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**'OPT-OUT' CLAUSES FOR EU ENERGY ISLANDS IN THE
THIRD LIBERALIZATION PACKAGE: STRIKING BALANCES?**

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Abstract

The Third Package allows EU energy islands to be exempted from most if not all of the *acquis communautaire* in energy, both on market design and the regulatory framework. However, even if a supply monopoly is the most efficient market structure in a given situation, this monopoly in theory still needs to be regulated. Therefore, has the EU struck the right balance in this area?

This paper first disentangles the complex system of derogations open to EU energy islands. It focuses *inter alia* on the unbundling regime and what it means to have an express derogation from Article 9 (ownership unbundling). The second part looks at the opening of the Cyprus gas market and the concrete effects of the derogation system on the powers of the Cyprus Energy Regulatory Authority, the national regulator, in monitoring this market. Cyprus is considered to be both an isolated (Article 49(1) of Directive 2009/73) and an emergent (Article 49(2) of Directive 2009/73) market under the new legislation and, as such, is an interesting case.

The paper argues that, beyond the complexity of the derogation regime applying to energy islands, the scope of possible derogations from the Third Energy Package seems to be exceedingly wide. The Package allows for full vertical reintegration and a loss in regulatory independence and powers which does not seem justified. The Third Energy Package's derogation system for energy islands should, strictly, be used to ensure the viability and attractiveness of the investments and, in particular, should not reduce the role, power and responsibilities of the national regulatory authority, especially on the issues of security of supply, transparency and consumer protection through the proper regulation of tariffs, bearing in mind that the market will be monopolistic.

Keywords

Energy islands, market liberalization, derogations, exemptions, Cyprus.

1. Introduction

At the time of the Cypriot presidency of the Council, it is interesting to take a closer look at the specific challenges of EU energy islands, which generally enjoy the status of ‘isolated’¹ and/or ‘emergent’² systems in EU legislation. On 4 February 2011, the European Council reasserted that ‘no EU Member State should remain isolated from the European gas and electricity networks after 2015 or see its energy security jeopardized by lack of the appropriate connections’.³ Following up on the conclusions of the Council, the European Commission restated the need to connect energy islands, in its staff working paper on *Energy Infrastructure Investment Needs and Financing Requirements* of 7 June 2011.⁴

In the EU internal market legislation, the peculiar situation of energy islands was taken into account from the very first days of liberalization. Even the first electricity Directive in 1996 contained a provision for so-called small isolated systems.⁵ Recently, the objective of paying special attention to the most isolated countries and regions in the Union’s energy market, and integrating these, was restated in the third set of liberalization Directives.⁶ For gas, the connection of isolated systems is said to have a wider security of supply dimension.⁷ However, there is much more on energy islands in the Third Energy Package than provisions, which are aimed at connecting them to the EU grid, whether this relates to completing the internal energy market or ensuring security of supply. Energy islands do indeed raise a number of specific issues and challenges, depending on their situations, and this is reflected in a complex network of inter-linked (express) derogations and possible exemptions, allowing them to adapt the EU requirements on energy market design to their own needs.

Of course the flexible system of differentiation through ‘opt-out’ clauses introduced in the successive liberalization Directives serves not only the needs of energy islands. In practice, three, often linked, objectives have been particularly visible. First, the system has served to accommodate the diversity of the situations of Member States. It is typically the case for energy islands that the isolated and emergent markets provisions in essence reflect the fact that the administrative and restructuring costs of transposition are likely to outweigh the potential benefits. Second, the system has helped to avoid institutional paralysis at the EU level. This is, for instance, the rationale for the provision of three alternative options for the unbundling regime, which were adopted to accommodate certain Member States with powerful vertically-integrated incumbents. This form of differentiated integration thus allows certain political problems to be solved.⁸ Third, it has helped to promote investment in infrastructure, especially for the most risky projects. This is the rationale behind the

¹ E.g. Article 44 of Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC, OJ L 211/87. Article 49 of Directive 2009/73/EC 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, OJ L 211/129.

² Article 49 of Directive 2009/73/EC, above n.1.

³ See page 2 of the conclusions: <http://register.consilium.europa.eu/pdf/en/11/st00/st00002-re01.en11.pdf>

⁴ SEC(2011) 755 final, pp. 8 and 12.

⁵ Article 24(3) of Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity.

⁶ Recitals 6, 25 and 58 of Directive 2009/72/EC, above n.1, and Recital 56 of Directive 2009/73/EC, above n.1.

⁷ Recital 22 of Directive 2009/73/EC, above n.1.

⁸ On the different ways to pursue differentiated integration, and the practical relevance of this for energy, see N. AHNER, A. DE HAUTELOCQUE and J.-M. GLACHANT, ‘Differentiated Integration Revisited: EU Energy Policy as Experimental Ground for a Schengen Successor?’, (2012) 39(2) *Legal Issues of Economic Integration*, 249.

merchant investment mechanism.⁹ The objective of the derogation/exemption system is therefore not only to address the heterogeneity of Member States' market structures and geographical peculiarities; it is also to support certain policy goals and the advancement of liberalization.¹⁰

Coming back to the specific case of energy islands, one could wonder whether they need an “across the board” exemption from all provisions of EU energy law. Indeed, a quick review of the relevant provisions of the Third Energy Package shows that they can be exempted from most if not all of the *acquis communautaire* in energy, both on market design and on the regulatory framework. However, even if a supply monopoly is the most efficient market structure in a given situation, this monopoly still needs to be regulated. Of course, the derogation system for energy islands answers the widely accepted need not to liberalize energy markets and introduce competition when energy systems are too small to deliver economies of scale and effective competition. Liberalization in these systems would probably even undermine security of supply at times. This paper therefore investigates whether the EU has struck the right balance in this area.

This paper will first try quickly to disentangle the complex system of derogations open to energy islands.¹¹ It will focus *inter alia* on the unbundling regime and what it means to have an express derogation from Article 9 (ownership unbundling). The second part will look at the opening of the Cyprus gas market and the concrete effects of the derogation system on the powers of the Cyprus Energy Regulatory Authority (CERA), the national regulator, in monitoring this market. Cyprus is considered to be both an isolated (Article 49(1) of Directive 2009/73) and an emergent (Article 49(2) of Directive 2009/73) market under the new legislation and, as such, is an interesting case.

2. The Derogation Regime under the Third Package for Energy Islands

One of the features of the EU market liberalization legislation is its capacity to accommodate the diverse market and industrial structures of the 27 Member States. As already outlined above, one of the vehicles for different speed and scope is the derogation regime, as foreseen in the Third Energy Package, which, in the same way as its predecessors, allows differentiated energy market liberalization. One illustrative example is the new unbundling regime introduced by the Third Package. Unbundling, i.e. the separation of the network business as a natural monopoly from the activities of production and supply, is considered to be a pre-requisite for effective competition. Yet, since it was a key component of the liberalization process in Europe, it was necessary to provide different degrees of structural separation for its actual implementation at the level of Member States, up to the possibility of full opt-outs, if necessary, for some Member States.

Derogations potentially cover a wealth of different situations and market design elements:

- derogations negotiated in the process of accession to the EU;
- small isolated systems (relevant for electricity);
- when Member States face technical difficulties in respecting the deadline for opening up the market to non-household customers (electricity);

⁹ Article 36 of Directive 2009/73/EC (see above, n.1) and Article 17 of Regulation (EC) 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 (EC) No 1228/2003, OJ L211/24. For more on the merchant mechanism, see A. DE HAUTECLOUQUE and V. RIOUS, ‘Regulatory Uncertainty and Inefficiency for the Development of Merchant Lines in Europe: A Legal and Policy Discussion’, in DELVAUX, HUNT and TALUS (eds.), *EU Energy Law and Policy Issues*, 2nd ed., Brussels: Euroconfidential 2010, pp.163-182.

¹⁰ It is also worth mentioning the possible derogations from Third Party Access provisions for gas if security of supply is endangered (Article 48 of Directive 2009/73), and the derogations granted in the context of the accession process. Derogations from retail market opening are also possible.

¹¹ We note that this applies equally to energy islands within Member States and Member States such as Malta or Cyprus.

- legal unbundling at distribution level (relevant for both electricity and gas);
- derogations to unbundling rules for Transmission System Operators (TSOs) (relevant for both gas and electricity);
- emergent and isolated gas markets;
- derogation from the requirements of Directive 2003/55 (that is now repealed by Directive 2009/73) where companies face serious problems due to gas bought on a take-or-pay basis that it can no longer sell (see Article 27 of Directive 2003/55, and then Article 48 of Directive 2009/73);
- exemption from the requirements of the gas Directive on third party access (TPA) for new 'merchant' infrastructure. A similar possibility exists under Regulation 714/2009.¹²

In the following sections we will focus on the derogations that are relevant for energy islands.

2.1. Derogations for small isolated systems (electricity)

As a matter of general principle, derogations in electricity are possible either following an application by the Member State concerned or by being explicitly granted, i.e. explicitly foreseen in the Directive 2009/72. Electricity systems can obtain derogations when they are considered 'small isolated systems', which means 'systems that had a consumption of less than 3000 GW/h in the reference year 1996, where less than 5 per cent of the annual consumption is obtained through interconnections with other systems [...]'. Electricity systems with a consumption of less than 500 GW/h in the reference year (1996) and where there is no connection with other systems are defined as micro isolated systems.¹³ Micro isolated systems can obtain additional derogations from the authorization and tendering procedure for the refurbishing, upgrading and expansion of existing capacity.¹⁴ The Commission can attach conditions to a positive decision to allow a derogation.

For so-called small isolated systems, the respective Member State must 'demonstrate [...] that there are substantial problems for the operation of their small isolated systems'. Member States can apply 'for derogations from the relevant provisions of Chapters IV, VI, VII, and VIII as well as Chapter III, in case of micro isolated systems'.¹⁵

This means that derogation is possible from:

- Chapter IV on TSOs. This Chapter introduces, *inter alia*, the new Ownership Unbundling regime (Article 9), the designation and certification of TSOs and the Independent System Operator model (ISO) (Articles 13 and 14).¹⁶
- Chapter VI (Articles 24 to 29), which contains the requirements for the legal and functional unbundling of Distribution System Operators (DSOs).
- Chapter VII (Articles 30 and 31), which specifies the regime for the unbundling of accounts as well as the scope of the right of access to accounts for the national regulator.
- Chapter VIII (Articles 32 to 43), which contains the rules on TPA, market opening and direct lines.

¹² C. JONES, W. WEBSTER and E. CABEAU, 'Derogations and Exemptions', in C. JONES (ed.), *EU Energy Law: Volume 1. The Internal Energy Market, The Third Liberalization Package*, 3rd ed., Leuven: Claeys & Casteels 2010, pp. 443-494.

¹³ See Articles 2(26) and (27) of Directive 2009/72.

¹⁴ Article 44 of Directive 2009/72.

¹⁵ See Article 44 of Directive 2009/72.

¹⁶ It also specifies the tasks of NRAs regarding the certification of TSOs (Articles 10 and 11) and the tasks to be undertaken by TSOs themselves (Articles 12 and 15), as well as some confidentiality requirements (Article 16).

In a nutshell, isolated electricity systems can thus obtain derogations from all the main provisions of the Directive, meaning the provisions concerning TPA, unbundling and market opening, except as concerns the authorization procedure for new generation capacity.¹⁷ Looking at the applications that have been made, we find them for the Azores¹⁸, Cyprus¹⁹, Malta²⁰ and Madeira²¹.

In the case of the archipelagos of the Azores and Madeira, Portugal obtained derogations from all the provisions of Directive 2003/54. These archipelagos qualify as ‘micro isolated systems’, with the consequence that Chapters IV, V, VI and VII, as well as Chapter III as far as the refurbishing, upgrading and expansion of existing capacity are concerned, do not apply to the islands constituting the archipelagos. The Commission in its Decisions made it explicit that ‘the objective of a competitive market in electricity is impossible or impractical to achieve given the very small level of production and the fact that the islands are also isolated from one another’. Competition in generation is impossible, as having more than one power station per island would be impractical, and consumption fluctuates too widely. Finally, the Commission noted that there is no high voltage transmission and that without competition in production, the Directive’s requirements regarding TPA and the unbundling of distribution systems lose their justification.

Cyprus qualifies under the provisions of the Directive as a ‘small isolated system’. In 1996, Cyprus consumed 2,315.3 GW/h and was thus considered (under Directive 2003/54) to be an isolated, not an interconnected, power system. The relevant Commission Decision of 25 September 2006, granting Cyprus derogation from opening its market until 31 December 2013, indicates that Cyprus qualifies as a small isolated system under the Third Energy Package.²²

The grant of a derogation by the Commission is, as mentioned above, not automatic, and there is a need to demonstrate that the provisions of the Directive create substantial problems for the operation of the ‘small isolated system’. In its Decision of 25 September 2006, the Commission did, in fact, consider that the information initially provided was not adequate to permit the request to be assessed, and asked Cyprus to resubmit.

After resubmission, the Commission found that Cyprus had provided enough evidence that it was not possible, for the time being, to achieve the objective of a competitive market in electricity, given the size and structure of the electricity market on the island and the fact that the prospect of this system becoming interconnected with the main grid of another Member State was remote. Opening up the Cypriot electricity market would also create security of supply problems.

Interestingly, the Commission also highlighted certain facts. First, it said that opening up the market would create a disadvantage for the incumbent supplier, who had to consent to major investments in view of the forthcoming opening of the gas market (in particular for Combined Cycle Gas Turbines (CCGTs)). Second, the public scheme to support investment in renewable energy was yielding a lot of interest among private investors. Unrestricted access to the network would thus have a

¹⁷ For a possible explanation of this, see C. JONES et al., above n.12, pp.447-448.

¹⁸ Commission Decision of 20 December 2004 on a derogation from certain provisions of Directive 2003/54/EC concerning the archipelago of the Azores, 2004/920/EC, OJ L 389 p. 31.

¹⁹ Commission Decision of 25 September 2006 granting the Republic of Cyprus a derogation from certain provisions of Directive 2003/54/EC, OJ L 270 p.72 (a delay in the opening-up of the market for all non-domestic consumers, until 31.12.2008).

²⁰ Commission Decision of 28 November 2006 granting Malta a derogation from certain provisions of Directive 2003/54/EC, 2006/859/EC, OJ L 332 p. 32.

²¹ 2006/375/EC: Commission Decision of 23 May 2006 on a derogation from certain provisions of Directive 2003/54/EC concerning the archipelago of Madeira (notified under document number C(2006) 2008) OJ L 142 , 30.05.2006 pp. 0035-0036.

²² Above n. 19.

negative impact on the reliability of the system and would necessarily entail costly reinforcement of the network, which would unduly increase prices.

As for Malta, the Commission pointed to the size and structure of the electricity market as the main barriers to competition. Opening up the market would jeopardize security of supply and would increase costs for final consumers. In the same way as for the archipelagos of the Azores and Madeira, there is no transmission system in Malta and therefore no operator can be designated. Without competition in supply, there also ceases to be any justification for the requirements of Directive 2003/54/EC regarding TPA to distribution systems.

In all these decisions, the Commission concludes first, in a fairly obscure manner, that it is satisfied that the derogation and the conditions for its application will not prejudice the achievement of the objectives of the Directive. The Commission then goes on to state that possible technological developments in the medium and long term that may bring about substantial changes that need to be taken into account. A review mechanism is thus organized. As far as reporting to the Commission is concerned, the Portuguese national authorities (not the regulator) must report to the Commission every 4 years. The derogations are granted for an indefinite period, as long as substantial changes in the electricity sector of these archipelagos do not occur. A first report must be submitted within 4 years and then a second after 9 years. As for Cyprus and Malta, the derogations are also conditional upon the evolution of the situation. These States are required to notify the Commission of any substantial changes, and in particular to provide information on new generating licences, new entrants into the market, price movements and new infrastructure plans that could necessitate a review of the derogation. They also committed to submit a general report to the Commission every two years. The reports must set out the tariff and pricing policies, together with measures taken to protect customers' interests in the light of the derogation.

We also note that derogations from certain provisions have been expressly granted to some Member States. Luxembourg, Cyprus and Malta are exempted from Article 9, while Malta also enjoys exemptions from Article 26 (unbundling of DSO), Article 32 (TPA) and Article 33 (market opening). As a consequence, Malta keeps the derogation from opening up the market that was granted under Directive 2003/54.

2.2. Derogations for Isolated Markets (Gas)

In the gas sector, Member States may obtain derogations for so-called isolated markets. As in electricity, express derogations have also been granted in the case of Cyprus, the Baltic countries and Finland.

In Article 49 of Directive 2009/73, an isolated market is defined as a system which is not connected to the system of any other Member State and in which one supplier has more than 75 per cent of the market share. In cases where participation in the wider internal gas market is not possible, granting derogations makes sense as well. Article 49 of Directive 2009/73 makes it possible for isolated markets to have derogations from a limited number of provisions:

- the authorization procedure (Article 4);
- the requirement to unbundle TSOs (Article 9);
- the market opening and reciprocity provision (Article 37); and
- the construction of direct lines (Article 38).

A derogation automatically expires when at least one of the two conditions mentioned in Article 49 that make a market qualify as an 'isolated' one is no longer fulfilled. However, isolated markets cannot obtain derogations from certain key provisions: the obligation to implement the rules on Public Service Obligation (PSO) (Article 3), the designation and certification of TSOs and DSOs (Articles 10/11 and 24/25), the unbundling of DSOs (Article 26), accounting unbundling (Article 31), regulated

TPA (Article 32), the access to storage (Article 33) and the establishment of a regulatory authority (Chapter VIII).

In the same way as for isolated systems in electricity, Article 49 of Directive 2009/73 foresees express derogations for isolated gas markets. Under the Directive, Cyprus has, for instance, obtained a direct derogation from all the four provisions mentioned above. The derogation will expire when Cyprus no longer qualifies as an isolated system. The same applies to Estonia, Latvia and Finland (for all of which the derogation applies until the country is directly connected to the interconnected system of any other Member State, except another of these countries or Lithuania).

2.3. Emergent Markets (Gas)

Finally, there is the option for so-called ‘emergent’ gas markets to obtain derogations when they experience substantial problems as a result of the implementation of the Directive. Concretely, the objective was to enable new investment in otherwise fairly risky assets.²³ Such a possibility already existed under the Second Package.²⁴ According to Article 49(2) of Directive 2009/73, a derogation from most of the operative requirements of the Directive can be granted. A Member State is an ‘emergent market’ if its first commercial supply under its first long-term natural gas supply contract was made not more than 10 years earlier.²⁵ For this period of 10 years it may derogate from:

- the authorization procedure (Article 4);
- the designation and unbundling of TSOs and DSOs, and certain tasks of TSOs, DSOs and storage and Liquefied Natural Gas (LNG) system operators (Article 9, Article 13(1) and (3), Articles 14 and 24, Article 25(5), and Articles 26 and 31);
- TPA (Article 32);
- market opening (Article 37(1)), i.e. there is no need to open the gas market to new entrant suppliers; and
- the construction of direct lines (Article 38), i.e. new entrants must not be allowed to build direct lines.

This is therefore very wide-ranging when compared to the possible derogations under the isolated market provisions. However, no derogation is possible for, for instance, PSOs, the monitoring of security of supply, the publication of technical rules, access to storage and, again, the obligation to establish a regulator.

As concerns the cases of derogations for emergent markets following an application, we find that Greece²⁶ has been exempted from the most important provisions of Directive 2003/55, as has Portugal. Portugal was exempted until 2010 (the Portuguese electricity law implemented Directive 2003/55 in 2006).²⁷ In both cases, gas requirements for the derogation have been fulfilled since natural gas was introduced only in 1996 or 1997.

The case of Cyprus serves as an illustrative example, again with an express, and thus automatic, derogation from all the provisions mentioned above. Cyprus therefore obtains direct derogation from additional provisions such as, for instance, non-discriminatory access to LNG and storage, the ISO

²³ See C. JONES et al. above, n.12, pp.451-452.

²⁴ Article 28(2) of Directive 2003/55/EC of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC, OJ L 176/57.

²⁵ Article 2(31) of Directive 2009/73, above, n.1.

²⁶ For details about the development of liberalization and the state of the market, see S. BERGLUND, *Putting Politics into Practice – A Study of the Implementation of EU Utilities Directives*, Delft: Eburon 2009, pp. 192f.

²⁷ INTERNATIONAL ENERGY AGENCY, *Portugal Country report*, 2009, pp. 21f.

model, and all TPA provisions (see detailed analysis below); the derogation will, however, expire from the moment Cyprus ceases to qualify as an emergent market.

Coming back to the provisions of Article 49, one finds that express derogation is, moreover, foreseen for emergent 'regions'. Following the same reasoning as that used for emergent 'markets', paragraph 4 of Article 49 addresses the special situation of certain geographically limited 'areas', where gas is to be introduced for the first time.

In its subsequent paragraph (5), Article 49 lists a comprehensive, although not exhaustive, set of criteria that need to be taken into account when the Commission decides about a possible derogation for such an emergent region. These criteria shall, *inter alia*, ensure that an exemption will only be granted if a limited period of monopoly supply rights is essential for the construction of new infrastructure.²⁸ Also, for gas infrastructure other than distribution infrastructure, a derogation may only be granted if no gas infrastructure has been established in the area or if gas infrastructure has been established for less than 10 years. The temporary derogation shall not exceed 10 years from the time gas is first supplied in the area. Paragraph (7) contains the requirement that the other Member States need to be consulted, i.e. that the Commission, before taking the Decision, must allow the other countries to comment on the case.

Finally, paragraph (8) of Article 49, referring to the peculiar situation of Greece, states that Greece benefits from an automatic derogation for some distribution concessions.²⁹

3. The Specific Derogations from the Unbundling Rules for TSOs (Gas and Electricity)

In this section we will focus on the unbundling of TSOs. Three Member States benefit from express derogations specifically targeting the unbundling rules for TSOs, for gas and electricity. These States are Cyprus, Luxembourg and Malta (Article 44(2) of Directive 2009/72 and Article 49(6) of Directive 2009/73). Luxembourg had already benefited from a derogation from the requirements on legal and functional/management unbundling under Directive 2003/55 (Article 28(6)). The exemption from the unbundling rules was given due to the very small size of Luxembourg's gas network.

3.1. The Unbundling Regime

Effective unbundling is considered to be a *conditio sine qua non* for the development of well functioning, liberalized energy markets. The Second Package enacted in 2003 required that network operations be legally and functionally separated from supply and generation or production activities. The Third Energy Package put forward by the Commission on 19 September 2007, and adopted after two years of discussions between the Commission, the EU Parliament and the Council, aims to go further, and contains three legally equivalent options for Member States for separating gas as well as electricity supply and production from transmission network operations:³⁰

(i) Ownership Unbundling (OU). This option requires that networks are no longer controlled and majority-owned by energy production or supply companies.

(ii) Independent System Operator (ISO). This option leaves ownership of the transmission networks with the supply companies, but requires that vertically integrated companies hand over the operation of their transmission network to a designated ISO which cannot be a subsidiary of the vertically integrated undertaking or have the same shareholders (e.g. the state).

²⁸ See C. JONES et al, above, n.12, p. 454.

²⁹ C. JONES et al, above, n.12, p. 457.

³⁰ For a detailed overview see M. HUNT, 'Ownership Unbundling: The Main Legal Issues in a Controversial Debate', in DELVAUX, HUNT, TALUS, *EU Energy Law and Policy Issues*, Rixensart: Euroconfidentiel 2010, p. 57 ff.

(iii) Independent Transmission Operator (ITO). This option leaves ownership of the transmission networks with the supply companies, but requires that the TSO abides by certain rules to ensure that the production/supply and transmission network operations are conducted independently. The ITO model remains very similar to the unbundling requirements of the Second Package but reinforces the ‘Chinese Walls’ to ensure the operational independence of the TSO.

As regards vertically integrated companies, the Third Energy Package further provides for the functional and legal unbundling of a transmission system owner and a gas storage system operator, which also includes the operator of the part of any LNG facilities that is used for storage.³¹

The new unbundling regime for the electricity sector is organized under Chapters IV to VII of Directive 2009/72: Chapter IV introduces the new OU (Article 9) and ISO (Articles 13 and 14) models. Chapter V (Articles 17 to 23) contains the practicalities of the new ITO model. Chapter VI (Articles 24 to 29) contains the requirements for the legal and functional unbundling of DSOs. Chapter VII specifies the regime for the unbundling of accounts as well as the scope of the right of access to the accounts for the national regulator. The organization of the unbundling regime for the gas sector under Directive 2009/73 broadly follows that of Directive 2009/72.

3.2. Express Derogation from Unbundling

The question that arises in this context is whether express derogation from Article 9 of the Directives implies derogation from the entire unbundling regime, i.e. whether a Member State enjoying the express derogation from OU is also expressly exempted from implementing the ITO and ISO models. In this case, since the first and second liberalization Directives have been repealed, no unbundling requirements would apply any longer. The common wisdom in the market and in the EU institutions appears to be that derogation from Article 9 would imply the complete absence of any unbundling requirement under the Directives. There is, however, no compelling legal reason to believe that this is correct and that the ITO and ISO models do not apply.

It is true that, for all the other 24 Member States, OU is optional and they can choose between the ISO and ITO models. It is thus legitimate to wonder why a direct derogation would be beneficial if it would not imply a full derogation from any unbundling requirements. It is, however, the case that opting out from OU and applying either the ISO or the ITO models is only possible when the transmission system already belonged to a vertically-integrated undertaking at the date of the entry into force of the Third Package, i.e. 3 September 2009. For new network assets, or network assets bought by a supply company after 3 September 2009, OU has to be applied and is therefore no longer optional. As a result, direct derogation from Article 9 gives the possibility of not applying OU in the future as well, i.e. at the time any new investment is undertaken. This is, for instance, beneficial in the case of Cyprus, which foresees the creation of a gas supply system in the mid-term. In addition, we can wonder why the Third Energy Package would allow certain Member States to go back to full reintegration when the unbundling regime of the Second Package has been implemented successfully. It is in fact sensible to not impose unbundling requirements when no unbundling provisions have been implemented. However, it hardly makes sense to undo the move towards unbundling at the national level when an unbundling regime is already in place. Instead of watering down the effects of the Second Package, the scope of possible derogations should remain limited to the full ownership

³¹ We note that the unbundling regime for DSOs remains largely unchanged. Where the DSO is part of a vertically-integrated undertaking, the main elements of the unbundling regime are the following (Article 26):

- legal unbundling of the DSO from other activities of the vertically-integrated undertaking not related to distribution;
- functional unbundling of the DSO in order to ensure its independence from other activities of the vertically-integrated undertaking;
- accounting unbundling: requirement to keep separate accounts for the DSO activities; and
- there must be a compliance officer within the DSO. This compliance officer has to be fully independent and to have access to all the necessary information of the DSO and any affiliated undertakings to fulfil his task.

unbundling regime, while the ITO model should apply without possible derogation. Obviously, the application of the ISO model would also remain an option.

4. The Powers of National Regulators in Isolated and Emergent Markets: The Case of the Cyprus Gas Market³²

In this fourth part, we investigate the specific question of the impact of the derogation system on the powers of the relevant national regulators, by looking at the particular case of the opening of the Cyprus gas market and, therefore, at the concrete effects of the derogation system on the powers of CERA, the national regulator, in monitoring this market.

In theory, the monopolistic character of the gas market of the Republic of Cyprus, as it is foreseen for the future, calls for strong regulatory powers, in particular licensing powers, in order to allow Cypriots to benefit fully from future imports of natural gas. The regulatory powers which the national regulator CERA will hold in the future gas market are, however, unclear, due to the complexity of the derogation system organized by the Third Energy Package, in particular for a natural beneficiary of exemptions such as Cyprus.

The present case study shows that the regulatory powers of CERA, after the transposition of Directive 2009/73³³ and the creation of the gas market, will, in fact, be largely dependent on the will of the national government.

4.1 The Gas Sector in Cyprus³⁴

The Government of the Republic of Cyprus (GoC) gave a mandate to the monopoly electricity producer, the Electricity Authority of Cyprus (EAC), in early 2009 to form a joint venture, the “LNG Terminal Company”, which would be responsible for the development, financing, operation and management of an onshore LNG import and re-gasification terminal, to be located at Vasilikos on the south coast of Cyprus. This onshore LNG terminal is intended to be the exclusive terminal for the import, storage and re-gasification of LNG in Cyprus, as long as emergent and isolated market conditions prevail.

A new public company called DEFA was also founded. DEFA is meant to have the exclusive right to purchase and import LNG and to supply gas to the Cyprus market. It will be the sole importer and supplier of all natural gas in Cyprus. The GoC will initially hold 100% of the issued share capital in DEFA, with the option for the EAC to participate in the share capital of DEFA by taking a 44% stake.

³² This part reflects the state of the law and facts as of July 2011.

³³ We note that Regulation 715/2009/EC of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005, OJ L211/36 (which specifies TPA conditions concerning storage and LNG) does not apply to small isolated systems and emergent markets such as Cyprus. When the derogation for emergent markets expires, it is possible to apply for a temporary derogation of two years from Regulation 715/2009 (see Article 30 of the Gas Regulation, or Article 16 of Regulation 1775/2005). To our mind, this possibility was created to facilitate the transition towards the normalization of former emergent markets, and to allow for the diversity of local situations, under the control of the Commission. The Commission has however not explicitly commented on what this derogation process entails in detail, or the criteria against which any application will be assessed. It can be assumed that, as for any derogation (such as the one from which Cyprus benefited in 2006), it is the responsibility of the country asking for a derogation to provide enough convincing evidence to the Commission. The assessment of the Commission should thus be done on a case-by-case basis.

³⁴ See generally the 2011 National Report – Cyprus/CEER Report to the European Commission in line with the Electricity and Gas Directives for the period July 2010 to July 2011, pp. 34-39 [http://www.energy-regulators.eu/portal/page/portal/EER_HOME/EER_PUBLICATIONS/NATIONAL_REPORTS/National%20Reporting%202011/NR_En/C11_NR_Cyprus-EN.pdf], and past reports of the same nature, for factual evidence about the Cyprus gas market.

A further 5% of the GoC shareholding in DEFA will be made available for other investors. It is envisaged that the EAC will exercise its 44% option in full. The initial operation of the LNG Terminal will be associated with the adjacent Vasilikos Power Station.

The formation of the joint venture, the LNG Terminal Company, and the development of the LNG Terminal at Vasilikos, is an important strategic initiative for the EAC and the GoC. Once developed, the LNG Terminal should indeed assist Cyprus in diversifying its energy sources, thereby ensuring an enhanced security of energy supply. Both the EAC and the GoC therefore regard the LNG Terminal as highly significant and important.

With regard to the provision of services to receive, store and re-gasify LNG, DEFA will enter into an agreement with the LNG Terminal Company at its terminal. The LNG Terminal Company will thus be responsible for the development, construction and operation of the LNG Terminal, and will provide LNG re-gasification services to DEFA. The gas will remain owned by DEFA during the full cycle.³⁵

It is worth noting that the electricity market in Cyprus has been partly liberalized since 2004, and that CERA is also responsible for regulating the electricity market and issuing the relevant licences to the electricity generators and suppliers. Currently all the industrial and commercial customers are eligible to choose their suppliers. As from 2014, the electricity market in Cyprus will be fully liberalized. It should be noted that, in line with the GoC decision that natural gas will be the primary source of energy for all electricity generating power plants of reasonable capacity, CERA decided that any power-producing unit over 50MW should be fuelled by natural gas.

4.2. Legal Qualification of DEFA and the LNG Terminal Company Pursuant to Directive 2009/73

The regulatory powers of CERA over DEFA and the LNG Terminal Company will first depend on the legal status of these two entities under Directive 2009/73. The legal status is determined on a functional basis, which means that the activities performed (rather than corporate law, for instance) are decisive. The legal status of DEFA and the LNG Terminal Company can thus change over time, and the regulatory powers of CERA will evolve accordingly.³⁶

It is our understanding that there will be two phases in the development of the gas market in Cyprus. In the first phase (which will last for one to two years at least), no transmission and distribution network will be developed. As a result, DEFA will simply qualify as a ‘natural gas undertaking’,³⁷ while the LNG Terminal Company will be considered as an “LNG system operator”.³⁸ In the second phase (the medium to long term), a transmission/distribution network will be developed

³⁵ We note that the intended structure, where DEFA will retain ownership of the commodity during the full process (ex-ship, through the terminal and regasification, ex-terminal), and where the LNG Terminal Company will be the owner and operator of the terminal, is a pretty standard form of agreement (usually known as a ‘tolling agreement’). To our knowledge, many other examples exist, for instance in the UK.

³⁶ This must be understood only to apply once the derogation system giving full powers to the GoC has lapsed. As long as the GoC decides to apply the express derogations granted by the Directive, the powers of CERA are defined as we describe in this chapter, and comprise, to our mind, very few (if any) powers to impose conditions, terms and regulation on the different actors. On the contrary, when the derogation system has lapsed (the conditions and timeframe for this are defined in the first part of this chapter), the Directive will clearly define the legal status of the different actors, depending on the activities they pursue, and the powers of CERA will be defined accordingly. Of course, if the GoC decides not to derogate, the powers of CERA are then clearly defined by the Directive.

³⁷ According to Article 2(1), a “natural gas undertaking” means a natural or legal person carrying out at least one of the following functions: production, transmission, distribution, supply, purchase or storage of natural gas, including LNG, which is responsible for the commercial, technical and/or maintenance tasks related to those functions, but shall not include final customers’.

³⁸ According to Article 2(12), an “LNG system operator” means a natural or legal person who carries out the function of liquefaction of natural gas, or the importation, offloading, and re-gasification of LNG and is responsible for operating a LNG facility’.

to cover the future development of CCGTs at the other EAC power stations, as well as possible independent power producers (IPP) penetration and industrial and commercial users. DEFA will therefore gradually become a 'transmission/distribution system operator'³⁹ within the meaning of Directive 2009/73.

We note that there is a remaining uncertainty concerning the legal status of the storage facilities to be located at the LNG terminal. Within the meaning of Directive 2009/73, a 'storage facility' is a facility used for the stocking of natural gas which is owned and/or operated by a natural gas undertaking, and includes the part of any LNG facilities which is used for storage (Article 2(9)). The definition, however, excludes the portion of the facilities used for production operations and facilities reserved exclusively for TSOs in carrying out their functions. The Commission itself acknowledges that the difference is not always clear-cut. It is thus hard to give a clear definition of the legal status of the future storage facilities. As we will see, this is, however, of little significance as regards CERA's powers for as long as a workably competitive gas market has not emerged in Cyprus.⁴⁰

4.3. Rationale and Application of the Derogation System in the Future Cyprus Gas Market

Cyprus is unambiguously considered both as an *isolated* (Article 49(1)) and as an *emergent* (Article 49(2)) market under the Third Energy Package, as it was under the Second Package. This leads to a wide array of express derogations from the substantive parts of Directive 2009/73. These derogations will expire from the moment that Cyprus no longer qualifies as an emergent or isolated market.

4.3.1. Express derogation

Importantly for our case study, Cyprus obtained express derogations from Articles 13(1) and 13(3) on the tasks of TSOs, on storage and on LNG operators, which means that the LNG Terminal Company and DEFA (if it qualifies as a TSO) are relieved from their obligations to operate, maintain and develop, under economic conditions, secure, reliable and efficient transmission, storage and LNG facilities, with due regard to the environment. They do not have to follow fair balancing rules and are discharged from the obligation of non-discrimination.

As far as DSOs are concerned, if this becomes relevant, Cyprus is expressly exempted both from the obligation to designate one (Article 25(5)) and from the obligation to implement non-discriminatory rules for balancing services. This mainly implies that, even if a distribution network is developed, DEFA might not qualify as a 'distribution system operator' and will therefore not have to undertake the related responsibilities under the Directive. On balancing, this follows the rationale of the exemption from Article 13(3).

As regards TPA provisions, Cyprus has an exemption from Article 32. Article 32 is a key provision of the Directive, as it leads logically to the unbundling provisions and to most powers of national regulatory authorities. Express derogation from Article 32 relieves the GoC from its obligations to

³⁹ According to Articles 2(4) and (6), a "transmission system operator" means a natural or legal person who carries out the function of transmission and is responsible for operating, ensuring the maintenance of, and, if necessary, developing the transmission system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meet reasonable demand for the transport of gas' and a "distribution system operator" means a natural or legal person who carries out the function of distribution and is responsible for operating, ensuring the maintenance of, and, if necessary, developing the distribution system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meet reasonable demands for the distribution of gas'.

⁴⁰ For more information on the legal status of storage facilities, see the Commission's interpretative note on Third-Party Access to Storage Facility, 22 January 2010 (available on the DG Energy website [http://ec.europa.eu/energy/gas_electricity/interpretative_notes/doc/implementation_notes/2010_01_21_third-party_access_to_storage_facilities.pdf]).

organize TPA to the LNG Terminal Company and to the future gas network. Accordingly, final tariffs do not have to be set, published and reviewed by CERA. Of course, Cyprus is also exempted from the unbundling regime.⁴¹

Lastly, Cyprus enjoys an express derogation from Article 4 on authorization. This means that when Cyprus law requires an authorization procedure, the GoC will not have to apply and make public fair and non-discriminatory criteria and procedures. We note that Article 4 does not define when or where a licensing procedure has to be organized, but rather defines how it should be organized. An exemption from Article 4 accordingly exempts the recipient Member States from these ‘procedural’ requirements, but does not influence the setting up of an authorization procedure as such; the organization of such a procedure remains at their discretion. The exemption from Article 4 (like most exemptions) must be understood as aiming to limit administrative and regulatory costs, as these additional costs would not be justified by sufficient additional benefits, such as those coming from increased competition.

When Cyprus becomes only an isolated market (and not an emergent market), the derogations will only concern the licensing procedures (Article 4), ownership unbundling (Article 9), market opening/reciprocity (Article 37) and the regulatory regime on direct lines (Article 38). For the most part, Cyprus will thus be subject to the common EU regime, and the Directive and Regulation clearly define the respective powers of CERA, the GoC and the future TSO with respect to such things as the quality of gas and the allocation of congested capacities at the terminal (see in particular Articles 5, 8, 13, 35 and 41 of the Directive, and the Regulation and its Guidelines in the Annex that will become applicable).

Following the derogation from Article 38, the GoC will also not have to give new entrants the chance to build direct lines. As regards market opening provisions and reciprocity (Article 37), the GoC simply does not have any obligation to open the gas market to new entrant suppliers.

4.3.2. Derogation for new infrastructure under Article 36: room for new powers for CERA?

It is also possible in theory for the ECA to submit an exemption request to CERA under the Article 36 mechanism on behalf of the LNG Terminal Company. We recall that the rationale for the Article 36 mechanism is to provide exemptions from certain key provisions of the Directive for potentially very risky projects whose profitability and operation cannot be ensured if they are completed on a regulated basis (and are thus subject to regular regulatory reviews).⁴² The power to grant exemptions under Article 36 is an important power of the national regulatory authority. It is therefore interesting to see whether CERA could impose conditions on the LNG Terminal Company through that channel.

Under Article 36, an operator can be exempted from Articles 9, 32, 33, 41(6), 41(8) and 41(10). As we saw, Cyprus already enjoys express derogations from Articles 9 and 32. Article 32 concerns TPA to storage facilities, and would not apply even if the LNG Terminal Company were to qualify as a ‘storage operator’, as there would be no TPA to LNG or to the grid network. Similarly, Articles 41(6), 41(8) and 41(10), which concern the powers of CERA to set/approve/review tariffs for connection and access to the national network, LNG facilities and balancing services, as well as access to cross-border infrastructure, and the duties of CERA to provide appropriate short (efficiency) and long-term (investment) incentives when setting tariffs, are all irrelevant either because Cyprus will not be interconnected or because Cyprus already enjoys an express derogation from Article 32, the TPA provisions.

It becomes clear that the exemption from some parts of Article 41 naturally follows the exemption from Article 32 (and Articles 33 and 34 the case may be). The core competence of regulators under the Article 36 mechanism is therefore the possible derogation from Articles 9 and 32. As Cyprus has

⁴¹ Articles 9, 14, 26 and 31. See the first part of this chapter.

⁴² We note that on 6 May 2009 the Commission published a staff-working document on exemptions for new infrastructure that provides a useful indication of the Commission’s intended policy for reviewing possible decisions from CERA.

express derogations from these two provisions, an Article 36 derogation would have very limited scope in any case.

4.3.3. Interim conclusion

Within the time boundaries of the express derogations, we see that the GoC remains sovereign in opening the gas market, in particular by controlling consumer eligibility and TPA. DEFA and LTC as a gas undertaking and an LNG facility operator, and in a second phase as a transmission/distribution operator and a storage facility operator, are relieved from most obligations concerning the non-discriminatory, secure, reliable and efficient use of the future gas system. Overall, Article 36 does not give new powers to CERA.

4.4. Remaining Powers of CERA over the LNG Terminal Company and DEFA after Transposition

Notwithstanding the fact that all competition can be prevented, Cyprus must nonetheless implement the remaining provisions of the Directive. The remaining provisions of the Directive in the case of Cyprus have to be understood as ensuring two key objectives: (i) to prepare for the opening of the market at a later stage and (ii) to ensure PSOs (in particular security of supply) and consumer protection. In the pursuit of these two objectives, Directive 2009/73 strengthens the powers of the national regulatory authorities. The new Directive enhances their independence, and Articles 40 and 41 provide for new objectives, duties and powers, which shall be assigned to the regulators and from which derogations are not possible. Article 40 (General objectives of the regulatory authority) contains a long list of general objectives for the national regulatory authority. However, the interpretative note⁴³ says clearly that the pursuit of these objectives must be carried out within the strict delineation (legal basis) of its duties and powers, which are mainly defined in Article 41. We also note that under Article 41(2), the GoC can grant the remaining powers of CERA to another authority. This authority should, however, obey the same governance requirements (e.g. independence). If this happens, CERA will have the right to obtain any information that is obtained by this authority. Except under Article 36, the objective of the Third Energy Package is not to deprive regulators of powers but instead to open up possibilities so that each Member State can find the best balance between restructuring, regulatory oversight and intended benefits.

The table below investigates the future competences of CERA in the areas of security of supply, quality of gas, customer protection, transparency and investment viability.

⁴³ Commission Staff Working Paper, Interpretative Note on Directive 2009/72/EC concerning common rules for the internal market in electricity and Directive 2009/73/EC concerning common rules for the internal market in natural gas, The Regulatory Authorities, 22 January 2010.

Powers of CERA after transposition in the areas of security of supply, quality of gas, customer protection, transparency and investment viability		
Powers	Legal basis	Comments
Security of supply (short and long term)	Article 5	This is a general duty to monitor security of supply, understood as the balance of (existing and future) supply and demand, the quality and maintenance of the network, and long-term investment adequacy. This duty, however, applies to the GoC, which retains the discretion to delegate it to CERA.
	Article 8	The GoC (or CERA if the GoC has so provided) must ensure that technical safety criteria are defined.
	Article 41(1)(h)	Rules regarding the performance of network reliability must be set and monitored. The GoC can give power to CERA to monitor compliance with the rules, but this is not compulsory. However, CERA must in any case be consulted in the process.
	Article 41(1)(t)	The implementation of the safeguarding measures devised by the GoC under Article 46 must be monitored by CERA.
	Article 41(9)	If DEFA becomes a TSO, CERA will have to manage congestion management rules.
Quality of gas	Article 41(1)(h)	As above, the GoC retains discretion on the allocation of responsibility, but CERA must be involved.
Customer protection	Article 41(1)(o) and Annex 1	CERA will have competence to enforce the Annex when there are new entrants for generation and/or the gas market becomes open for household customers and businesses.
	Article 3(12)	Creating a checklist of gas consumer rights – relevant only at market opening.
Transparency	Article 41(1)(i)	CERA will have the duty to ensure compliance with transparency requirements.
Investment	(Article 41(1)(g))	If DEFA is a TSO, CERA will have powers regarding the monitoring of investment plans.

We note that most regulatory powers described in this table remain within the competence of the GoC. However we believe that CERA should be closely involved, as the non-transposition of these requirements by the GoC into national law may lead to an infringement procedure for non-conformity or violation of the Directive 2009/73.

Overall, it appears clear that the system of express derogations (from Article 9 and other provisions of Directive 2009/73) is intended to make sure that the national governments concerned, such as the GoC, retain full discretion in the way they structure, and allocate responsibilities among the different actors in, new markets. In the case of the Cyprus gas market, the allocation of responsibilities among DEFA, the LNG Terminal Company and any other (old or new, national or foreign) actor remains at the full discretion of the GoC, who can, for example, fully delegate this choice to the management of the EAC. In short, all options are possible, and there is no constraint imposed by the Directive.

However, we also note that CERA will enjoy real powers in specific areas, as defined in the table above, but that these powers cannot be used on an *ex ante* basis. They are in the realm of *ex post* regulatory oversight, and will gradually develop along with the development of the Cyprus gas market. We also note that the GoC cannot derogate from granting to CERA certain rights allowing it to fulfil its duties under the Directive: the rights to issue binding decisions, carry out investigations, require

information from any gas undertaking and impose effective, proportionate and dissuasive penalties (Article 41(4)).

Last, we note that, according to Article 41(1)(b), CERA must ensure that gas undertakings comply with their obligations under the Directive and other relevant EU legislation. Compared to the limited powers to review complaints under the Second Directive, this provision grants a very general competence to CERA to ensure that gas operators comply with their obligations. The obligations can be in the Directives or Regulations, or in any other EU legislation. As we saw, the express derogation from Article 13 relieved DEFA and the LNG Terminal Company from almost all duties under the Directive. Article 41(1)(b) therefore does not give additional powers to CERA under the Directive 2009/73, at least for now.

5. Conclusion

One of the features of EU market liberalization legislation is its capacity to fit with the diverse market structures of the 27 Member States. One of the vehicles allowing for different speed and scope, i.e. for gradual market liberalization, is the derogation regime foreseen in the Third Energy Package. The Third Energy Package, like its predecessors, by means of its derogation and exemption regime allows for differentiated energy market liberalization within the EU.

As far as energy islands are concerned, and beyond the complexity of the derogation/exemption regime applying to them, our conclusion is that the scope of possible derogations from the Third Energy Package seems to be exceedingly wide. As we saw, the Package allows for full vertical reintegration and a loss in regulatory independence and powers, which does not seem justified. Overall, if the Member States concerned wish to do so, they can take several steps backwards in the liberalization process. Of course, this can always be seen as a recognition that the costs of organizing liberalization are, sometimes, structurally too high compared to the potential gains. The Third Energy Package's derogation system for energy islands should, strictly, be used to ensure the viability and attractiveness of the investments and, in particular, should not reduce the role, power and responsibilities of the national regulatory authority, especially on the issues of security of supply, transparency and consumer protection through the proper regulation of tariffs, bearing in mind that the market will be monopolistic.

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