judicial review by the European Court of Justice is a pretty much live question. In this respect, at least three preliminary considerations might affect any future judicial review on energy sector legislations.

Firstly, two major liberalisation directive packages have been adopted in the last decade. More than a dozen directives now regulate several economic aspects including energy taxation, renewable energy sources, emission trading, security of supply, energy efficiency and cogeneration of heat and power. Secondly, not all the Member States have already adopted these measures. Therefore, the full impact of the new regulation is yet to be achieved. Thirdly, in some Member States a privatisation process has already taken place: the State dismissed its shareholding in the network company, which may now be a fully private law company (maybe even listed on a stock exchange).

The energy sector underwent a lot of changes in the last ten years and is now a highly regulated industry. It is, therefore, important that all the Member States quickly achieve the same level of implementation of EC Law. Differences in the implementation level of EC Law among Member States are likely to impair or slow a successful liberalisation process. A Member State will not be pro-active on these issues, until it is reasonably sure that other Member States are behaving similarly, failing to comply with the liberalisation process requirements.

Achieving full implementation of Directives may require some work also on the side of European Institutions (e.g. infringements procedure) and should be considered as a priority effort over the making of new European Legislation.

4.4. "*Fouls*" unbundling and the European Convention on Human Rights

Protocol 1 to the European Convention on Human Rights (1950) provides for (Article 1) "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties[12].

The link between the EC Treaty and the European Convention on Human Rights is yet to be fully explored by the European Court of Justice. However, the Court expressly stated that "rights of ownership are protected by the Constitutional laws of all the Member States" and "must be viewed in the light of social function of the property. For this reason, rights of this nature are protected by the law subject always to limitations laid down in accordance with the public interest. Within the Community legal order it likewise seems legitimate that these rights should, if necessary, be subject to certain limits justified by the overall objectives pursued by the Community, on condition that the substance of these rights is left untouched" (see C-4/73 *Nold*).

The Court also stated that any restrictions to property rights "should not constitute a disproportionate and intolerable interference with the rights of the owner, such as to impinge upon the very substance of the right of property" (see C-44/79 *Liselotte Hauer*).

It may well be the case that any possible judicial review by the European Court of Justice on ownership unbundling legislative provisions, be "circumspect", due to the policy choices involved in the matter. However, justifying a form of expropriation (such as ownership unbundling) would certainly require a very good underlying reasoning upon EC Commission.

[12] On this paragraph see P. Craig & G. De Burca, EU Law: Text, Cases and Materials, Oxford, United Kingdom, 2006.

4.5. "*Fouls*" unbundling and national laws

Many Constitutional Charts of the Member States protect right of ownership as a fundamental right. A combined "action" of Article 295 EC Treaty and of the national Constitutional Chart provisions would clearly prove to be an obstacle to the adoption of a legislative unbundling provision at European level[13].

In this respect, the European Court of Justice expressly stated that "the court has already stated fundamental rights form an integral part of the general principles of law, the observance of which it ensures. In safeguarding these rights, the Court is bound to draw inspiration from Constitutional traditions common to the Member States, and it cannot therefore uphold measures which are incompatible with fundamental rights recognised and protected by the Constitutions of those States" (see C- 4/73 *Nold*).

5. A case study: the Italian national transmission grid

5.1. The story

Together with the majority of Member States, Italy is still in the process of fully implementing the second liberalisation Directive (i.e. Directive 2003/54/EC). However, Italy is also a rare example of a Member State which achieved a major target in the liberalisation process, by actually enacting a law that:

- implemented a mandatory reduction of the market share of the incumbent (i.e. Enel); and

- unbundled the vertical integrated monopoly (i.e. Enel), by forcing it to sell the network system.

In 1962, Italy nationalised the electricity sector by creating a State owned legal monopoly (covering generation all phases of energy transmission,

[13] On this paragraph see F. Pocar, Diritto dell'unione e delle comunità economiche europee, Milano, Italy, pag. 323 ff.

distribution and supply), whilst in 1993, it transformed it into a private law company wholly owned by the State. In 1999, Italy then implemented the first liberalisation Directive for the electricity sector (i.e. Directive 1996/92/EC).

The Italian liberalisation law of 1999 set a cap to the market share in electricity generation and production: in the Italian market no one may be allowed to produce or import more than 50% of the overall amount of electricity produced or imported in Italy (see Article 8(1) Legislative Decree 79/1999). In this respect, the former legal monopoly - Enel Spa– was then forced to sell 15.000 Mw of its own production capacity, through a competitive tender process (see Article 8(1) Legislative Decree 79/1999).

According to the national law implementing the Directive (i.e. Legislative Decree 79/1999), transmission and despatching activities were reserved to the State.

With respect to the national transmission grid, Italy at first implemented an independent system operator regime by separating ownership and management of the network. Then, it turned to a full ownership separation of the network from Enel.

In fact, in 1999 Italy firstly obliged Enel to separate the ownership of the electricity national transmission grid (which Enel transferred to a wholly owned subsidiary retained by Enel) from the management thereof, which was then attributed to a different State owned company (see Article 3(4) Legislative Decree 79/1999).

Keeping a separate ownership and management of the national transmission grid, however, proved to be unsuccessful with respect to an efficient management and maintenance of the network. Investments in new capacity were considered insufficient.

As a consequence, in 2003 a new legislation provided for reunification of ownership and management of the national transmission network (see Law Decree 239/2003). Eventually, they were reunified under a sole company – Terna Spa- wholly owned by Enel, which then Enel privatised in 2004/2005 (see Decree of the Prime Minister 11 May 2004).

Terna Spa currently owns and manages the Italian electricity transmission

network. Terna Spa is currently a listed company.

Furthermore, Italian law provides that no operator being active in the energy sector may hold more than 20% of the shareholding of any transmission system operator (see Article 1-ter(4), Law Decree 239/2003).

Currently, Enel owns approximately a 5% shareholding of Terna Spa, whilst 29.9% is owned by a company participated by the Italian State, named Cassa Depositi e Prestiti Spa. The remainder participation is owned by several investors.

The by-laws of Terna provides for some special rights applying in favour of the Italian State, including veto rights on transfer of Terna's shares and major transactions involving Terna. The by-laws also provide for a statutory limitation to 5% of any participation in Terna and voting rights.

5.2. Lessons to be drawn from the Italian experience

The Italian experience has been some how complicated and lengthy. However, few considerations may be drawn from it, which are summarised here below.

5.2.1. Replicating the Italian experience

Italy materially reduced the market share of Enel (the former legal monopoly) and separated the ownership of transmission system network from the other activities still carried out by Enel (the incumbent).

Italy could actually design and implement the whole "unbundling transaction", as described above, due to the State control over Enel (i.e. the former monopoly).

At the time Italy enacted the liberalisation law Enel was a vertically integrated company, wholly owned by the State.

Any attempt to replicate the "Italian transaction" within a Member State where the vertical integrated company is a private company (or participated by private shareholders), would clearly be very difficult. A series of legal issues concerning the protection of the right of ownership would

immediately arise.

5.2.2. Public nature of the transmission system operator

The Italian Competition Authority suggests that the transmission system operator should be a State owned entity. In fact, the transmission system operator should have as main mission the efficient and safe management, maintenance and increase of the grid, which require large economic and long term investments. According to this theory, a private undertaking may be influenced by short time framework investment decisions, which would affect the safety of the network[14].

Based on the considerations above on Article 295 EC Treaty, it is difficult to conceive how any such result may be achieved through a European legislation provisions, rather than on a case by case decision of Member States.

In fact, the public or private nature of property is per se irrelevant for EC Law (see Article 295 EC Treaty).

5.2.3. Conflict of interests

When carrying out its competition law merger control over the privatisation process involving Terna (the "TSO"), the Italian Antitrust Authority detected a peculiar conflict of interest situation[15].

In particular, the Italian Competition Authority stated that being simultaneously a shareholder of the incumbent and a shareholder of the transmission system operator creates a conflict of interest situation, which may be of detriment to the energy sector.

It is noteworthy that in the case scrutinised by the Italian Competition Authority the above conflict of interest situation was detected upon a private company in which the Italian State has a majority of the shareholding.

[14] See Italian Competition Authority, provision no. AS278 of 15 April 2004, www.agcm.it.
[15] Italian Competition Authority, provision no. AS278 of 15 April 2004, www.agcm.it.

In other words, the Italian Competition Authority detected a conflict of interest situation irrespective of the nature of the "dual" shareholder being public.

The Authority then imposed a dismissal remedy to solve the conflict of interest, ordering the sale of any shareholding held in the incumbent as a condition to purchase a shareholding in the transmission system operator.

5.2.4. Principle of proportionality

The Italian experience shows that ownership unbundling may be reached, even in the absence of a mandatory provision imposing a straightforward and indistinctly applicable ownership unbundling.

In this respect, any future European Directive imposing ownership unbundling could be unnecessary and disproportionate for Italy and other Member State falling in similar situations.

5.2.5. Separating network management and ownership

Even if no general ownership unbundling provisions were provided for under the law, Italy ensured a substantial independence of the transmission system operator and third party access. However, in Italy separation of ownership from management of the transmission system proved to be unsuccessful, as it was abandoned in 2005.

6. Conclusion

The "fouls" approach to unbundling in the energy sector raises significant legal concerns, which, to the very least, suggest an extremely cautious and thorough examination thereof, by all competent constituencies.

Having in mind that, the goal to be achieved is that of truly efficient and modern energy networks.

These concerns relate to fundamental issues of property and constitutional law, as we are accustomed to know them under our legislative frameworks.

They also deal with welfare and efficiency targets which shall be necessarily viewed in the medium- long term, paying due attention to the need of protecting investments and innovations, as well as preventing free riding.

In view of the above, some scepticism may be expressed as to the possibility that "fouls" unbundling may represent the best solution for the European energy market.

The Italian experience shows that its implementation requires a number of special circumstances which are no longer present in a number of European countries.

The example of the telecom industry seems to confirm that less invasive and more proportionate regulatory models are indeed available.

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