

Regulated Energy Prices in the Energy Community – State of Play and Recommendations for Reform

Report to the Permanent High Level Group

1. Introduction

According to the Energy Community Treaty, Directives 2003/54/EC and 2003/55/EC¹ and Annex I in particular, all non-household customers shall be eligible as from 1 January 2008, and all customers as from 1 January 2015. The right of eligibility allows customers to choose their supplier freely and without legal restrictions.

The eligibility right should not be confused with the (non-)regulation of the price of energy supply, i.e. the end-users' price. Where functioning competitive electricity and gas markets are in place, customers are able to freely negotiate the prices with their suppliers. However, despite the commenced liberalization of the electricity sector, and formally opening of the markets in line with the Directive's requirements, most of the Contracting Parties define tariff customers (as opposed to non-tariff customers or "eligible" customers) as a group of customers – usually the large majority – for which they maintain regulated end-user prices. This group of tariff customers generally consists of not only household consumers and small businesses, but also medium to large-size business and even energy-intensive industries. In some jurisdictions, transitional periods for phasing-out of price regulation are envisaged.

A regulated price is a price subject to regulation by a public authority, as opposed to a price set exclusively by supply and demand. Price regulation can take different forms, such as the setting or approval of prices, price caps or combinations of these. Regulating prices has an impact on the introduction of competition in the energy markets. Even though price regulation is not prohibited per se by the *acquis*, it has distorting effects on the market and contradicts certain principles of Energy Community law, as will be elaborated below.

In its 2007 Position Paper, ERGEG emphasized that building competitive electricity markets is in the interest of customers,² and (end-user) price regulation distorts the functioning of the market and jeopardises both security of supply and the efforts to fight climate change. Similarly, the ECRB in its 2009 and 2011 Position Papers³ stressed the negative effects of regulation of energy prices at non cost-reflective level. In fact, if regulated end-users' prices are not fully cost-reflective, suppliers that do not benefit from significant low-cost generation capacities due to not cost-reflective deliveries enforced by national legislation through equivalent long term contracts will not be able to make competitive offers that cover their supply costs. In particular, if prices are regulated at a level below cost, there is not only no incentive but also no economic viability for new entrants to enter the supply market. With the limited number of existing suppliers, there will be no development of wholesale and retail markets, and liquidity will remain at a low level. As a result, neither the wholesale nor the retail markets will be

¹ Article 21 Directive 2003/54/EC and Article 23 Directive 2003/55/EC

² ERGEG, End-user energy price regulation: An ERGEG Position Paper, Ref: E07-CPR-10-03, 18.07.2007.

³ ECRB, Vulnerable Household Customers - An ECRB Contribution to a Common Understanding (2009) and ECRB, Treatment of the vulnerable customers in the Energy Community (2011).

competitive. Artificially low regulated prices also limit the incentives of customers to switch supplier and from this perspective also limit competition in the market. The lack of competition on the retail markets has a negative impact on customers' choice. It is through exercising their right to choose that customers stimulate retail competition between suppliers.

Moreover, the Secretariat has been made aware many times, by public utilities and private investors alike, that prices regulated below real costs endanger not only the viability of these companies, but of the energy systems as a whole. To the extent artificially low regulated end-user prices are backed up by generation deliveries at non cost-reflective level, they discourage, or even render impossible, investment in generation and thus represent a risk for security of electricity supply. If taking into account the role of gas used for power production, electricity prices regulated below real costs also negatively affect the development of anchor loads in the gas market. The same goes, *mutatis mutandis*, for network tariffs regulated at a level below full cost-reflectivity and their impact on infrastructure investment.

Finally, artificially low energy prices are counterproductive for the efforts to save energy to which the Contracting Parties committed through the incorporation of three directives in that sector.

Regulated prices for households and small enterprises are often justified by the necessity to protect customers as a measure taken as a public service obligation under Article 3 of Directives 2003/54/EC and 2003/55/EC. In this case, price regulation must satisfy the legal requirements of these Articles, including the interpretation given by the case law of the Court of Justice. Moreover, it shall only be in place for a certain transitory period, with a clear roadmap for phasing it out. In particular, and as also underlined by the ECRB in its 2009 and 20011 Position Papers⁴, while acknowledging the aim of protecting vulnerable customers, this target needs to be addressed in a broader context of national social welfare systems and has to be taken into account when implementing the Social Action Plans of the Contracting Parties. Vulnerability of customers typically does not refer to energy consumption only. At the same time, the ECRB analysis⁵ shows that the schemes applied in the Contracting Parties for protection of vulnerable energy customers via regulated energy prices to a certain extent also address consumer groups whose vulnerability against higher energy prices is, at least, questionable.

It is for this reason of compliance that the Secretariat proposes the present analysis of end-users' price regulation.

2. Need for action

The two Athens Memoranda already envisage "comprehensive tariff reforms" by the (now) Contracting Parties to the Energy Community. The discussion on the level of price regulation has continued within the institutions of and the events organized by the Energy Community ever since. Low and non-cost-reflective energy prices have been identified by many studies as the key impediment to the establishment of competitive regional energy markets. The need to reform and phase-out the existing system of price regulation was underlined both by the Secretariat in its Implementation Reports and the European Commission in its 2011 Report on the Energy Community Treaty. At its meeting of 5 October 2011, the Permanent High Level Group "*reiterated its concern about persisting barriers to the establishment of open national and regional markets, including excessive price regulation.*" **The Secretariat was invited to make proposals in that respect for the first meeting in 2012.** The present paper follows up on this invitation.

Due to the peculiarities of markets in electricity, natural gas and oil – the three commodities covered by the Treaty – a uniform approach to all three is difficult. Given the greater maturity of market integration, the impossibility to be substituted as well as the high social and economic relevance for all Contracting Parties, the Secretariat proposes to **focus on electricity** in a first phase of approaching the issue of regulated prices. The experience made in this endeavour and the decision taken may later be extended, as the case may be, to the other sectors.

⁴ ECRB, Vulnerable Household Customers - An ECRB Contribution to a Common Understanding (2009) and ECRB, Treatment of the vulnerable customers in the Energy Community (2011).

⁵ ECRB, Treatment of the vulnerable customers in the Energy Community (2011), chapter 2.1.

3. Regulated Electricity Prices and the Energy Community Objectives: Interaction and Conflicts

3.1. Regulated Electricity Prices as a Cause for Lack of Investments - Indirect Risk for Security of Supply

There is a link between price regulation and the security of supply, one of the Energy Community's objectives. In most if not all the Contracting Parties the grid tariffs as well as the regulated prices do not cover fully the true costs of electricity transportation and supply. In order to meet the increasing demand and to replace old generation plants (which will be required also due to implementation of the Energy Community environmental *acquis*) new investments are needed. The low existing price levels in the Contracting Parties cannot support new generation investments.⁶ They will neither attract private investors to the Contracting Parties nor provide domestic utilities with the means to invest on their own. In addition to the insufficient generation capacities, the network infrastructure is largely outdated. Increased security of supply will require both a more efficient use of the existing system, but also new investments in both generation and network infrastructure. When price levels are below the cost of new investments, it will not be possible to get new commercially driven investments, which may even worsen the supply-demand balance. If the investment in long-term remains inadequate, there is serious risk for security of supply, for which low regulated prices would be a key reason. The Wholesale Market Opening Study confirmed that higher electricity prices would increase new investments and security of supply.⁷

3.2. Legal Framework Governing Electricity Price Regulation

Since the time of signing the Athens Memorandum of 2002, the Contracting Parties have agreed to develop their energy policy and ensure the provision of energy under secure conditions at *competitive prices* with high levels of public services and consumer protection.⁸

This has later been reflected in the goals and the activities of the Energy Community, with its establishment by the Energy Community Treaty.⁹ The goal of the Energy Community as stipulated in Article 2 of the Treaty is the creation of a single regulatory space for trade in energy, enhancing security of supply by providing a stable investment climate, improving the environmental situation, energy efficiency, fostering the use of renewable energy, and setting out the conditions for energy trade, as well as developing energy market competition on a broader geographic scale and exploit economies of scale. In order to achieve the goals, Article 3 of the Treaty outlines the activities to be taken, that comprise implementation of the relevant *acquis* on energy, environment, competition, renewable and energy efficiency as well as setting up of a specific regulatory framework permitting the efficient operation of energy markets across the territories of the Contracting Parties.

One of the tasks of the Energy Community as stipulated in Article 31 of the Treaty is "to promote high levels of provision of Network Energy to all its citizens within the limits of the public service obligations contained in the relevant *acquis communautaire* on energy." The relevant *acquis* in the context of electricity prices is essentially Directive 2003/54/EC.

3.2.1. Directive 2003/54/EC and Regulation (EC) 1228/2003

Only the networks transporting electricity (transmission and distribution) are considered natural monopolies as it is not economically feasible to build competing networks to serve the same customers. On the other hand, competition is to be introduced in the service activities (generation and supply). Therefore, the EU liberalisation *acquis* requires reforms in the form of separation of the potentially competitive (generation and supply) from the non-competitive activities (transmission and distribution). The general goal of the electricity market reforms is to open electricity markets in

⁶ POYRY and NORD POOL, South East Europe Wholesale Market Opening, Final Report – updated with Ukraine and Moldova December 2011 (hereinafter, Wholesale Market Opening Study), p.100

⁷ Wholesale Market Opening Study, p.101

⁸ Memorandum of Understanding on the REM in South East Europe and its Integration into the European Union Internal Electricity Market, signed in Athens on 15/11/02 bis D(2002) C2/BD/CA

⁹ Treaty establishing the Energy Community, signed on 25 October 2005, and entered into force on 1 July 2006.

generation and supply and give consumers a choice of supplier through introducing competition while complementing it with regulation of the parts to remain monopolistic, distribution and transmission.

Directive 2003/54/EC and Regulation (EC) 1228/2003 contain rules for establishing cost-reflective and non-discriminatory tariffs for access¹⁰ and use of the distribution and transmission system to be approved prior to their entry into force in accordance with Article 23 of Directive 2003/54/EC. It imposes a requirement on the Contracting Parties to task regulatory authorities with fixing or approving the tariffs, or at least the methodologies underlying the calculation of transmission and distribution tariffs.

3.2.2. Network tariffs

The Secretariat had the chance to pronounce itself on the notion of cost-reflectivity in the context of its activities in dispute settlement.¹¹ Accordingly, cost-reflectivity requires taking into account the long-term, marginal, avoided network costs from distributed generation and demand-side management measures.¹² These tariffs, or methodologies, *shall allow furthermore the necessary investments* in the networks to be carried out in a manner allowing these investments to ensure the viability of the networks.¹³ On a similar note, Article 6(1) of Directive 2005/89/EC requires the establishment of a regulatory framework providing for investment signals for the distribution system network operators “to develop their networks in order to meet foreseeable demand from the market” and “facilitate[ing] maintenance and, where necessary, renewal of their networks.” Furthermore, Article 4(1) of Regulation 1228/2003/EC requires that access charges “reflect actual costs incurred”. Article 4(2) of the same Regulation explicitly calls “the amount of network losses” and “investment costs for infrastructure” to be taken into account.

These provisions of the Energy Community *acquis*, read together, call for system operators to be given the possibility to recoup the costs of operation, maintenance and investments of the network. This possibility is an essential prerequisite for the various and important tasks assigned to network operators under the *acquis*, which in turn are essential to achieve the goals of functioning, efficient and competitive markets for network energy, the very goals of the Treaty itself.¹⁴ In this sense, the *acquis* establishes a general principle of cost-reflectivity of network tariffs.¹⁵

The principle of cost-reflectivity under Energy Community law is not an absolute one. It does not necessarily require a rigid and automatic correspondence between the costs of the regulated business and the revenues collected from network tariffs.¹⁶ Article 4(1) of Regulation (EC) 1228/2003 indicates that access charges shall “reflect actual costs incurred insofar as they correspond to those of an efficient and structurally comparable network operator”. Furthermore, Article 3(7) of Directive 2003/54/EC encourages Contracting Parties to take “measures” including, “in particular, the provision of adequate economic incentives [...] for the maintenance and construction of the necessary network infrastructure ...”. Article 4(2) of Regulation (EC) 1228/2003 also allows for deviations from the cost-reflectivity principle for the sake of locational signals in order to achieve a balance between generation and consumption in a given region of a Contracting Party. Article 37(8) of Directive 2009/72/EC further reinforces that principle of cost-efficiency. Thus, the National Regulatory Authorities have certain discretion in assessing costs incurred and claimed by a regulated entity as to the efficiency of the underlying activities or cost-factors. The regulatory measures adopted may aim at offering incentives to the regulated subjects to keep avoidable costs down. Regulatory authorities may thus, for instance, incentivize network operators to work more efficiently and to reduce costs where appropriate, or encourage them to make investments. The principle of cost-efficiency could be implemented, for example, through benchmarking as suggested by Article 4(1) of Regulation (EC) 1228/2003, or other appropriate measures.

¹⁰ Article 20(1) Directive 2003/54/EC, Article 4 Regulation (EC) 1228/2003

¹¹ In particular in the Opening letter of Case ECS-12/11.

¹² Recital 18, Directive 2003/54/EC

¹³ Article 23(1) Directive 2003/54/EC

¹⁴ Article 2 of the Treaty.

¹⁵ The Secretariat pronounced itself on that principle already in the Reasoned Opinion in Case ECS-2/08 against the former Yugoslav Republic of Macedonia of 17 July 2009.

¹⁶ Interpretative Note of DG TREN of 14.1.2004 on the role of the regulatory authorities, at section 3.1.

Cost-reflectivity of network tariffs is further required in order to avoid cross-subsidies, a potential source of discrimination. In this regard, the Directive 2003/54/EC contains a prohibition for cross-subsidies between generation, transmission, distribution and supply activities¹⁷ to be ensured by effective unbundling of accounts of the electricity undertakings.¹⁸

3.2.3. Regulated energy prices

Unlike for network tariffs, Directive 2003/54/EC does not contain explicit provisions on price regulation of energy supply.

a) Article 3 of Directive 2003/54/EC

The Directive's principle assumption is the opening of the electricity markets based on freely negotiated prices. At the same time, the Directive requires the Contracting Parties to ensure that household customers and, if Contracting Parties deem it appropriate, small enterprises, enjoy the right to be supplied with electricity of a specified quality at easily and clearly comparable, transparent and *reasonable prices*.¹⁹ In addition, the Contracting Parties have the right to impose Public Service Obligations that may relate to security, including security of supply, regularity, quality and *price of supplies* and environmental protection, including energy efficiency and climate protection. Such obligations shall be clearly defined, transparent, non-discriminatory, verifiable and shall guarantee equality of access for electricity companies to national consumers.²⁰

The case law of the Court of Justice represents a point of reference for interpreting Energy Community law, and its explanations shall be respected by the institutions of the Energy Community as well as by the Contracting Parties. In relation to the analysis of end-users' price regulation, the judgment of the Court of Justice in the *Federutility* case is relevant.²¹ The Court assessed a national measure related to the price of supply adopted under the Public Service Obligation provision from Directive 2003/55/EC. The judgement of the Court of Justice provides the legal framework governing the end-users' price regulation in energy. Even though this case is related to the Directive 2003/55/EC, the reasoning is applicable to the interpretation of Directive 2003/54/EC as well.²²

The Court of Justice held that even though prices should be determined solely by demand and supply, State intervention is allowed as long as it satisfies the criteria of Article 3(2). It then analysed the application of those conditions. It assessed whether the intervention is in the general interest, the compliance with the principle of proportionality as well as whether the criteria from Article 3(2) (i.e. the measure should be clearly defined, transparent, non discriminatory and verifiable, and to guarantee equal access for EU gas companies to consumers) are fulfilled. The Court stated that the measure need to be *limited in duration* and *should not go beyond* what is necessary to achieve the objective pursued. Accordingly, it stated that the prices could be regulated *in order to* limit the impact of the

¹⁷ Article 23(1)e) Directive 2003/54/EC

¹⁸ Article 19(3) Directive 2003/54/EC

¹⁹ Article 3(3) Directive 2003/54/EC

²⁰ Article 3(2) Directive 2003/54/EC

²¹ Case C-265/08, *Federutility*, Assogas, Libarna Gas SpA, Collino Commercio SpA, Sadori Gas Srl, Egea Commerciale Srl, E.On Vendita Srl, Sorgenia SpA v Autorità per l'energia elettrica e il gas [2010] 20.04.2010 (hereinafter, *Federutility* case).

²² The opinion was given in a preliminary ruling proceeding requested by the Regional Administrative Court of the Italian region of Lombardy. The case concerned the power granted to the Italian National Regulatory Authority by legislation adopted few days before 1 July 2007 (when full liberalization was supposed to take place) to set "reference prices" that the suppliers of gas were bound to incorporate in their commercial offers as part of their Public Service Obligations. In the proceedings concerning several actions from undertakings and associations of undertakings active in the Italian gas market against the decision of the Italian National Regulatory Authority, the Italian Regional Administrative Court of Lombardy referred a preliminary reference to the ECJ. It asked whether maintaining in effect the power of the National Regulatory Authority to set reference prices for the supply of natural gas to domestic customers, which distributors or suppliers within the scope of their Public Service Obligation are bound to include in their commercial offers, is contrary to the EU law after the liberalization of the market, or whether it could be allowed due to the particular circumstances of the market, still characterised by an absence of "effective competition".

increase in the price of fuel that would in the absence of intervention have had a major impact on the sale price offered to final customers, in cases where the competition in particular on the wholesale market was not fully developed.²³ *The regulation however, should be limited only to the price component influenced by the specific circumstances, but not to the final end-users' price.*²⁴

The Court of Justice also held that the Directive “*does not in principle exclude the possibility*” that the “*undertakings irrespective of their size*”, as final consumers of gas, “benefit from the Public Service Obligations which Member States may adopt in the context of Article 3(2) of that directive.” The important requirement that the Court of Justice sets nevertheless, is that it would be necessary “to take account, in assessing the proportionality of the national measure in question, of the fact that *the situation of undertakings is different from that of domestic consumers*, the objectives pursued and the interests present being not necessarily the same and also of objective differences between the undertakings themselves, according to their size,” and it would be disproportionate only if these two types of customers “were to benefit in an identical manner”.²⁵ Underlining that measure, such as intervention in the end-users’ price, “constitutes an obstacle to the realisation of an operational internal market”, the Court sets the requirement that such measures “*must be limited in duration* to what is strictly necessary in order to achieve its objective.”²⁶ The national administration shall “make a periodic re-examination, at close intervals, of the need for it to intervene in the [gas] sector and the manner of its doing so, having regard to the development of that sector.”²⁷

The essential message from the Court of Justice’s interpretation of Article 3 of the liberalisation Directives in relation to price regulation is that the Contracting Parties could use this Public Service Obligation to protect their undertakings (irrespective of their size, but nevertheless reflecting the difference in protection of the households and the companies) only in exceptional and clearly defined circumstances²⁸ with a temporary measure related to regulation of price component influenced by the specific circumstances, and not across-the-board regulation of the final end-users’ price, complying at all the times with the conditions stipulated in Article 3(2) and with the proportionality principle.²⁹

b) State aid rules

In accordance with Article 18(1)c) and Annex III of the Energy Community Treaty, the Contracting Parties are also under obligation to comply with the EU State aid rules by considering “incompatible any public aid which distorts or threatens to distort competition by favouring certain undertakings or energy resources insofar the aid may affect trade of energy between the Contracting Parties.”

It is important to underline that price regulation might involve State aid with the potential of affecting trade of electricity between the Contracting Parties.³⁰ If an undertaking is supplied with electricity at low regulated prices (i.e. below market prices), an advantage would be conferred on the recipient of the electricity as compared to other market participants in the Energy Community. If the public supplier and/or generator are State-owned (as is the case in most Contracting Parties), the aid is provided from state resources as the State-owned companies are foregoing potential profit. The loss for supplying at low regulated prices incurred by the (usually public) supplier and/or the (usually incumbent State-owned) generator may be further need to be covered from the State budget in the form of additional State aid to the electricity supplier and/or generator in question.

The Commission has initiated several cases against EU Member States investigating whether the low regulated prices for large companies constitute State aid, and if so, whether they could be justified on the basis of, inter alia, Article 3(4) of Directive 2003/54/EC requiring that “*any financial compensation*

²³ Para.37 *Federutility* case.

²⁴ Para.38 *Federutility* case.

²⁵ Para.42-43 *Federutility* case

²⁶ Para.35 *Federutility* case

²⁷ Para.35 *Federutility* case

²⁸ Immediate risk of security of supply, urgent necessity to protect the customers from price shocks due to reasons that are out of the influence of the national authorities.

²⁹ Para.36 *Federutility* case

³⁰ A State Aid study commissioned by the Secretariat has also identified low regulated end-user electricity prices in the Contracting Parties as an issue that raises State aid concerns. See: State Aid Rules and Effectiveness of State Aid Control in the Electricity Sector under the Energy Community Treaty, Final Report, 8 April 2011

or exclusive right granted to the company in charge of providing the Public Service Obligation has to be assigned in a non discriminatory and transparent manner.”

The French and the Spanish case are particularly relevant and instructive in this respect, as they represent examples of what type of conflicts with State aid rules might be faced by the Contracting Parties by maintaining in force low regulated electricity prices for all customers' categories. In France, regulated tariffs for end-users applicable to both companies and household customers existed. In view of the fact that the regulated tariffs for large and medium-sized undertakings were likely to favour these undertakings *vis-à-vis* their competitors, the Commission argued that these regulated tariffs constituted State aid incompatible with the common market.³¹

The Commission also challenged a system introduced in France in 2007 to allow customers that opted for the liberalised electricity market to benefit once again from a “returned tariff” fixed by State for a period of two years.³² The system was financed by two levies, one payable by all French electricity consumers, and the other payable by the large producers of electricity (i.e. mainly paid by EDF). The return tariff, even though higher than the regulated tariffs, was lower than the prices that customers could negotiate with suppliers in the liberalised market.

The French scheme created an obstacle to the liberalisation of the French electricity market,³³ and in 2009, the Commission concluded that it is a State aid scheme.³⁴ Following the opening of formal investigation by the Commission, in September 2009 the French authorities offered commitments aimed at eliminating the regulated electricity tariffs for large and medium size enterprises.³⁵

Similarly to the case of France, in 2007 the European Commission opened investigations to examine the potential State aid received by large and medium-sized companies in Spain in the form of artificially low regulated electricity prices. The regulated tariffs led in 2005 to a deficit of €3.8 billion in the Spanish electricity system which would be financed by a new charge paid by all Spanish consumers in their electricity bill over the following 14 years.³⁶ In 2009, the Commission concluded that the regulated tariffs that led to the debt were financed at least in part through State resources, that they provided a selective advantage to certain professional consumers and that they affected trade between Member States.³⁷ The Commission analysed whether the aid could be justified under Directive 2003/54/EC. Article 3 of the Directive includes provisions to guarantee the universal service of electricity. However, in this case, the Commission excluded that the regulated tariffs could be justified as for providing a services of general economic interest due to the fact that it was applicable to large and medium size companies, rather than small enterprises.

c) Infringement Proceedings Against EU Member States

The Commission sees intervention in gas (and electricity) pricing as “*one of the causes and one of the effects of the current lack of competition in the energy sector*”.³⁸ Therefore, the Commission has initiated infringement proceedings in order to verify whether the regulated prices in place in most of the Member States are in line with EU law. The assessments by the Commission were related to medium and large business as well as the energy intensive industries. They do not cover regulated prices for household customers of the EU Member States. As clarified by the Court of Justice in the *Federutility*

³¹ European Commission, State aid: Commission opens investigation into regulated electricity tariffs in France. IP/07/815, 13 June 2007, Brussels

³³ European Commission, State aid: Commission extends investigation into regulated electricity tariffs in France, IP/09/376, 10 March 2009, Brussels

³⁴ In practice, it benefited a limited number of companies; it was attributable to the State and was financed, at least in part, by of State resources gathered from two compulsory levies. See: European Commission, Decision: State Aid C 17/07 (ex NN 19/07) Regulated electricity tariffs in France — Extension of the procedure; Invitation to submit comments pursuant to Article 88(2) of the EC Treaty, OJ C 96/18, 25 April 2009

³⁵ European Commission, Commissioners welcome French reform proposal for national electricity market, MEMO/09/394, 15 September 2009, Brussels

³⁶ European Commission, Decision: State Aid C 3/07 (ex NN 66/06) Regulated electricity tariffs in Spain — Invitation to submit comments pursuant to Article 88(2) of the EC Treaty, OJ C 43/9, 27 February 2007

³⁷ *Ibid.*

³⁸ Para.30 AG Colomer Opinion, *Federutility* case.

case, the regulated prices for large business consumers could not easily be justified as a Public Service Obligation. Therefore, the Commission has started to take actions against the EU Member States that maintained regulated prices for that category, verifying whether the regulated prices are in line with the electricity *acquis*. In cases where the prices are regulated at a level lower than the market price, State aid investigations are initiated, verifying whether the measure amounts to an aid granted by the State and if so, whether it could be justified.³⁹

Already in April 2006 there was a wave of infringement proceedings initiated against the Member States by sending 28 letters of formal notice to 17 Member States,⁴⁰ followed by reasoned opinions to 16 Member States including some new Member States from Central and Eastern Europe.⁴¹ Among the main problems was the existence of regulated energy prices.⁴² The Commission found out that in several Member States⁴³ the regulated tariffs applied to every category of customers and that they were too low as to allow for new market entries, disincentive new investments and prevent energy demand to adapt to prices increases. In other countries⁴⁴ the infringement related rather to the fact that the right to supply at a regulated price was granted on a discriminatory basis. Finally, for several Member States⁴⁵ the European Commission was aware of the existence of regulated tariffs but it did not gather sufficient proof to show that the latter prevented market opening to start proceedings on this basis. Therefore, the Commission asked these countries for additional information concerning their systems of prices control. The Commission's investigations ended in 2008, when the Commission decided to start infringement actions in relation to the maintenance of regulated end-users' prices before the Court of Justice *vis-a-vis* those Member States which had not brought their electricity and gas legislation into compliance with the EU directives.⁴⁶

In June 2009 the European Commission started new investigations for 25 out of 27 Member States for maintaining a system of regulated prices, especially for large customers, which created obstacles to new market entrants.⁴⁷ Following the investigations, the Commission sent letters of formal notice to Greece, Poland,⁴⁸ Portugal, Romania and Lithuania concerning regulated prices.⁴⁹ In particular, in Portugal the regulated prices were available to all eligible customers without any provision linking the level of regulated prices to that prevailing in the market, nor were they transparent or targeted to vulnerable customers.⁵⁰ In addition, the obligation to supply at regulated prices fell to a designated company whose selection had not been the subject of a tendering procedure. In Romania, the National Regulatory Authority approved end-user regulated prices for electricity and gas for non-

³⁹ See Part 3.3 above in relation to State aid cases initiated by the Commission against the EU Member States.

⁴⁰ See: European Commission, Infringement procedures opened in the gas and electricity market sector, by Member State, MEMO/06/152, Brussels, 04.04.2006 and European Commission, The Commission takes action against Member States which have not opened up their energy markets properly, IP/06/430, Brussels, 04.04.2006.

⁴¹ Member States concerned were: Germany, Austria, Belgium, the Czech Republic, Estonia, Spain, France, Greece, Ireland, Italy, Lithuania, Latvia, Poland, Sweden, Slovakia and the United Kingdom. Moreover, letters of formal notice were also sent to Portugal and Hungary on 4 July and 18 October. European Commission, 2006, IP/06/1768

⁴² *"Electricity and gas prices do not reflect costs leading therefore to underinvestment and future supply crunches. Regulators have, on occasion, been put in a position where their decisions clearly go against the objective of creating a single internal market for electricity and gas, usually due to direct or indirect influence from national governments. The clearest, although not the only, example of this is inappropriate regulated supply tariffs"*, European Commission, 2006, IP/06/1768, *supra*.

⁴³ Spain, France, Estonia and Latvia

⁴⁴ Italy and Ireland

⁴⁵ Czech Republic, Germany, Poland, Slovakia, Lithuania and Italy for gas

⁴⁶ European Commission, Commission brings actions before Court of Justice against several Member States for incorrect transposition of Electricity and Gas Directives, IP/08/855, 05.06.2008, Brussels. The Member States concerned were Belgium, Poland, Sweden, Greece and Hungary.

⁴⁷ European Commission, Commission acts to ensure effective and competitive energy market across Europe, IP/09/1035, 25 June 2009, Brussels

⁴⁸ The Commission found out that the Polish gas wholesale price was subject to regulatory approval and this had the effect of freezing the price competition on the Polish gas wholesale market. Although non-household customers theoretically could opt for the open market, in practice they were unlikely to switch suppliers due to the lack of choice of suppliers and lack of competition in the retail supply market. See: European Commission, Energy infringements. Country fact sheets - Poland, MEMO/09/296, 25.06.2009, Brussels

⁴⁹ European Commission, Energy infringements. Country fact sheets - Poland

⁵⁰ European Commission, Energy infringements. Country fact sheets - Portugal

household customers, including the largest energy customers in the country.⁵¹ The European Commission had not received from Romania any notification of the application of a Public Service Obligation measure to preserve regulated prices for non-household customers in the country. The case of Lithuania was similar to that one of Romania,⁵² i.e. the National Regulatory Authority approved regulated tariffs for non-household customers, but Lithuania did not notify any Public Service Obligation to the European Commission.

The situation in the EU Member States against which the European Commission took action resembles the situation in the Contracting Parties, as will be demonstrated in the following Section.

4. Regulated Electricity Prices in the Contracting Parties of the Energy Community

The size of the national markets of the Contracting Parties of the Energy Community varies greatly, but most of the markets are small both in terms of generation and electricity consumption.⁵³ In the total consumption, households have a very large share (the region's average for 2008 was around 47%).⁵⁴ This, among other reasons, is due to the lack of alternative energy sources and the use of electricity for heating, cooking and other household needs. In addition, the energy intensive economy of the countries, which have a high share of the industry in the GDP and high energy intensity of the industry itself, add to the already high demand. With the development of the countries' economy, the demand for electricity is expected to grow even further.

Moreover, the region is dependent on imported electricity; Bosnia and Herzegovina is at times the only Contracting Party that exports electricity. In most of the countries there is one dominant, state-owned generator. Since the national markets are small, the possibility for introducing competition at generation level is limited. The existence of complementary energy sources and the small size of the national markets are some of the basic indicators that show the necessity of opening the national electricity markets and further regional integration. Moreover, one integrated company also dominates distribution and supply in most of the Contracting Parties. That dominant supplier has kept a large share of sticky customers (tariff as well as eligible) that have not been incentivised to switch to another supplier even after the formal market opening. The reason for this is that the incumbent generator is in charge of offering its (entire) generated portfolio to the (public) supplier for satisfying the needs of the tariff customers at regulated prices. Since tariff customers are very widely defined in all Contracting Parties, the regulated sector in all of them comprises a great portion of the total consumption.

4.1. Price Regulation in the Contracting Parties: Legislative Analysis

4.1.1. Albania

a) Eligibility

The Power Sector Law defines eligible customers as customers that have the right to choose the electric supplier for the electricity he uses for his own needs,⁵⁵ and tariff customers as customers supplied by the public supplier with regulated prices and tariffs.⁵⁶

Under Article 48 of the 2003 Power Sector Law, within the month of January each year, the Albanian regulatory authority ("Energy Regulatory Entity", ERE) establishes and publishes the level of annual consumption as well as other requirements for a customer to get the status of eligible customer. ERE approved a specific Regulation on Criteria for Granting and Revoking the Status of Eligible

⁵¹ European Commission, Energy infringements. Country fact sheets - Romania

⁵² European Commission, Energy infringements. Country fact sheets – Lithuania

⁵³ Wholesale Market Opening Study, p.48

⁵⁴ Energy Community Secretariat, Annual Report, May 2009, p.16

⁵⁵ Article 3(32) Power Sector Law No. 9072, dated 22.5.2003, as amended: No. 9512 of 10.4.2006; No. 9226, of 16.10.2006; No. 9750 of 4.6.2007; No. 9776 of 12.7.2007; No. 9776 of 12.7.2007; No. 9913 of 5.5.200; Nr. 9997 of 22.9.2008; No. 10 196 of 10.12.2009; No. 10362, of 16.12.2010 (hereinafter, Albanian Power Sector Law)

⁵⁶ Article 3(33) Albanian Power Sector Law

Customer.⁵⁷ After receiving the status, the eligible customer *has the right* to sign electricity supply contracts with any local or foreign qualified supplier, licensed by ERE. The contract shall be in conformity with electricity market rules approved by ERE.

Under Article 4 of the Regulation on Criteria for Granting and Revoking the Status of Eligible Customer the status of eligible customer *may be acquired* by customers that have consumed during the previous year an amount of electricity equal or larger than the consumption threshold approved by ERE. Customers *may decide* to go back to the regulated tariff system, for which they shall notify ERE at least 2 months in advance. Based on the amendments to the Power Sector Law dated 10 April 2006,⁵⁸ it is a *duty of ERE to consider and to grant eligibility* status to customers after defining an electricity consumption threshold. By the end of 2006, the eligibility threshold was set at 100 GWh/year that has been fulfilled by two consumers.⁵⁹ At the beginning of 2007 the eligibility threshold was set at 10 GWh/year (10 million kWh), which has been fulfilled by 15 consumers. Consumption thresholds of this kind violate Article 21 of Directive 2003/54/EC. Reportedly, as from 2008 all non-households are free to switch supplier and there are no restrictions on who may apply for a supplier license.⁶⁰

In 2011, the Power Sector Law in Albania was further amended.⁶¹ All customers connected to high voltage grid as well as those with a consumption over 50 million kWh/year (50 GWh) are automatically considered eligible customers, and are supplied under market conditions. All other non-household customers may become eligible, upon request to and approval by ERE.

b) Price Regulation

ERE sets the tariffs for regulated activities in the electricity sector based on the Power Sector Law,⁶² and the secondary legislation based on this law. According to the Power Sector Law, supply of tariff customers shall be carried out by the retail public supplier under regulated tariffs, which shall in turn purchase electricity from the wholesale public supplier, whereas the supply of eligible customers shall be carried out by Qualified Suppliers under terms and conditions of bilateral contracts.⁶³

In June 2008, ERE adopted tariff methodologies for: publicly owned generation,⁶⁴ electricity transmission, electricity distribution system operator,⁶⁵ wholesale public supplier⁶⁶ and retail sales to regulated tariff customers.⁶⁷ ERE approves also the electricity supply agreement between the wholesale public supplier and retail public supplier.⁶⁸ According to that agreement, the wholesale public supplier has the obligation to provide all electric energy requested by the retail public supplier, as well as ancillary and other transmission services against a price paid by the retail public supplier as approved by ERE. If its generation portfolio is not sufficient for satisfying the needs of the tariff

⁵⁷ Available at ERE's website, without reference number and date of adoption

⁵⁸ Article 48 Albanian Power Sector Law

⁵⁹ CARDS Project 2005, Facilitating and Implementing the Energy Community in South East Europe: Quarterly Progress Report (January - March 2007), July 2007, p.90.

⁶⁰ IPA Energy and Water Economics, Study on Tariff Methodologies and Impact on Prices and Energy Consumption Patterns in the Energy Community: Report to the Energy Community, March 2009, as updated by the ECRB, Electricity Prices and Tariffs in the Energy Community 2008–2009, p.15. However, the decision from 2008 has never been made available to the Secretariat.

⁶¹ Power Sector Law as amended by Law, No. 10485, dated 26.11.2011

⁶² Article 8(2)b) and Article 26(1) in particular Articles 26-28, Albanian Power Sector Law.

⁶³ Article 45 Albanian Power Sector Law

⁶⁴ ERE, Publicly-owned generation tariff calculation methodology, Nr.77, 26 June 2008

⁶⁵ ERE, Electricity distribution system operator tariff calculation methodology, Nr. 79, 26 June 2008

⁶⁶ ERE, wholesale public supplier tariff calculation methodology, Nr.78, 26 June 2008

The price cap method is used for calculation of the tariffs for the wholesale public supplier and the first regulatory period was the year 2009. Paras. 3.1. and 3.2. respectively. See: ERE, wholesale public supplier tariff methodology, 2008, *supra*

⁶⁷ ERE, Retail sales to regulated tariff customers tariff calculation methodology, Nr.80, 26 June 2008.

⁶⁸ The Contract about Electricity Supply between wholesale public supplier and retail public supplier, as Approved with the Decision of Board of Commissioners, No 72, date 24 June 2008, available on the ERE website: http://www.ere.gov.al/doc1/Albanian_Draft_Contract_WPS_-_RPS.pdf (05.02.2012)

customers, the wholesale public supplier shall “purchase electricity from public generation, Independent Power Producers, Small Power Producers and traders.”⁶⁹

On the basis of the tariff methodologies, ERE adopts tariffs for public wholesale supply, transmission, distribution and electricity wholesale and retail prices for tariff customers. In the retail prices for tariff customers approved by ERE for 2011, ERE regulated the end user prices for all categories of customers, i.e. customers connected at high voltage (transmission and Customers supplied at distribution 110 kV), medium voltage (Customers supplied at 35, 20, 10 and 6 kV) and low voltage (industry, commercial customers and households). In December 2011 the new tariffs for the third regulatory period 2012-2014 were adopted.⁷⁰ The average price is 9,53 leke/kWh as in the 2010 and 2011 regulatory periods.

The decisions for setting the end-users’ prices for the third regulatory period 2012-2014 reflected the amendments of the Power Sector Law from 2011. The difference with the regulatory period 2011 is that ERE does not regulate anymore the end-users’ prices of electricity for the customers connected at high voltage or those with consumption of more than 50 million kWh per year. Nevertheless, ERE still regulates the end-user electricity price for customers connected at medium and low voltage, which includes industry and commercial customers in addition to the households.

4.1.2. *Bosnia and Herzegovina*

In Bosnia and Herzegovina, the conditions for obtaining the eligibility status defined in the Decision on market opening⁷¹ adopted by the State Electricity Regulatory Commission (SERC) in addition to the criteria set by the Regulatory Commission for Electricity in Federation of Bosnia and Herzegovina (FERC),⁷² Regulatory Commission for Energy of Republika Srpska (RERS)⁷³ and the competent body of Brčko District, have to be fulfilled.

The state Law on Transmission of Electric Power, Regulator and System Operator of Bosnia and Herzegovina defines the term customers as “distribution companies and end-use customers directly connected to the transmission grid,” and system users as “any natural or legal person supplying, or being supplied by, a transmission or distribution system.”⁷⁴ Moreover, in its decision, SERC prescribed that “the eligible customer shall be the customer that fulfils the conditions and criteria prescribed by special acts of the competent electricity regulatory commission and that is free to purchase electricity at the market from supplier at its own choice.”⁷⁵ According to Article 8 of the Law on Transmission, Regulator and System Operator of Bosnia and Herzegovina, the electricity market shall be opened in accordance with laws and regulations defining the scope, conditions and time schedule of the market opening.

SERC is in charge to regulate and approve tariffs for transmission, ancillary services and ISO operations, whereas the regulatory authorities of the entities are in charge with defining methodologies and setting prices for supply of tariff customers.

I. Federation of Bosnia and Herzegovina

a) Eligibility

The Law on Electricity of Federation of Bosnia and Herzegovina defines the terms eligible buyer as “any buyer that annually consumes more electric power than the amount determined by the special criteria of the Regulatory Commission and is allowed to purchase electric power in its discretion.” A non-eligible buyer is a “buyer who is supplied electric power in a regulated manner and at regulated

⁶⁹ Article 46(1)a) Albanian Power Sector Law

⁷⁰ ERE, Decisions no. 145, 146, 147 and 148, 7 December 2011

⁷¹ SERC, Decision on scope, conditions and time schedule of electricity market opening in Bosnia and Herzegovina, No.04-02-252-19/05, 8 June 2006, amended with a Decision No. No: 04-02-147-12/09, 23.9.2009.

⁷² FERC, Rule on obtaining eligible customer status, No. 04-07-707-04/06, 8.9.2006

⁷³ RERS, Rulebook on getting a status of eligible customer, No. 01/450/06, 6.9.2006

⁷⁴ Article 2 Law on Transmission of Electric Power, Regulator and System Operator of Bosnia and Herzegovina

⁷⁵ Article 2(4) SERC, Decision on market opening, 2009

prices (tariffs).⁷⁶ Article 8 of the Law on Electricity in the Federation of Bosnia and Herzegovina stipulates that “gradual introduction and development of the electricity market up to its full liberalization shall be implemented pursuant to the energy policy and the reform of the energy sector, as well as the implementation of regulations, including the regulations on organization of the electricity market.” The FERC Rulebook on eligible customer defines that eligible customer “shall mean electricity customer that has obtained the right to purchase electricity on its own choice, after fulfilment of the conditions prescribed within its rule on eligible customers.” It also adds that the customer may have the status of eligible customer and may chose not to exercise the right to choose the supplier.⁷⁷

In 2006, FERC adopted a Rulebook on acquiring the status of eligible customer,⁷⁸ Article 3 of which defines the dynamics of electricity market opening. The opening of the market was planned in three phases. In the first phase, all customers with consumption over 10 GWh connected to the transmission network became eligible as from 1 January 2007. In the second phase, as from 1 January 2008, all customers except the households became eligible. Finally, the third phase is expected to take place as from 1 January 2015 from when all customers (including household customers) shall become eligible. With the amendments of the Rulebook on acquiring the status of eligible customer from 2011, the obligation for applying and being granted with eligibility status by FERC has been abolished. The amendments stipulate that all customers except households have become eligible, and the household customers shall become eligible as from 1 January 2015.⁷⁹

In a temporary period until 31 May 2012,⁸⁰ eligible customers are allowed, for security of supply reasons, to select a reserve supplier with whom they could contract electricity supply in case their selected supplier terminates the supply of electricity. The reserve supplier could supply the eligible customers for a period not longer than 30 days at prices reflecting the full costs for supply.⁸¹ By the end of the temporary period, FERC shall develop rules for supply by a reserve supplier.

b) Price Regulation

Based on the Law on Electricity of Federation of Bosnia and Herzegovina, FERC is tasked to define the methodology and criteria for setting prices of electric power supply to non-eligible buyers.⁸² FERC has adopted a Rulebook on tariff methodologies and tariff proceedings in July 2005,⁸³ which was amended in 2010.⁸⁴ In these Rules, FERC prescribes the methodology for tariff determination with respect to the activities of generation, distribution and supply of electricity. It also determines tariffs for distribution system users and non-eligible customers.⁸⁵ The methodology is based on the

⁷⁶ Article 3, Law on Electricity of Federation of Bosnia and Herzegovina, Official Gazette Federation of Bosnia and Herzegovina 41/02, 24/05, 38/05 and 61/09

⁷⁷ FERC, General conditions for electricity supply, No: 01-07-583-02/08 23.5.2008, as amended

⁷⁸ Rulebook on acquiring the status of eligible customer, No: 04-07-707-04/06, 08.09.2006, adopted by FERC's decision No. 04-07-707-03/06 of the same date and amended No. 04-07-1280-04/11, 14.12.2011

⁷⁹ Article 3 amendments to the Rulebook on acquiring the status of eligible customer, No. 04-07-1280-04/11, 14.12.2011

⁸⁰ Article 3 amendments to the Rulebook on acquiring the status of eligible customer, No. 04-07-1280-04/11, 14.12.2011 that amended the previously established temporary period until 1 January 2012.

⁸¹ The customers connected at low voltage of 0,4 kV, could be supplied by the reserve supplier also for longer period than 30 days, at prices established by FERC.

⁸² Article 14, Law on Electricity of Federation of Bosnia and Herzegovina

⁸³ FERC, Rulebook on tariff methodologies and tariff proceedings, No. 07- 07- 471 - 02/05, 8 July 2005

⁸⁴ FERC Rulebook on amendments of the Rulebook on tariff methodologies and tariff proceedings, No. 01-07-1436-06/10, 4 November 2010.

⁸⁵ Tariff methodology is to establish tariffs that are: a) reasonable, non-discriminatory, based on objective criteria, and determined in a transparent manner; b) cost-based, including justified operational costs, costs of maintenance, replacement, construction and reconstruction of facilities, depreciation costs, taxes, taking into account the approved return rate for investments made, and taking care of environmental protection and protection of customers; c) established in a way to eliminate cross-subsidies between different activities and different customer classes; d) based on usual international practices; e) simple and understandable; and f) established to provide the power companies with an adequate flow of revenues which will provide them with the opportunity to earn an approved return if they operate their business in a proper manner. Article 5 FERC, Rulebook on tariff methodologies and tariff proceedings, 2005, *supra*

determination of the revenue requirement in generation for each generating unit, and in distribution and supply for each distribution and supplier individually, which are in turn based on justified costs.⁸⁶

On the basis of the tariff methodology, in 2010 FERC adopted a Decision on tariffs for sales of electricity to non-eligible (tariff) customers of Elektroprivreda Hrvatske zajednice Herceg Bosne, Mostar (EPHZHB).⁸⁷ FERC has also adopted Decision on tariffs for sales of electricity to non-eligible (tariff) customers of Elektroprivreda Bosne i Hercegovine, Sarajevo (EPBiH) in 2011.⁸⁸ Both decisions cover the customers' categories connected to high, medium and low voltage level, thus including industry and large companies.

II. Republika Srpska (RS)

a) Eligibility

The Law on Energy of Republika Srpska⁸⁹ defines the terms non-eligible tariff customer (a customer that buys energy for its own needs at regulated prices pursuant to the tariff system) and eligible customer (an end user which got the right to buy energy by its own choice pursuant to regulations which define the power market) referring to all types of energy. The Law on Electricity of Republika Srpska on the other hand defines the terms eligible customers as being customers connected to the transmission or distribution network and allowed to purchase electricity in its own discretion⁹⁰ and non-eligible customers, as end users supplied with electricity in a regulated manner and at regulated prices.⁹¹ Article 49 of the Law on Electricity in the Republika Srpska specifies the process of internal electricity market opening through the definition of the eligible customer status.

RERS adopted a new Rulebook on eligible customers in 2011, which defines the eligible customer as a "customer of electricity that got the right to buy electricity at its own choice," and non-eligible (tariff) customer as an "end user of electricity that buys electricity in a regulated way and at regulated prices and that did not get the right to buy electricity at its own choice."⁹² Article 4 of the Rulebook on eligible customers defines the phases of market opening in Republika Srpska. In the first phase, as of 1 January 2007, all customers with annual consumption of electricity is more than 10 GWh, were entitled to choose supplier. This right was given to all customers except households as from 1 January 2008. Finally, as of 1 January 2015, all customers, including the households will become eligible.

The Rulebook defines small customers as of 1 January 2012 to be the "small industrial and commercial customers, which structures are connected to the distribution system of electricity at the voltage of less than 1 kV and that have less than 50 employees and whose total annual turnover does not exceed 10 million EUR in the BAM counter-value." The public supplier is considered to be a

⁸⁶ Article 8(1)(2) FERC, Rulebook on tariff methodologies and tariff proceedings, 2005, *supra*. The revenue requirement for the performance of regulated activity is established based on: a) the costs of operation and maintenance, including depreciation costs; b) return on assets; and c) taxes and other duties. See: Article 13(1) FERC, Rulebook on tariff methodologies and tariff proceedings, 2005, *supra*

⁸⁷ This decision determines the "tariff rates for non-eligible (tariff) customers by categories and groups of consumption, depending on costs of generation, procurement (including settlement), distribution and supply of electricity, and costs of transmission and ISO operation including covering secondary and tertiary regulation that these categories create with their manner and time of usage of electricity, taking into account the principle of gradualism in changes." Article 2 FERC, Decision on tariffs for sales of electricity to non-eligible (tariff) customers of EPHZHB, No: 07-07-306-82/10/11, 27 June 2011, Mostar

In addition, FERC adopted a Decision on tariffs for users of distribution system of EPHZHB, No. 07-07-306-81/10/11, 27 June 2011, Mostar. This decision states that "tariff rates for users of distribution system are applied for billing and invoicing of service for using distribution and transmission grid to eligible customers whose facilities are connected on distribution grid for covering the costs of using distribution and transmission grid, operation of ISO, including costs of secondary and tertiary regulation services and over-accepted reactive energy."

⁸⁸ Decision on tariffs for sales of electricity to non-eligible (tariff) customers of EPBiH e, Sarajevo, No. 07-07-306-82/10/11, 27.06.2011

In addition, FERC adopted a Decision on tariffs for users of distribution system of EPBiH, No. 07-07-306-81/10/11, 27.06.2011.

⁸⁹ Article 3(x)(y)(z) Law on Energy of Republika Srpska

⁹⁰ Article 48 and 49 Law on electricity of RS, defines the eligibility threshold at 10GW.

⁹¹ Article 3 Law on electricity of Republika Srpska.

⁹² Article 3, RERS, Rulebook on Eligible Customer, Official Journal of Republika Srpska, No. 131/11

supplier of last resort, and it shall be allowed to supply “those eligible customers that did not choose or are left without the supplier of eligible customer.”

b) Price Regulation

According to the Law on Electricity of Republika Srpska, RERS is in charge of adopting the methodology and criteria for determination of the price for using distribution network and electricity price for supply of non-eligible customers as well as fee for connection to the distribution network; the tariff system for sale of electricity and use of the distribution network; the tariff rates for distribution system users and tariff rates for non-eligible customers.⁹³ RERS has adopted the Rule on tariff methodology and tariff proceeding in 2005⁹⁴ and the Rule on methodology for determination of the fee for connection to the distribution network.⁹⁵ In 2007, for the first time, and then again in 2009, RERS adopted a Decision on tariff rates for non-eligible customers of electricity in Republika Srpska.⁹⁶

The Rulebook on eligible customers from 2011 defines the method of supplying eligible customers at the electricity market after the market opening. The Rulebook establishes a transitional period until 1 July 2012, in which the eligible customers may benefit from supply by the Public supplier at regulated end-users' prices, if they decide to be supplied as tariff customers, and it also sets the rules for supplying eligible and non-eligible customers until 2015 and thereafter.

The general rule is that only the tariff customers buy electricity from the licensee for supply of tariff customers at tariffs as determined by Decision on the tariff rates for non-eligible customers of electricity in RS adopted by RERS.⁹⁷ However, in the transitional period, the eligible customers may decide to be supplied as tariff customers under the same tariffs as non-eligible (tariff) customers.⁹⁸ Moreover, if the eligible customers, including small customers,⁹⁹ until 31 May 2012,¹⁰⁰ do not submit a notice to RERS that they have chosen a supplier of eligible customers from whom they will buy electricity as from 1 July 2012, it is considered that they have chosen to remain to be supplied by the public supplier (supplier of last resort) until 1 January 2015.¹⁰¹ After 1 January 2015, the households and small customers that do not select a supplier for eligible customers may continue to be supplied by the public supplier without time limit, under economically justified, user-friendly and transparent prices”.¹⁰²

In 2009, RERS adopted a Decision for determining the prices for supply of electricity to non-eligible customers.¹⁰³ With that decision, RERS regulates the end-users' prices of all customers' categories

⁹³ Article 23(1), Law on Energy of RS, No.01-794/09, 14.5.2009 as amended in December 2011 (amendments published in Official Journal No.01/11)

⁹⁴ RERS, Rule on tariff methodology and tariff proceeding in 2005, No: R-15-676-36/05, 4 June 2005, Official Gazette of Republika Srpska, No. 61/05

⁹⁵ RERS, Rule on methodology for determination of the fee for connection to the distribution network, Official Gazette of Republika Srpska, No. 123/08

⁹⁶ This decision determines the revenues for the supply activity covering the costs for supply of electricity, procuring electricity as well as for using the transmission and distribution network and allocating them to the different categories of the customers. RERS, Decision on tariff rates for non-eligible customers of electricity in Republika Srpska, No. 01-966-27/09, 30 December 2009.

In addition, RERS adopted a Decision on the determination of tariff rates for distribution system users in Republika Srpska, No. R-01-966-26/09, 30 December 2009. This decision covers the acknowledged costs for determining the revenue of the electricity distribution companies in the Republika Srpska, covering costs such as distribution losses (acknowledged technical losses, as well as non-technical losses up to 10% of the acknowledged technical losses), allocation of assets (between distribution and supply activities which are not unbundled), depreciation and return of capital.

⁹⁷ Article 5 Decision on the tariff rates for non-eligible customers of electricity in RS adopted by RERS

⁹⁸ Article 6(1) RERS, Rulebook on Eligible Customer, Official Journal of Republika Srpska, No. 131/11

⁹⁹ Article 6(3) RERS, Rulebook on Eligible Customer, Official Journal of Republika Srpska, No. 131/11

¹⁰⁰ Article 17(2) Decision on the tariff rates for non-eligible customers of electricity in RS adopted by RERS

¹⁰¹ Article 6(2) RERS, Rulebook on Eligible Customer, Official Journal of Republika Srpska, No. 131/11

¹⁰² Article 7(2) Decision on the tariff rates for non-eligible customers of electricity in RS adopted by RERS

¹⁰³ RERS, Decision for determining the prices for supply of electricity to non-eligible customers, No.01-966-27/09, 30.12.2009

connected to high, medium and low voltage level, thus including industry and large companies, as supplied by the five licensed suppliers of tariff customers.¹⁰⁴

4.1.3. Croatia

a) Eligibility

The electricity market is fully open and all customers, including households, are considered eligible as of 1 July 2008. Practical implementation of eligibility took place in phases.¹⁰⁵

According to the amendments of the law from 2008, customers *have an obligation* to choose a supplier in 6 months after they obtain eligibility status, except if the eligible customer is a household or a small customer that does not wish to exercise its eligibility right, or is not able to find a supplier, in which case they may be supplied by the supplier for tariff customers.¹⁰⁶ Being *obliged* by the amendments of the law, eligible customers are in fact exercising their right of eligibility by buying electricity from the only supplier active on the market – HEP Osceba. According to HERA's Annual Report, in 2009, all customers using high voltage and a considerable number of customers using medium voltage concluded contracts on supply i.e. they used their eligibility status.¹⁰⁷ Public supply services are performed by the DSO - HEP ODS and are available under regulated and published tariffs.

With the amendments to the Electricity Market Act from 2011,¹⁰⁸ the Croatian Energy Regulatory Agency (HERA), was allowed to grant a company established outside of the territory of Croatia a status of "temporary customer" which can be supplied with electricity under the same conditions as Croatian customers by suppliers licensed in Croatia. The Government of Croatia will decide whether there is a public interest or not, a condition for HERA to grant the foreign company status of a temporary customer, and afterwards to regulate the conditions of the contract for supply of electricity to that specific temporary customer including the electricity price.

b) Price Regulation

The tariff methodologies are adopted by HERA, after an opinion of the undertaking to which the tariff system applies and the Ministry. The calculation of tariffs in accordance with the tariff methodology is a responsibility of the energy companies. The Government is responsible for approval of the tariff amount.¹⁰⁹ HERA is responsible for supervising the application of all tariff systems.¹¹⁰

In accordance with Article 28 Energy Act of 2001 and its amendments of 2004, the National Regulatory Authority passed four tariff methodologies on 19 December 2006, which is the basis for the calculation and determination of the retail tariffs. These methodologies were implemented for the first time in 2008, and the amounts of tariff items were set.¹¹¹ In 2010, these methodologies were amended and currently the following tariff methodologies (without the amount of tariff items) are in place:

¹⁰⁴ The five suppliers of tariff customers in Republika Srpska are: "Electro Doboj" AD Doboj, "Electro-Bijeljina" AD Bijeljina, "Electrokrajina" AD Banjaluka, "Electrodistribucija" AD Pale and "Electro-Herzegovina" AD Trebinje

¹⁰⁵ Article 31(2) Croatian Electricity Market Act, 2004 provided that firstly, all customers with annual consumption above 20 GWh and all customers directly connected to the transmission system were to obtain the status of eligible customers, while the dynamics of the further opening of the electricity market were to be as follows: as from 1.7.2006 for customers with consumption exceeding 9 GWh; from 1.7.2007 for entrepreneurs and from 1.7.2008 for all customers.

¹⁰⁶ See: Article 10 amendments of the Croatian Electricity Market Act 2008 and Articles 2(25), 45, 46, 47 (default supplier) General conditions for supply of electricity, 2006.

¹⁰⁷ HERA, Annual Report for 2009, p.46

¹⁰⁸ Law amending the Electricity Market Act, Official Journal of Republic of Croatia, No.14/11

¹⁰⁹ Article 28 Croatian Energy Act 2001 and Article 19 amendments of 2004

¹¹⁰ A proposal for the change in tariff item rates of the tariff systems may be submitted to the Ministry by the energy undertaking on whose services the tariff system is applied, or by the Agency. See: Article 12(3)(4) of the amendments in 2007

¹¹¹ HERA, Annual Report for 2008, p.11

generation of electricity (apart from electricity generation for eligible customers); transmission of electricity and distribution of electricity,¹¹² as well as tariff system for electricity supply, with the exception of eligible customers.¹¹³ HERA has not yet adopted any methodology for setting the end-users' prices to the so-called "temporary customers". On the basis of the adopted methodologies, on 12 June 2008 the Government adopted a Decision on the amount of the tariff items within the tariff systems for generation, transmission, distribution and supply with the exception of eligible customers.¹¹⁴ All prices are defined based on tariff items from the tariff systems for regulated electric power activities.

If they do not wish to use their eligibility status, the household customers and all customers who lose their supplier or whose supplier went out of business, have the right to be supplied by the tariff customers' suppliers. For non-households this right is for up to 30 days. If after 30 days they are not able to find a new supplier, they pay for the electricity supply at the balancing price determined by the Methodology of Providing Energy Balancing Services in the Electric Power System. According to that methodology, they pay the valid corresponding tariff item amounts from the tariff system for electricity generation for tariff customers, increased by 20%.

Besides the cases where eligible customers could be supplied under regulated tariffs for thirty days in case they do not choose supplier (but at tariffs higher than for the tariff customers), only the foreign customers with status of "temporary customer" (if any) would have the right to be supplied under prices regulated by HERA. The latter category might be even large or medium size companies. In any event, households and small and medium enterprises could benefit from regulated price of electricity.

4.1.4. former Yugoslav Republic of Macedonia

a) Eligibility

The Energy Law from 2011 defines eligible customers as customers that purchase energy from generators, suppliers or trades at their own preference, and small customers as "enterprises with less than 50 employees and total annual income or total assets less than 10 million EUR in MKD counter value, excluding the energy generators and transmission and distribution system operators."¹¹⁵

Article 82 of the Energy Law of 2011 stipulates that all electricity customers shall be deemed eligible, but all of them (except the customers connected to the high voltage grids that were already eligible according to the previous Energy Law) will in practice obtain the eligibility status when certain secondary legislation enters into force.¹¹⁶ Households shall be captive until 31 December 2014.¹¹⁷ The eligible customers shall sign an electricity supply contract. Article 82(5) authorizes the relevant system operator to discontinue delivery of electricity to consumers without electricity supply contracts signed, except to households and small consumers that shall be supplied by the electricity supplier of last resort.

The supplier of last resort is defined as an electricity supplier that provides a public service of electricity supply to households or small consumers in cases stipulated in the Energy Law,¹¹⁸ and detailed regulation of the procedure under which households or small consumers can obtain the right to be supplied by the electricity supplier of last resort.¹¹⁹ The supplier of last resort is under an

¹¹² Tariff system for electricity distribution, transmission and generation, without the amounts of tariff items, all published in Official Journal No.143/06 and 26/10.

¹¹³ Tariff system for electricity supply, with the exception of eligible customers, without the amounts of tariff items, Official Journal No.143/06, 26/10 and 34/10

¹¹⁴ Government of the Republic of Croatia, Decision on the amount of the tariff items within the tariff systems for electricity generation, with the exception of eligible customers, without the amount of tariff items; Tariff system for electricity transmission; Tariff system for electricity distribution, without the amounts of tariff items; and Tariff system for electricity supply with the exception of eligible customers, without the amount of tariff items, No.310-02/08-01/02, 12 June 2008

¹¹⁵ Article 3 Energy Law 2011

¹¹⁶ Article 197(1) Energy Law 2011

¹¹⁷ Article 197(1) Energy Law of 2011

¹¹⁸ Article 3 Energy Law of 2011

¹¹⁹ According to Article 28 of the Energy Law of 2011 ERC shall adopt the Rules on Electricity Supply of Last

obligation to purchase electricity to address the demand of households and small consumers that have decided to be supplied by it.¹²⁰ It shall have a contract with the generator that is in charge with a Public Service Obligation to provide electricity to address the demand of households and small consumers. The contract shall be approved by the Energy Regulatory Commission (ERC)¹²¹ and generation for these purposes is considered a regulated activity.¹²² The generator that has to provide public service is obliged first to satisfy the demand of the customers supplied by the supplier of last resort, and only afterwards it could sell excess electricity on the electricity market pursuant to the rules previously approved by ERC.¹²³ The supplier of last resort is only allowed to buy electricity on the open market (instead of buying from the regulated generator), provided that market terms and conditions and market prices are more favorable or the electricity generated from the generator with Public Service Obligation is not sufficient for meeting the needs of the households and the small customers supplied by the supplier of last resort.¹²⁴ In exceptional cases, if necessary for securing reliability of supply to households and small consumers, Article 80(7) of the Energy Law of 2011 provides a possibility ERC to put in charge another market participant with Public Service Obligation to purchase electricity for the households and small consumers for a temporary period determined in ERC's decision. ERC shall adopt such a decision upon request from the supplier of last resort, and upon provision of "evidence in support of [supplier of last resort] inability to purchase electricity in a manner in which it secures reliability of supply."¹²⁵ ERC has a task to revoke such decision as soon as it has determined that the reasons for its adoption do no longer exist.¹²⁶ In December 2011, based on Article 80(7) of the Energy Law of 2011, ERC approved a Decision for buying electricity for the needs of the tariff customers by which it tasked the incumbent generator to secure electricity necessary for satisfying the needs of the tariff customers in the country for the full 2012.¹²⁷ In practice, ERC's decision thus turns the exception into the rule.

In February 2011, ERC adopted the Rulebook for prices of electricity for tariff customers.¹²⁸ In June 2011 it adopted the Rulebook for conditions for supply of electricity to tariff customers.¹²⁹ These two Rulebooks define in more details the rights and the tasks of the generators in charge with providing Public Service Obligation, the supplier of last resort as well as the tariff customers.

b) Price Regulation

According to the Energy Law of 2011¹³⁰ ERC has the competence to adopt regulations and tariff systems and adopt or approve tariff-setting methodologies for regulated energy activities; adopt regulations, price-setting and tariff system methodologies on relevant energy type and/or energy fuel delivery to captive consumers and to adopt decisions on prices and tariffs, based on relevant regulations, methodologies and tariff systems.¹³¹ ERC also stipulates the manner of setting, approving and control of electricity end prices to be paid by consumers supplied by supplier of last resort.¹³² The tariff systems for electricity supplied by the supplier of last resort shall stipulate the price-setting method for electricity. The decisions on electricity prices and regulated service tariffs shall establish the prices of electricity, pursuant to the relevant price-setting regulations, which shall be adopted by ERC.¹³³

Resort for Households and Small Consumers

¹²⁰ Article 80(1) Energy Law of 2011

¹²¹ Article 66 Energy law of 2011

¹²² Article 4(4) Energy Law of 2011

¹²³ Article 66(7) and 66(8) Energy Law of 2011

¹²⁴ Article 80(4) Energy Law of 2011

¹²⁵ Article 80(7) Energy Law of 2011

¹²⁶ Article 80(8) Energy Law of 2011

¹²⁷ ERC, Decision for buying electricity for the needs of the tariff customers

¹²⁸ ERC, Rulebook for prices of electricity for tariff customers, 01-266/1, 21.02.2011, as amended No.01- 1616/1, 28.11.2011

¹²⁹ ERC, Rulebook for conditions for supply of electricity to tariff customers, No. 01 -825/1, 30.06.2011

¹³⁰ former Yugoslav Republic of Macedonia Energy Law, Official Gazette No.16/2011

¹³¹ Article 22(1) Energy Law of 2011

¹³² Article 24(2) Energy Law of 2011 and on the supplier of last resort please see Article 8 Energy Law of 2011.

¹³³ Article 26 Energy law of 2011

In June 2011, ERC adopted also the tariff system for sale of electricity to tariff customers,¹³⁴ which defines the groups of tariff customers. The category of tariff customers cover those connected at 35 kV (direct customers and other customers), customers connected at 20, 10 and 6 kV, and customers connected at 0,4 kV (households, public lightening and other customers).¹³⁵ On the basis of the Rulebook for prices of electricity for tariff customers ERC adopted a Decision for approving the regulated maximum income for performing regulated activity supply of electricity to tariff customers.¹³⁶ The later decision defines also the prices of the elements for calculating the tariffs for the different categories of tariff customers.

Regulation of end-users' prices of electricity does not cover the customers connected at the transmission grids, but it covers those connected at medium and low voltage. The latter category includes all commercial customers and the households.

4.1.5. Moldova

a) Eligibility

Article 4 of the Electricity Act of Moldova¹³⁷ defines eligible customer of electricity who is free to purchase electricity from the supplier or producer of its choice, including foreign ones. The term supplier of last resort is also defined as a "supplier designated to supply electricity to final customers under specific regulated conditions."¹³⁸ The Electricity Act also defines universal service and it requires ensuring universal service only for household customers. According to the Electricity Act, the electricity market shall be open in stages, and as from 1 January 2013 all non-household customers and as from 1 January 2015 all households shall be eligible and free to choose supplier.¹³⁹

b) Price Regulation

The National Energy Regulatory Agency of Moldova (ANRE) is in charge to develop and approve methodologies for calculation and application of regulated tariffs for electricity, for services of transmission and distribution of electricity, of tariff for supply of electricity at regulated tariffs, as well as of final tariff for electricity supplied to final customers.¹⁴⁰ Based on those methodologies, the undertakings providing regulated services calculate and submit the tariffs for determination approval by ANRE,¹⁴¹ which also monitors whether the companies have observed the principles of necessity and justifiable costs.¹⁴² After the tariffs are approved, ANRE monitors their correct application¹⁴³

The licensee that supplies electricity at regulated tariffs is tasked to purchase electricity at the lowest price, ensuring, at the same time, reliability of the process of electricity supply to customers, notifying the contracts for purchase of electricity to ANRE.¹⁴⁴ According to the Electricity Act, the supplier of electricity to tariff customers is not allowed to carry out activity of electricity supply at non-regulated tariffs within the territory where it performs the activity of electricity supply at regulated tariffs,¹⁴⁵ until 1 January 2013.¹⁴⁶ This is not entirely in line with Directive 2003/54/EC, which does allow the same entity to perform supply at regulated and unregulated tariffs, provided that it maintains separate

¹³⁴ ERC, Tariff system for sale of electricity to tariff customers, No. 01- 824/1, 30.06.2011

¹³⁵ Article 5 Tariff system for sale of electricity to tariff customers, No. 01- 824/1, 30.06.2011

¹³⁶ ERC, Decision for approving the regulated maximum income for performing regulated activity supply of electricity to tariff customers of EVN former Yugoslav Republic of Macedonia, No. 08 – 74/1, 30.12.2011.

¹³⁷ Moldova Electricity Act, Nr.124-XVIII Chisinau, 23.12.2009

¹³⁸ Article 4 and 43(7) Moldova Electricity Act, 2009 stipulates that the supplier of last resort shall conclude contracts with "any final customer".

¹³⁹ Article 52(1) Moldova Electricity Act, 2009

¹⁴⁰ Article 8(1)e) and Article 51 Moldova Electricity Act, 2009

¹⁴¹ Article 8(1)f) and Article 51(1) Moldova Electricity Act, 2009

¹⁴² Article 8(1)g) Moldova Electricity Act, 2009

¹⁴³ Article 9(1)b) Moldova Electricity Act, 2009

¹⁴⁴ Article 43(2) Moldova Electricity Act, 2009

¹⁴⁵ Article 43(5) Moldova Electricity Act, 2009

¹⁴⁶ Article 52(2) Moldova Electricity Act, 2009

accounts for both services. Moreover, ANRE designates the supplier of electricity at regulated tariffs as supplier of last resort on its designated area.¹⁴⁷

Taking into account that the opening of the market for the non-household customers is scheduled as from 1 January 2013, currently ANRE regulates the end user price for all final customers. There are three distribution companies, which also perform the services of supply to customers in the country, RED Union Fenosa, RED Nord and RED Nord-West, and the prices they charge to the end-users are regulated by ANRE.

ANRE regulates also the generation price for the following generators: S.A. "CET-1", S.A. "CET-2", S.A. "CET-Nord" and Î.S. „NHE Costești". Since these generation companies could satisfy only approximately 20% of the domestic consumption, the suppliers of tariff customers (the three distribution companies) purchase electricity from the generation plants located in Ukraine or Transnistria. The costs for purchasing electricity, according to the contracts notified to ANRE, are taken also into account for determining the final end-users' price.

4.1.6. Montenegro

a) Eligibility

The new Energy Law adopted in 2010¹⁴⁸ defines the terms customer¹⁴⁹ and final customer.¹⁵⁰ Final customers may be eligible customers or tariff customers. Tariff customers are final customers supplied at regulated tariffs and not entitled a right to select a supplier.¹⁵¹ Eligible customers are on the other hand final customers who are free to purchase electricity from the supplier of their choice,¹⁵² and they have balancing responsibility.¹⁵³ The households remain tariff customers until 1 January 2015.¹⁵⁴ The energy activities supply of electricity performed by public supplier as well as the activity of trade in electricity for electricity supply as a public service, are considered activities of public interest and shall be performed at tariffs set by the the Regulatory Agency for Energy (Agency).¹⁵⁵

The public supplier, defined as a supplier carrying out a public service of electricity supply at regulated tariffs to households and eligible customers that choose that form of a supply,¹⁵⁶ is appointed by the Government. It may be only an energy undertaking with a seat in Montenegro licensed for supply.¹⁵⁷ The Government shall nominate the public supplier within six months months from the entry into force of the Energy Law, and the public supplier shall propose to the Agency general conditions for public supply in three months from the day of nomination.¹⁵⁸

b) Price Regulation

The Agency is in charge of adopting the methodologies for setting tariffs for tariff customers and customers supplied at regulated tariffs by a public supplier,¹⁵⁹ and for approving the methodologies for setting of tariffs of a supplier of last resort.¹⁶⁰ It also sets the rules and procedure for change of tariffs initiated by an energy undertaking or upon its own initiative.¹⁶¹ Regulated tariffs for supply of electricity is set by the supplier of tariff customers and by the public supplier,¹⁶² to be approved by the Agency.¹⁶³

¹⁴⁷ Article 43(6) Moldova Electricity Act, 2009

¹⁴⁸ Montenegro Law on Energy, No. 01-70/25, adopted 22.4.2010.

¹⁴⁹ Article 5(29) Montenegro Law on Energy, 2010

¹⁵⁰ Article 5(30) Montenegro Law on Energy, 2010

¹⁵¹ Article 5(73) Montenegro Law on Energy, 2010

¹⁵² Article 5(31) Montenegro Law on Energy, 2010

¹⁵³ Article 93(2) Montenegro Law on Energy, 2010

¹⁵⁴ Article 205(1) Montenegro Law on Energy, 2010

¹⁵⁵ Article 67(1) and Article 68 Montenegro Law on Energy, 2010

¹⁵⁶ Article 5(25) Montenegro Law on Energy, 2010

¹⁵⁷ Article 154(5) and (6) Montenegro Law on Energy, 2010

¹⁵⁸ Article 192(1) and (3) Montenegro Law on Energy, 2010

¹⁵⁹ Article 38(1)(3) Montenegro Law on Energy, 2010

¹⁶⁰ Article 39(1)(4) and Article 53 Montenegro Law on Energy, 2010

¹⁶¹ Article 38(2)(2) Montenegro Law on Energy, 2010

¹⁶² Article 51(5) Montenegro Law on Energy, 2010

While the Agency decides about applications submitted by the energy undertakings for approval of regulatory allowed revenue, prices and tariffs, it may limit increase in prices and tariffs under its competence in order to fulfil the economy and energy policy of Montenegro.¹⁶⁴

According to the Energy Law from 2010, electricity supply at regulated tariffs provided by the public supplier shall be possible for household customers as well as for eligible customers that choose that way of supply.¹⁶⁵ Furthermore, if the Government decides, final customers connected to transmission system (the large industry), may also benefit from supply from the public supplier under regulated tariffs until 31 December 2012, in the event of economic, social or other justified reasons.¹⁶⁶

In December 2011 the Agency adopted the Methodology for determining the regulated income of the public supplier and for setting regulated tariffs for supply with electricity.¹⁶⁷ This methodology establishes the rules for calculating the prices for the customers connected at medium voltage (35 kV) and low voltage (10 kV and 0,4 kV). The first regulatory period starts from 1 July 2012.¹⁶⁸ Before this new methodology became applicable, on 16 December 2011, the Agency adopted a decision for setting the prices of electricity¹⁶⁹ charged by the public supplier from 1 January until 30 June 2012. In its decision setting the electricity prices, the Agency sets the prices for the customers directly connected to the transmission grid of 110kV, in addition to the customers connected to the distribution grid of 35kV and lower voltage level. The prices set thereby cover the large and medium size businesses in the country as well small customers and households. As from 1 July 2012, when the prices shall be set according the new methodology, they will be applicable to customers connected to medium and low voltage grid, thereby covering all households and all non-household customers connected to the distribution network.

4.1.7. Serbia

a) Eligibility

The Energy Law from 2011 does not define tariff customers, but it defines eligible customers, as well as small customers as "final customer who have less than 50 employees and whose balance sheet or total annual revenue is up to EUR 10 million in RSD equivalent with their facilities connected to the electricity distribution system with voltage level lower than 1 kV."¹⁷⁰ The law also defines public supply as sale of electricity to households and small customers at regulated prices,¹⁷¹ provided by the public supplier.¹⁷²

All customers are eligible according to the Energy Law, except the households, that will become eligible as from 1 January 2015.¹⁷³ The Energy Law of 2011 allows that the final customers of electricity that have not selected their suppliers shall be supplied by the energy entities that supply the tariff customers, under regulated prices, until they select the supplier of their choice, and by 31 December 2012 at the latest.¹⁷⁴ Moreover, all electricity customers connected to the distribution system at a voltage level lower than 1 kV shall enjoy a possibility to be supplied by the public supplier under regulated price until 1 January 2014, whereas the households and the small customers will have

¹⁶³ Article 51(8) Montenegro Law on Energy, 2010

¹⁶⁴ Article 52(1) and 52(10) Montenegro Law on Energy, 2010

¹⁶⁵ Article 154 Montenegro Law on Energy, 2010

¹⁶⁶ Article 192(3) Montenegro Law on Energy, 2010

¹⁶⁷ Methodology for determining the regulated income of the public supplier and for setting regulated tariffs for supply with electricity, No. 11/2738-11, 30.12.2011

¹⁶⁸ Article 31 Methodology for determining the regulated income of the public supplier and for setting regulated tariffs for supply with electricity, No. 11/2738-11, 30.12.2011

¹⁶⁹ Agency, Decision for setting prices of electricity, 11/2698-29, 16.12.2011

¹⁷⁰ Article 2(32) Serbian Energy Law of 2011, Official Journal of Republic of Serbia 57/2011, as amended in Official Journal 80/2011

¹⁷¹ Article 2(25) Serbian Energy law of 2011

¹⁷² Article 2(24) Serbian Energy Law of 2011

¹⁷³ Article 140 Serbian Energy Law of 2011

¹⁷⁴ Article 206(2) Serbian Energy Law of 2011

that possibility until 1 January 2015.¹⁷⁵ The public supplier shall buy the electricity needed for the tariff customers on a bilateral or organised market.¹⁷⁶

The Energy Law of 2011 stipulates the possibility for supply from the supplier of last resort to any final customer that is not entitled to public supply in cases when its supplier goes into bankruptcy, its license cease or is cancelled or if he (or a new customer) fails to select a supplier.¹⁷⁷ The supplier of last resort could supply such customers for a period not longer than 60 days and if they do not select a new supplier within that period, the supplier of last resort may terminate the supply of electricity to them.¹⁷⁸

The Government of Serbia shall select both the public supplier and the supplier of last resort through a public tender. In case the selections are not done through a tender, the Government¹⁷⁹ will designate the public supplier and the supplier of last resort by 1 October 2012 at the latest.¹⁸⁰

b) Price Regulation

The Energy Agency of the Republic of Serbia (AERS) is in charge of adopting by 1 August 2012¹⁸¹ methodologies for determination of electricity for public supply,¹⁸² and to approve regulated prices¹⁸³ as well as to supervise the implementation of those methodologies and prices.¹⁸⁴ Prices of electricity for public supply are regulated¹⁸⁵ and shall be determined by the energy entities and approved by AERS.¹⁸⁶ Until the methodologies are adopted based on the Energy Law from 2011, the methodologies and tariff systems adopted under the previous Energy law from 2004 are in place. AERS has adopted the methodology for charging tariff customers¹⁸⁷ and electricity tariff system for tariff customers.¹⁸⁸ Under Article 66 of the Energy Law from 2004 the supplier defines the prices of energy delivered to tariff costumers after having obtained an opinion from AERS. In addition, the Government gives its consent to the act on prices.

Based on the old methodologies and tariff systems, AERS has approved the price list¹⁸⁹ for electricity sale to tariff customers as adopted by a Decision of the energy incumbent,¹⁹⁰ as approved by the Government.¹⁹¹ The price list valid as from 1 April 2011 specifies the tariff elements for all consumer categories connected to high, medium and low voltage grids, thereby covering also the large industry and medium-size customers, in addition to the small customers and the households.

¹⁷⁵ Article 206(3) Serbian Energy Law of 2011

¹⁷⁶ Article 140(4) Serbian Energy Law of 2011

¹⁷⁷ Article 145 (1) Serbian Energy Law of 2011

¹⁷⁸ Article 145 (5) Serbian Energy Law of 2011

¹⁷⁹ Article 140(5) and 140 (7) Serbian Energy Law of 2011 for public supplier and Article 146(6) for supplier of last resort respectively

¹⁸⁰ Article 202(1) Serbian Energy Law of 2011 for public supplier and Article 203(3) for supplier of last resort

¹⁸¹ Article 196(1) Serbian Energy Law of 2011

¹⁸² Article 46(1)(1) and Article 65(1) Serbian Energy Law of 2011

¹⁸³ Article 46(1)(7) Serbian Energy Law of 2011

¹⁸⁴ Article 46(2) Serbian Energy Law of 2011

¹⁸⁵ Article 64(2) Serbian Energy Law of 2011

¹⁸⁶ Article 67(1) Serbian Energy Law of 2011

¹⁸⁷ AERS, The electricity charging methodology for tariff customers, from 13.04.2010 that covers Electricity Pricing Methodology for Tariff Customers (Official Gazette of the Republic of Serbia No. 68/06), as amended in Official Gazette No. 18/07 and 116/08.

¹⁸⁸ AERS, Electricity tariff system for tariff customers version from 6.07.2010 that covers Electricity Tariff System for Tariff Customers (Official Gazette of the Republic of Serbia No. 1/07), as amended in Official Journal No. 31/07, 50/07, 81/07, 21/08, 109/09 and 100/10

¹⁸⁹ PE "Electric Power Industry of Serbia", Price list for electricity sale for tariff customers, No. 815/6-11, 03.03.2011

¹⁹⁰ Decision of the Management Board of the PE "Electric Power Industry of Serbia" on Electricity Pricing for Tariff Customers, No. 1-2617/10-10 of 28.12.2010

¹⁹¹ Government decision No. 338-1282/2011, 25.02.2011

4.1.8. Ukraine

a) Eligibility

The Electricity Law of Ukraine¹⁹² defines the term consumers of electricity as “business entities and individuals who use energy for their own needs on the basis of agreement on its sale and purchase.”¹⁹³ It does not define the different types of customers and in particular it does not define the eligible customers. According to the Protocol of Accession of Ukraine to the Energy Community, all non-household customers should be eligible as from 1 January 2012 and all customers, including households, as from 1 January 2015. The Electricity Law does not establish criteria for market opening and for determining the eligible customers.

The Electricity Law defines power suppliers, and supply of electricity as a “provision of electricity to consumers by technical means of transmission and distribution of electricity on the basis of agreement.” The term wholesale market of electricity is also defined in the Electricity Law as a market established by business entities for purchase and sale of electricity on the basis of agreement, and wholesale supply of electricity as purchase of electricity, formation of wholesale price and sale of electricity at wholesale price to energy supplier. The Law furthermore regulates the functioning of the wholesale electricity market of Ukraine, establishing one wholesale market as a legal entity (Energoynok) based on an agreement,¹⁹⁴ and prohibiting other wholesale electricity markets in the country.¹⁹⁵ The wholesale electricity market is a single buyer of electricity and is established by the business entities active on the electricity market.

The customers are supplied by suppliers that have a license to supply electricity in certain area, and those suppliers are prohibited to supply customers in an area for which they are not licensed.¹⁹⁶ All electricity suppliers purchase electricity from the single buyer at a wholesale price established by the single buyer, and they are not allowed to buy electricity directly from generators.¹⁹⁷ The suppliers that supply electricity at regulated tariffs have an obligation for supplying all customers at the territory for which they have a license, whereas the suppliers that supply at non-regulated tariffs do not have such obligation.¹⁹⁸

b) Price regulation

The Electricity Law gives power to local executive authorities and self-governance bodies to regulate the tariffs for energy,¹⁹⁹ and to the National Energy Regulatory Commission of Ukraine (NERC) to ensure pricing and tariff policy in the power sector.²⁰⁰ The prices of the generation companies and the wholesale price shall be specified by the Rules of wholesale electricity market,²⁰¹ and the retail price of electricity shall be established by the suppliers.²⁰² The Law however provides that NERC is in charge of setting the transmission tariff and the tariff for supply of electricity through local power networks.²⁰³ The generation price is also regulated by NERC for a determined period for each plant separately,²⁰⁴ whereas the wholesale price is determined by the single buyer.²⁰⁵ NERC also regulates the price of

¹⁹² Law of Ukraine on the Electricity Sector, No. 575/97-VR, 16 October 1997, as amended last time with No.2799-VI of 17.12.2010

¹⁹³ Article 1 Electricity Law of Ukraine, 1997

¹⁹⁴ Article 15(4) Electricity Law of Ukraine, 1997

¹⁹⁵ Article 15(1) Electricity Law of Ukraine, 1997

¹⁹⁶ The two EU energy packages and Ukraine, Draft Assessment Report prepared y the ESBS Project, 20 May 2011, p.34

¹⁹⁷ The two EU energy packages and Ukraine, Draft Assessment Report prepared y the ESBS Project, 20 May 2011

¹⁹⁸ The two EU energy packages and Ukraine, Draft Assessment Report prepared y the ESBS Project, 20 May 2011, p.23. It is not clear which type of customers buy electricity at non-regulated tariffs.

¹⁹⁹ Article 10(5) Electricity Law of Ukraine, 1997

²⁰⁰ Article 12(2) Electricity Law of Ukraine, 1997

²⁰¹ Article 15(9) Electricity Law of Ukraine, 1997. Those Rules have not been submitted to the Secretariat.

²⁰² Article 17(4) Electricity Law of Ukraine, 1997

²⁰³ Article 17(5) Electricity Law of Ukraine, 1997

²⁰⁴ The two EU energy packages and Ukraine, Draft Assessment Report prepared y the ESBS Project, 20 May 2011, p.23

²⁰⁵ The two EU energy packages and Ukraine, Draft Assessment Report prepared y the ESBS Project, 20 May

supply of electricity. The Law does not define which customers benefit from regulated end-users' price of electricity and which may/shall buy at a market price.

The licensees that supply electricity at regulated tariffs have an obligation for supply at privileged tariffs, and the losses from supplying at such prices is compensated from the wholesale tariff of electricity.²⁰⁶ According to the Electricity Law, the power suppliers are entitled to reimbursement to part of the price not paid by the consumers, through the funds of the state or local budget.²⁰⁷ The Electricity law however, does not provide further details about the reimbursement.

4.1.9. Kosovo^{*f}

a) Eligibility

The Law on Electricity 2010 defines eligible customer as “customer who is free to purchase electricity from the supplier of their choice”²⁰⁸ and non-eligible customer as “any final customer who is not an eligible customer.”²⁰⁹

According to the Law on Electricity 2010, those customers who have been granted the status of eligible customers at the time when the law became effective retained such status.²¹⁰ All customers shall be granted the status of eligible customers by 1 January 2015, whereas by then all customers except households are eligible.²¹¹ The public supplier supplies electricity to non-eligible customers at regulated tariffs,²¹² but it also has the right to supply electricity to eligible customers, where requested to do so, at regulated prices as well.²¹³ The Public supplier buys electricity from the regulated generators at tariffs regulated by ERO and according to Article 7 all producers with installed capacity exceeding 5MW shall provide electricity under regulated prices to the public supplier if needed to fulfil its obligations for the tariff customers. Subject to this requirement, they could sell the electricity they generate at the open market.²¹⁴ The public supplier has right to purchase capacity and electricity from other producers or suppliers at an unregulated tariffs as well.²¹⁵ Besides this, according to Article 38(1) of the Law on Electricity, a State-owned enterprise (other than Transmission System Operator) shall have the obligation to import electricity required to meet the demand of non-eligible electricity customers in cases when domestic generation is insufficient and when without such import, the non-eligible customers would be disconnected. The Law provides 1 January 2015 as a phase out date and termination of such obligation, but it also stipulates a possibility for earlier termination in case the domestic generation capacity installed and available would be estimated by ERO to be sufficient for satisfying the demand of non-eligible electricity customers.²¹⁶

b) Price regulation

The tariffs in the energy sector may be regulated or unregulated and the introduction of unregulated tariffs shall be “dependent on the development of effective competition capable of sustaining unregulated tariffs in the relevant part of the energy sector, and on the requirements of any applicable Public Service Obligation.”²¹⁷ The regulated tariffs in the energy sector shall only be charged after being approved by ERO or having been set in accordance with a tariff methodology approved by

2011, p.16

²⁰⁶ The two EU energy packages and Ukraine, Draft Assessment Report prepared by the ESBS Project, 20 May 2011, 23

²⁰⁷ Article 24(4) Electricity Law of Ukraine, 1997

²⁰⁸ Article 2(1.13) UNMIK Law on Electricity 2010

²⁰⁹ Article 2(1.24) UNMIK Law on Electricity 2010

²¹⁰ Article 19(3) UNMIK Law on Electricity 2010

²¹¹ Article 19(4) and (5) UNMIK Law on Electricity 2010

²¹² Public supply as activity and public supplier are also defined in Article 2(1.29) and 2(1.28) respectively. For details about public supplier see Article 18 Law on Electricity 2010.

²¹³ Article 18(2) and 18(6) UNMIK Law on Electricity 2010

²¹⁴ Article 8 UNMIK Law on Electricity 2010

²¹⁵ Article 18 UNMIK Law on Electricity 2010

²¹⁶ Article 38(3) UNMIK Law on Electricity 2010

²¹⁷ Article 19(1) UNMIK Law on Energy 2010

ERO,²¹⁸ and they shall allow the regulated energy company to recover its full “annual reasonable cost of service.”²¹⁹

The Law on Energy Regulator from 2010 defines the details about tariff regulation.²²⁰ ERO has a responsibility to develop tariff methodologies²²¹ for the supply of energy at regulated tariffs,²²² approve the tariff methodologies developed by the system operators²²³ and approve and modify or resubmit for review the applications for tariffs for regulated energy services submitted by energy enterprises.²²⁴ The Law on Energy regulator stipulates the principle of cost-reflectivity of tariffs, and requires rebalancing of tariffs in order to phase out all cross-subsidies by 31 December 2014.²²⁵

Regarding the possibility of the public supplier to supply eligible customers under regulated end-users' prices, the Law on Energy Regulator from 2010 sets the criteria which shall be closely linked with the satisfactory level of competition existing on the supply market. The phase out date for termination supply of electricity at regulated end-user tariffs to eligible customers is 1 January 2015, provided that ERO is satisfied with the competition in the supply of electricity market.²²⁶

In September 2011, ERO adopted a Rule on Public Electricity Supplier Pricing,²²⁷ which repealed the “Rule on Principles of Calculation of Tariffs in the Electricity Sector (Pricing Rule)” and “Tariff Methodology for the Electricity Sector” from 2005. The new Rule determines the methodology for determining the tariffs that the public supplier charges to the tariff customers as well as the process for reviewing and adjusting the tariffs. The Law on Electricity does not provide any time limitation or phasing out for this price regulation, which might cover all customers' categories. The Rule from September 2011 stipulates that the public supplier could supply the eligible customers under regulated prices only until “the Regulator is not satisfied that competition in the supply of electricity is effective.”²²⁸ Besides the definitions from the primary legislation, this Rule defines also regulated and unregulated customers.²²⁹

Accordingly, ERO has approved the tariffs applicable from 1 April 2011 that cover all customers' categories: customers connected at high voltage (even 220kV), as well as those connected at medium and low voltage, which includes large and medium-size industry and commercial customers, in addition to the household customers.

4.2. Regulated Prices, Tariff Evolution and Cross-Subsidies in the Contracting Parties

For an overview of the regulation of end-users' prices in the Contracting Parties, the USAID Tariff Benchmarking analysis from 2006²³⁰ and the IPA Study from 2009, as well as its update by the Energy Community Regulatory Board (ECRB), provide a good basis.²³¹

The IPA study found that the prices in the Contracting Parties, residential and non-residential, are much lower than the prices in the Member States. Domestic users are paying prices 6.8 times lower than the average EU27 price, while industrial users are paying only 2.1 times less.²³² Montenegro is a specific example where commercial customers pay significantly more than other customer types.

²¹⁸ Article 19(2) UNMIK Law on Energy 2010

²¹⁹ Article 17 UNMIK Law on Energy 2010

²²⁰ UNMIK Law on the Energy Regulator 2010

²²¹ Article 42 Law on Energy Regulator from 2010 establishes the principles for developing tariff methodologies

²²² Article 14(2.4) Law on Energy Regulator 2010

²²³ Article 14(2.5) Law on Energy Regulator 2010

²²⁴ Article 14(2.6) Law on Energy Regulator 2010

²²⁵ Article 40 Law on Energy Regulator 2010

²²⁶ Article 41 Law on Energy Regulator 2010

²²⁷ ERO, Rule on Public Electricity Supplier Pricing, 30.09.2011

²²⁸ Article 1(2.2) Rule on Public Electricity Supplier Pricing, 30.09.2011

²²⁹ Article 2(1.29) and 2(1.41) Rule on Public Electricity Supplier Pricing, 30.09.2011

²³⁰ USAID, South East Europe REM Support (SEE REMS) Project: Tariff Benchmarking (Task 3), October 2006.

²³¹ In the IPA study the term tariffs refers to the overall revenues divided by the electricity consumed rather than the specific charges for energy, demand, fixed fees of individual customers. IPA, Study on tariffs, 2005, p.5.

²³² DG TREN, Special issue, 2009, p.22.

Montenegro is also unique for the fact that there are special tariffs for certain industries, the most interesting example being the aluminium industry whose tariffs are lower than other industrial customers, which shows clear support for this industry that needs to be scrutinized under State aid rules.²³³ In most of the other markets, the price for residential customers is considerably lower than for commercial customers (Bosnia and Herzegovina, former Yugoslav Republic of Macedonia, Serbia, Kosovo*), even though a justification could hardly be found on the basis of difference in costs to supply these two categories.

For the period 2007-2009, in Bosnia and Herzegovina, former Yugoslav Republic of Macedonia and Kosovo* there was cyclical movement of end-consumer prices, i.e. the combination of residential and non-residential prices were found to be very similar at the beginning and the end of the 2-year period. The cases of Montenegro, Albania, Serbia and Croatia show a tendency of gradual appreciation of price, bringing it closer to the EU average.²³⁴ The ECRB update shows that in the period 2008-2009 there are still considerable differences among average retail prices in the Contracting Parties, the lowest (in Serbia) being approximately half of the highest (in Croatia). However, the price levels continued to increase throughout the Contracting Parties.

In summary, the overall average retail tariff varies considerably between the countries with the lowest tariffs being approximately half of the higher tariffs.²³⁵ In 2004, as identified by the World Bank, the average tariffs in the region were between 2.8 and 7.6c/kWh, and the average tariff for the region was around 4.8c/kWh,²³⁶ whereas in 2009 the tariffs were between 5.32 and 9.20c/kWh. The tariffs in the Contracting Parties were increasing in the period of 2005-2009, often by quite significant amounts, and it appears that those countries with the lowest tariffs at the start of the period are currently facing the greatest increases, which should lead to a reduction in the differences between the countries. There are also differences in the average tariff by customer type in the different countries. The average end user-prices in the Energy Community in 2011 varied between 49.37 €/MWh in Kosovo* to 94.50 €/MWh²³⁷ in Moldova, the average price in the region being 69.01 €/MWh.

Residential customers are generally paying less (sometimes significantly less) than commercial customers that are supplied at the same voltage levels, in Bosnia and Herzegovina, Montenegro, Serbia, Kosovo* and former Yugoslav Republic of Macedonia. Even the industrial tariffs are higher than the residential tariffs in some countries. The large differences are subject to regulatory action, and gradual rather than immediate rebalancing is more acceptable due to the political unacceptability of large price shocks. The following section will present the analysis of the different components of end-user electricity prices in the Contracting Parties, with a view of verifying cost-reflectivity of tariffs and reflection of all costs to the final users as preconditions required for successful opening of the electricity markets to competition.

4.3. Breakdown of End-Users' Electricity Prices

The end-user electricity price consists of several components: the costs for generation and supply service, as well as the costs for access and use of the transmission and distribution systems, expressed in cost-reflective and non-discriminatory tariffs. The generation and supply are supposed to be competitive services, and the costs for their provision should not be regulated but instead be freely negotiated between the market players. In the Contracting Parties however, the generation costs are regulated as long as the generation is necessary for satisfying the needs of the tariff customers. Moreover, as it will be shown in the analysis below, the costs for generation, but also the distribution and transmission tariffs in none of the Contracting Parties complies with the principle of cost-reflectivity and allows investment in new capacity and improving the infrastructure. The IPA Tariff Study confirms this finding.

- *Generation costs*

²³³ IPA, Study on tariffs, 2009, p.11.

²³⁴ DG TREN, Special issue, 2009, p.23.

²³⁵ IPA, Study on tariffs, 2009, p.7

²³⁶ World Bank (2004)

²³⁷ ERO, Annual Report for 2010. See:

http://ero-ks.org/Annual%20Report/Annual%20Report%202010/Raporti_vletor_2010_ZRRE_final_srb.pdf

With regard to the generation cost coverage, all Contracting Parties take fuel costs into consideration, but none of them takes into account waste disposal costs. Moreover, *the rate of return*, even though part of the assessment, *might not reflect the full costs* because the Government is the owner of the dominant generation capacities in the countries and it might prefer to keep the prices down instead of receiving a complete return of equity.²³⁸ These costs of generation due to the differences in generation costs between hydro and thermal (coal) fuels in practice are making the differences in the overall tariffs.

In Albania, former Yugoslav Republic of Macedonia and Kosovo*, the dominant generators are obliged to sell their generated electricity firstly to satisfy the needs of the tariff customers, and only afterwards they are allowed to sell the excess generated capacity on the open market. Since there is lack of domestic generation to satisfy the full demand in the countries, most (if not all) of the domestic generation is “reserved” for the tariff customers (defined broadly in the Contracting Parties). If not sufficient, the incumbent generator is even in charge to import electricity in order to satisfy fully the needs of the tariff customers.²³⁹ However, not the full costs (for domestic and imported electricity) are taken into account and passed through to the final tariff customers. Instead, the small amount of customers that in few Contracting Parties (Albania, former Yugoslav Republic of Macedonia and Croatia) are “expelled” to buy electricity on the open market, in the lack of domestic generation, are obliged to buy imported high-priced electricity. This issue will be further addressed below. Based on the Wholesale Market Opening Study, opening the generation market (by allowing/requiring the incumbent generator to make certain volumes of its generation capacity available at the short-term markets) and reflection of the real cost to all final customers (including the tariff customers), is crucial for incentivising all eligible customers to exercise their eligibility right, ensuring viability of the industry and thus successful establishment of competitive electricity markets.

- *Transmission costs*

There is substantial variation between the different costs that were covered in the transmission tariffs of the Contracting Parties. They vary between 0.5 €/MWh and 10 €/MWh²⁴⁰

While the depreciation was assessed in a consistent manner, the *rate of return* of asset base shows the greatest variation between the countries. It should be noted that by 2007 not all the countries have included this component in the transmission costs. This was done in 2008 in Croatia, Montenegro, Serbia and former Yugoslav Republic of Macedonia.²⁴¹ It is characteristic that in Serbia for 2008 the AERS held that the TSO would have sufficient financial resources, and *return was not allowed*. In Kosovo* on the other hand, return is allowed only for new investment after 2006 because *the other infrastructure is old and is held not to have an economic value*. Finally, in Montenegro, even though rate of return is allowed, it was acknowledged to be *below the real costs*. The components “return” and “others” are the ones that create the biggest differences between the transmission costs in the Contracting Parties.²⁴²

A number of countries did not include transmission losses as part of the costs to be covered by transmission revenues during 2007 because there was no separate regulated transmission tariff at this time. However by 2008 separate transmission tariffs had been established and the cost of transmission losses included in determining that tariff.²⁴³ The level of transmission losses is generally considered acceptable and is similar to the losses in the EU Member States. In the SEE region they vary between 2% and 3.68%, whereas in the EU they are 1.5% to 2.5%.²⁴⁴ The IPA study shows that not all relevant costs (rate of return and/or new investments) are included in the transmission tariffs in the Contracting Parties.

- *Distribution costs*

²³⁸ IPA, Study on tariffs, 2009, p.17.

²³⁹ This is the case in Albania and in the former Yugoslav Republic of Macedonia.

²⁴⁰ ECRB, update IPA tariff study, p.14

²⁴¹ IPA, Study on tariffs, 2009, p.20.

²⁴² ECRB, update Tariffs study 2010, p.15.

²⁴³ IPA, Study on tariffs, 2009, p.22.

²⁴⁴ ECRB, update Tariffs study, p.22.

With regard to the distribution costs, as with the transmission costs, there is a variation between the Contracting Parties. In 2005 only in former Yugoslav Republic of Macedonia a rate of return was included in the distribution tariff, whereas in 2008 the other countries have also done that. Serbia determined the distribution tariffs according to a new methodology including a rate of return in 2008. As for the transmission return of assets, in Kosovo* the return is allowed only for new investment after 2006 because the existing infrastructure is old and is held not to have an economic value, whereas in Montenegro the return of assets is acknowledged below the real costs.²⁴⁵

Distribution losses, unlike transmission losses, represent a significant part of the regulated distribution revenues. The notion of network losses is not defined by Energy Community law itself. According to a definition used by ERGEG, losses may be understood as "*the absolute difference between the volume of electricity entering the system (metered or estimated at the point of entry) and the customer related volume of electricity exiting the system (metered or estimated at the point of exit)*".²⁴⁶ Accordingly, what constitutes network losses follows from a purely mathematical operation, and not from the reason why the exiting volume of electricity is lower than the entering volume of electricity. As a matter of fact, there are no regulatory or legal criteria, nor any accepted technical procedures, which would allow distinguishing between technical and non-technical losses. Only the total level of losses can be determined with satisfactory precision. Consequently, the definition of losses in UCTE (now ENTSO-e) terminology emphasises: "*electric system losses are total electric energy losses in the electric system*".²⁴⁷ Thus, network losses, and consequently the costs of their procurement, are to be understood as one inseparable category. From the perspective of tariff-setting in line with the cost-reflectivity principle, they both result in costs. This is true for both technical (due to the nature of the distribution network and the equipment used), and even more for commercial losses (due to theft, inaccurate metering and low collection rates). Article 14(5) of Directive 2003/54/EC requires distribution system operators to "*procure the energy they use to cover energy losses ... in their system according to transparent, non-discriminatory and market based procedures...*". Moreover, under the principle of cost-reflectivity stemming from the *acquis communautaire*, the costs incurred by this procurement are to be taken into account, in principle, in the methodology for and the actual calculation of distribution system tariffs. The principle of cost-reflectivity may, under the limits set out above, be balanced against a principle of cost-efficiency, in particular in establishing incentive-based regulation.

Levels of distribution losses are generally quite high, although they vary quite significantly. Croatia had the lowest levels, at around 10%, whereas others had loss levels significantly higher, with the most extreme being Kosovo* (around 43%).²⁴⁸ The costs for coverage of distribution losses also contribute to the great differences in distribution tariffs between the Contracting Parties. Most of the countries have a consistent approach to encourage the lowering of distribution losses. In particular, the National Regulatory Authorities usually assumes some pre-determined level of losses which is used as the basis of determining regulated revenues, and when the actual losses differ from this, the additional cost or saving remains, with the distribution company giving them an incentive to reduce losses and thus increase profits.²⁴⁹

Noting the increase of complaints to the Secretariat related to regulatory decisions in relation to distribution tariffs, there is a clear need for strengthening and improving cost-reflectivity in most of the Contracting Parties. As the IPA study confirmed, not all reasonable costs related to the different components of the distribution tariffs are taken into account by the National Regulatory Authorities when setting the distribution tariffs, making them not fully cost-reflective.

- Supply costs

Supply has a small proportion in the total price of electricity paid. However, it should be noted that most of the Contracting Parties have a dominant supplier, bundled with the distribution company,

²⁴⁵ IPA, Study on tariffs, 2009, p.27.

²⁴⁶ ERGEG Position Paper Treatment of Electricity Losses by Network Operators, Conclusions Paper of 19 February 2009, p. 4.

²⁴⁷ https://www.entsoe.eu/fileadmin/user_upload/library/publications/ce/oh/glossary_v22.pdf

²⁴⁸ For the EU Member States, distribution losses are generally in the range of 5% to 10%. See: IPA, Study on tariffs, 2009, p.39.

²⁴⁹ IPA, Study on tariffs, 2009, p.28.

which prevents incentives for new suppliers to enter the market. Since these two activities are integrated, supplier's costs per customer are not available. Collection rate was used as a measure in the IPA study, i.e. the amount received as a percentage of the amount billed.²⁵⁰ The collection rates vary from one country to another and the low collection rates discourage new entrants in the competitive supply market. Croatia has collection rates for each category of customers close to 100% whereas former Yugoslav Republic of Macedonia in 2007 had a collection rate around 90%. However, it should be noted that in Kosovo* 30% of the electricity consumed is not even billed. The collection rate of the remaining 70% billed electricity is around 90%.²⁵¹ The ECRB has noted an increase in the collection rates in the Contracting Parties over the last couple of years. However, the collection rates for the residential customers are still particularly low in some Contracting Parties²⁵² even though the collection rates are in general higher for residential than for other customer categories.²⁵³

Since the supply activity, as generation, is supposed to be competitive, the price for providing supply services should be a result of the interaction of demand and supply on the market. However, as only one (incumbent) supplier offers electricity supply at low regulated prices to all tariff and most of the eligible customers and that supplier is bundled with the distribution activity, other suppliers will hardly have any incentive to enter the supply markets of the Contracting Parties. Since supply costs are not available to the regulators, they are not properly calculated and included in the end-user electricity price.

4.4. Summary of the Legislative Analysis

The legislative analysis above has shown that the issue of electricity price regulation raises concerns and requires further action. In addition, there are issues related to eligibility and the electricity market models currently in place in the Contracting Parties that are closely linked with end-users' price regulation. This section aims at summarising the findings of the legislative analysis for the Contracting Parties and to assess their compliance with the Energy Community *acquis*.

a) Eligibility

The regulation of eligibility of the Albanian customers is not compliant with the Energy Community *acquis*. First of all, the latest amendments to the Power Sector Law make automatically eligible only the customers connected to high voltage grid as well as those with a consumption over 50 million kWh/year, but not all non-household customers as required by Directive 2003/54/EC and the Energy Community Treaty. All other non-household customers that have a consumption below 50 million kWh/year, including all small commercial customers, still need to request from ERE an approval of their eligibility status according to the Albanian Regulation on Criteria for Granting and Revoking the Status of Eligible Customer.

Furthermore, according to the definition of eligibility in Albania and Montenegro eligibility status is linked with undertakings' own consumption and does not include resale of electricity. This is in breach of the eligibility rules from the Energy Community Treaty in particular Annex 1 read together with Article 21 of Directive 2003/54/EC, which requires that as from 1 January 2008 all non-household customers are eligible, including those customers who would afterwards resell the electricity bought from a supplier of their choice.

The amendments to the Electricity Market Act from 2011 in Croatia introduced a possibility for granting a status of "temporary customers" by HERA to undertakings established outside of Croatia if the Government decides that there is public interest. Granting this status in order to allow those customers to be supplied in the same manner as Croatian customers is incompliant with the eligibility requirement of the Treaty, because it involves an undertaking that should have been eligible (or is considered eligible in its country of origin) as from 2008, to apply for obtaining such status in Croatia. Furthermore, if obtaining the status of "temporary customers" is a precondition for supplying those customers in the same manner as the Croatian customers, this would imply that without such a status those customers

²⁵⁰ IPA, Study on tariffs, 2009, p.40.

²⁵¹ IPA, Study on tariffs, 2009, p.40

²⁵² UNMIK (50%) and Albania (71.48%)

²⁵³ ECRB, update Tariff study, p.25

are treated differently than the domestic customers. This would possibly encroach upon the non-discrimination principle embedded in the Energy Community Treaty.

Finally, the Electricity Law of Ukraine does not define the eligible customers, and there are no rules regarding market opening and obtaining eligibility status, even though according to the Accession Protocol of Ukraine to the Energy Community, all non-household customers should have become eligible as from 1 January 2012. The Electricity Law does not in fact define even the term customers, but defines the term consumers, which covers only consumers using electricity for their own needs. Such a definition, similarly to Albania and Montenegro, excludes all suppliers and other entities that would need electricity in order to resell it to final customers in line with Directive 2003/54/EC.

b) Electricity Market Model and Relationship between Market Participants

Several Contracting Parties still have electricity market models that impede market opening and establishing competitive electricity markets. Even if the primary legislation has been amended in most of the Contracting Parties, Public Service Obligations have been imposed on the incumbent generators to supply electricity for the needs of the tariff customers to the (retail) public supplier, which in some cases is named even a supplier of last resort.²⁵⁴ The (incumbent) generator is under an obligation to sell its generated capacity for the needs of the tariff customers. All the more, in some countries, the incumbent generator has even to buy capacity from other sources (domestic and from import) in order to satisfy the needs of the domestic tariff customers.

The Albanian electricity market model is not in line with Directive 2003/54/EC as it still maintains a single buyer in place. Being obliged to sell not only its full generation portfolio, but also to buy from other generators and sell capacity to the retail public supplier for satisfying the needs of the tariff customers, the wholesale public supplier acts as a single buyer of electricity, which is not allowed under Directive 2003/54/EC. The retail public supplier, on the other hand can not buy from other sources alone, but is obliged to buy capacity from the wholesale public supplier.

The electricity market of Ukraine is also based on a single buyer model. The single buyer (Energorynok) is actually considered to be the wholesale electricity market. This wholesale electricity market consists of all generators and licensed suppliers active on the Ukrainian electricity market. The single buyer model has been abolished in the second electricity liberalisation package and is not in compliance with Directive 2003/54/EC. The single buyer buys electricity from the domestic generators at prices regulated by NERC, and then sells to the suppliers of electricity. The suppliers are not allowed to buy electricity directly from generators or other entities from their choice, but they are obliged to buy from the single buyer. This arrangement prevents them from exercising their eligibility right and infringes Article 21 of Directive 2003/54/EC. Moreover, suppliers are allowed to sell electricity only to customers from the area for which they have a license to supply, which amounts to partitioning of the electricity market in the country. The customers from other areas are in that manner prevented from choosing a supplier that has no license for their territory and could not therefore exercise their eligibility right to choose a supplier as required by Article 21 of Directive 2003/54/EC.

In former Yugoslav Republic of Macedonia and in Kosovo*, even though the public supplier is allowed to buy electricity for the needs of the tariff customers at the open market, they could do so only when the conditions offered at the free market are better than those offered by the (Public) domestic generators. Since the price of domestic generation, needed for the supply of (the large category) of tariff customers is regulated (at levels that do not always cover the costs and/or the future investments), the conditions offered by the incumbent generators are always preferable in comparison to the market-priced imported generation. This limits the incentive of the eligible customers to exercise their eligibility right, and they prefer (where allowed) to remain supplied by the public supplier.

In the former Yugoslav Republic of Macedonia, the Energy Law of 2010 gives a possibility for the supplier of last resort to request ERC to task another market participant with Public Service Obligation to purchase electricity for the households and small consumers for a temporary period. By using this possibility, in December 2011 the supplier of last resort requested and ERC adopted a decision for imposing a task to the regulated generator to import electricity. However, imposing the import

²⁵⁴ Though closely related, the understanding of supplier of last resort is out of the scope of the present report.

obligation on the incumbent generator was not done as an ad hoc measure, but it covers the import for full 2012 year and does not provide for any review by ERC throughout the year on whether such an obligation is necessary depending on the development of the market and whether it does not go beyond what is necessary for ensuring security of supply. Therefore, this decision does not seem to comply with the requirements from Article 3 of Directive 2003/54/EC on Public Service Obligation and with the principle of proportionality. Similarly, the Law on Electricity of Kosovo* allows that a State-owned enterprise (other than Transmission System Operator) shall have the obligation to import electricity required to meet the demand of non-eligible electricity customers in cases when domestic generation is insufficient and when without such import, the non-eligible customers would be disconnected. This obligation shall be in place until 1 January 2015. The Secretariat is not made aware of any decision taken in this respect, in charging one market participant to perform this function. If such decision would be taken, it must comply with the requirements from Article 3 of Directive 2003/54/EC, and shall provide for a periodical review of the necessity for such obligation to be imposed.

The electricity market structure in Albania, former Yugoslav Republic of Macedonia, Ukraine and in Kosovo* is not favourable to the development of competitive wholesale and retail electricity markets in the Contracting Parties because: *firstly*, by requesting the domestic incumbent generators to sell all the electricity they generate for the needs of the tariff customers, there is no domestic electricity available for the short-term market to open and stimulate development of the wholesale electricity markets (since most of these countries are importers of electricity, and they rarely would have excess electricity generated); *secondly*, the price of the domestic generation is fully regulated by the regulatory authorities at levels that do not cover the costs (usually for future investment), which is detrimental for ensuring long-term security of supply in these countries; *thirdly*, (large) domestic customers supplied at regulated tariffs benefit from the fact that the generation is priced at regulated tariffs set by the regulatory authorities and these customers (for which reserving the domestically generated electricity is reserved) are not made responsible for paying the full cost for procuring generation at the open market (including the costs for importing electricity); and *fourthly*, this market structure does not stimulate development of competition at retail level because there is no incentive for new suppliers to enter the markets and the eligible customers do not have an incentive to switch supplier.

c) Generation Price for Tariff Customers is Regulated

In Albania, former Yugoslav Republic of Macedonia, Montenegro, Moldova and Kosovo*, the generation price of the (public) domestic generator is regulated as long as necessary for the supply of the tariff customers. In Ukraine, the electricity price of all domestic generators is regulated by NERC. Even though in all Contracting Parties (except in Albania and Ukraine) the supplier of tariff customers is allowed to buy electricity at the open market, it has no incentive to do so if the regulated domestic generation is available at lower regulated prices, or if the domestic generation company is in charge for procuring electricity in the open market for satisfying the needs of the domestic customers. Since the Directive 2003/54/EC aims at introducing competition in the generation segment of the electricity market, regulating the price of the generation fully is not in line with such principle. Moreover, since the Contracting Parties are importers of electricity, the generation price shall include the full generation portfolio – domestic and imported. Since the price of the generation is regulated by the National Regulatory Authorities, not always the price of imported electricity is taken into account when the final end-users' price is established.²⁵⁵ In Ukraine, the suppliers are obliged to buy electricity from the single buyer, which prevents them from exercising their eligibility right in accordance with Article 21 of Directive 2003/54/EC.

d) Public Supplier / Supplier of Last Resort

In Republika Srpska, former Yugoslav Republic of Macedonia and Moldova the public supplier is considered a supplier of last resort, and in these countries as well as in Montenegro and Kosovo*, the public supplier is allowed to supply those eligible customers that did not choose supplier, or customers that have requested that form of supply.

²⁵⁵ The only exception seems to be Moldova, where the Agency takes into consideration the contracts for importing electricity between the distribution/supply companies and the foreign generators.

The supplier of last resort in the Directive 2003/54/EC is only a possibility for the Contracting Parties in order to ensure provision of universal service. As defined, the concept of supplier of last resort does not comply with the meaning of the concept of supplier of last resort from Article 3 of the Directive 2003/54/EC. This concept as understood as a replacement for a supplier for any eligible customer who terminated his supply contract or that has not selected (or does not wish to select) a supplier. As this supplier of last resort is also the public supplier, it increases the number of captive customers supplied by the same company and unduly forecloses the market.

The legislation shall clearly establish who has the right to be supplied by the supplier of last resort and under which conditions. Not all final consumers who do not have a supplier should automatically be allowed to be supplied by the supplier of last resort. This confuses supply of last resort with the concept of public supplier and effectively contributes to market foreclosure. Furthermore, the universal service obligation has to be implemented through the selection of the supplier of last resort in a transparent and non-discriminatory way, by a tendering procedure, and it shall not impede the opening of the market provided for in Article 21 of Directive 2003/54/EC. Thus, imposing an obligation to the incumbent public supplier to provide the function of a supplier of last resort by the Governments, does not satisfy the requirement of transparency.

e) *End-users' Price Regulation*

Even if all Contracting Parties (except Ukraine) define eligibility in line with the requirements from Directive 2003/54/EC, they allow to all categories of eligible customers, including large and medium size businesses, to be supplied in the same manner as tariff customers, i.e. under regulated end-users' prices. Only Croatia, that allows eligible customers to be supplied at regulated tariffs for 30 days if they do not find a new supplier, provides for higher prices for those customers in comparison to the regulated prices for tariff customers. On the other hand, regulating the end-users' price of electricity for the "temporary customers" in Croatia is an issue raising concerns in relation to end-users' price regulation of electricity supply. Since the "temporary customers" are undertakings as eligible customers including large industry, price regulation for such category of customers is incompliant with the *Federutility* judgment and might raise State aid concerns. Besides Moldova (for which the deadlines for opening the electricity market to competition has not expired yet and currently the end-users' prices are regulated for all customers' categories) and Croatia, it can be concluded that end-users' price regulation raises issues of concern in all other Contracting Parties.

In Albania, after the new amendments of the primary legislation, ERE does not regulate anymore the price for customers connected at transmission level and for customers with consumption above 50 GWh/year. Nevertheless, it regulates the end-users' price for all customers connected at medium and low voltage. Besides, as not all non-household customers are automatically considered eligible, they may remain (provided they do not apply for obtaining the eligibility status) tariff customers being supplied by the public supplier under regulated prices and tariffs. Thus the eligibility status is unduly linked with price regulation. Moreover, the eligible customers that have chosen to be supplied at market prices have the right (if they so request) to go back to the system of regulated prices without time limitation in the same manner and at the same level as the tariff customers. This resembles the French "return tariffs" and it does not comply with the requirement for providing different protection of different types of customers from the *Federutility* judgment.

The regulatory authorities of both entities in Bosnia and Herzegovina link the eligibility requirement with end-users' price regulation and both of them set the end-users' prices for all customers' categories. FERC regulates the prices for customers connected to high, medium and low voltage level, thus including industry and large companies without time limitation. RERS on the other hand provides a transitional period until 1 January 2015, until when also the eligible customers, including industry and large companies, may choose to be supplied under regulated prices at the same level as the tariffs established for tariff customers. After 1 January 2015, households and small customers could remain supplied by the public supplier under regulated tariffs without time limitation. By allowing end-users' price regulation of all customers in the same manner, without linking it with concrete specific circumstances, Bosnia and Herzegovina does not comply with the *Federutility* case. Even though RERS has developed a phasing out period, it should provide for a periodical review on whether the end-users' price regulation has not become unproportional before 1 January 2015 and whether it does

not go beyond what is necessary for achieving the objective for which it has been allowed, taking into account the developments of the competition in the wholesale electricity market.

In Ukraine, the end-users' price is regulated for all customers and there is no plan developed for phasing out price regulation. Even though the Electricity Law mentions the possibility that some customers buy electricity at non-regulated tariffs, taking into consideration that the wholesale price is regulated fully by NERC, and that all suppliers are obliged to buy electricity at the wholesale price from the wholesale market (the single buyer), it could be incurred that end-users' price regulation is available for all customers.

In former Yugoslav Republic of Macedonia, as in Albania, all customers connected to the transmission grids are not allowed to buy electricity under regulated prices, but all eligible and not eligible customers connected at medium and low voltage could benefit from end-users' price regulation without time limitation.

Montenegro, Serbia and Kosovo* provide a plan for phasing out regulated end users' prices:

- In Montenegro, all customers' categories could benefit from price regulation until 31 December 2012. However, as from 1 July 2012, when the prices shall be set according the new methodology, they will be applicable to customers connected to medium and low voltage grid, thereby covering all households and all non-household customers connected to the distribution network. This provision shall be amended in order not to link the public supply with voltage level. If meant to implement the universal service provision, it shall define the customers as households and small and medium enterprises in line with Article 3(2) of Directive 2003/54/EC. Moreover, it is critical that the Agency is allowed by the Energy Law of Montenegro to limit the increase in prices and tariffs under its competence "in order to fulfil the adopted economy and energy policy of Montenegro." This right of the Agency is very broadly defined and it should include an additional assessment in case it is implemented by the Agency. In such a case, the Agency should link a decision for not increasing the prices and tariffs to imposing a Public Service Obligation, and provide proof that such an obligation complies with the requirements from Article 3(2) of the Directive 2003/54/EC and with the principle of proportionality. Moreover, this provision from the Energy law of Montenegro, suggests that cost-efficiency is not the decisive motive behind determining the costs to be included in the calculation of tariffs (and end-users' electricity prices). Deviating from the principle of cost-reflectivity as embedded in Energy Community law on account of the wish to mitigate electricity price rises in line with a general and not further determined economic policy is not motivated by striking the balance between the principles of cost-reflectivity and cost-efficiency as required by the *acquis*.²⁵⁶
- At the moment, all customers' categories in Serbia enjoy regulated end-users' prices of electricity. The Energy Law from 2011 however, provides for a phase out of end-users' prices of electricity supply, under which all customers could be supplied by the public supplier until 31 January 2012; afterwards all customers connected to distribution could be supplied under regulated prices until 1 January 2014. The households and the small customers could be supplied by the public supplier until 2015.
- Finally, the phase out date for termination supply of electricity at regulated end-user tariffs to eligible customers in Kosovo* is 1 January 2015. Nevertheless, this is subject to ERO being satisfied with the competition in the supply of electricity market. The provisions meant to phase out regulated end-users' prices should be further developed, similarly to Montenegro. The end-users' price regulation for large industry shall be terminated, and the end-users' price regulation for the other customers' categories shall be reviewed periodically.

The regulation of end-users' prices of electricity in the Contracting Parties is not in compliance with the Directive 2003/54/EC, the *Federutility* judgement and European State aid law. First of all, by allowing to all eligible customers (including large industrial customers) to choose to be supplied by the public supplier at regulated prices grants them a possibility to benefit from the same tariffs established for the tariff customers that are lower than the market electricity prices. Secondly, even though a date for phasing out the price regulation is established in some countries, it is linked with connection at a

²⁵⁶ The Secretariat has analysed the application of this provision in the Opening Letter in Case ECS-12/11 against Montenegro of 28 November 2011.

certain voltage level. This might go beyond providing universal service only to households and to small and medium enterprises as defined in the Directive 2003/54/EC because also enterprises with bigger size might be connected to the distribution network, and for them a default end-users' price regulation is not allowed. On the other hand, Albania, former Yugoslav Republic of Macedonia and one of the Bosnia and Herzegovina's entities do not include a time limit and do not consider supply at regulated prices a temporary measure. Therefore, it could be concluded that most of the Contracting Parties regulate the end-users' prices for supply with electricity for all customers' categories including not only households and small customers, but also medium and large businesses.

The Secretariat finds that at this point in time, none of the Contracting Parties complies with the requirements and the criteria for assessment of regulated end-users' prices established by the case law of the Court of Justice. *Firstly*, all of the Contracting Parties regulate not only one component of the price (influenced by the specific circumstances in question), but the final end-users' price of electricity. *Secondly*, none of the Contracting Parties links the end-users' price regulation with exceptional circumstances and/or reasons related to security of electricity supply.²⁵⁷ *Thirdly*, most of the Contracting Parties allow protection in the same manner of all customers' categories i.e. large businesses and small commercial customers and households, without thereby complying with the requirement established by the Court of Justice that those two categories (and even the different companies depending on the size) are not allowed to benefit from the same treatment and protection. *Fourthly*, most of the Contracting Parties do not have an end date for phasing-out the regulated end-users' prices and a roadmap for doing so. In practice, the Contracting Parties do not show the temporary character of the end-users' price regulation. *Fifthly*, none of the Contracting Parties have offered any justification of the necessity for maintaining end-users' price regulation for all customers' categories as a price of supply or any other Public Service Obligation that complies with the conditions from Article 3(2) of Directive 2003/54/EC. *Sixthly*, none of the Contracting Parties seems to comply with the proportionality principle and the end-users' price regulation goes beyond what is necessary to ensure provision of services of general economic interest. *Seventhly*, these services of general economic interest or public service obligations suffer from a lack of clear definition.

As follows from the analysis above, the low regulated end-users' prices currently in place in the Contracting Parties probably also constitute prohibited State aid, very similarly to the French and the Spanish case. If in a first place an undertaking is supplied with electricity at low regulated prices, an advantage would be conferred to that undertaking that benefits from the low regulated electricity prices. This seems to be the case in all Contracting Parties currently. In addition, the loss for supplying at low regulated prices incurred by the (usually public) supplier and/or the (usually incumbent State-owned) generator entrusted with Public Service Obligations, may also need to be covered from the State budget in the form of additional State aid to the public electricity supplier and/or public generator in question. Finally, the possibility given to the eligible customers that have exercised their eligibility right to return and to request supply from the (public) supplier of tariff customers under the same conditions and under the same regulated end-users' prices as the tariff customers, might raise State aid concerns as in the French case.

f) *Cost-Reflectivity of Grid Tariffs and Cross Subsidisation*

A general feature across the region is that the commercial customers are typically paying more than the household customers. The Wholesale Market Opening Study has pointed out that this can hardly be explained by differences in the cost structure motivating such differences in end-users' prices.²⁵⁸ Instead, the reasons are the regulated prices that are below levels at which new entrants would be able to enter the market to compete effectively, and are below the wholesale energy price, which a new supplier would have to buy energy at.

The analysis of each component of the end-user electricity price has confirmed that the end-users' prices of electricity are regulated at artificially low and not cost-reflective levels. The generation costs are not fully included in the final price. The customers benefiting from regulated end-users' prices pay only the regulated generation prices for the capacity generated domestically, and do not pay the costs

²⁵⁷ Croatia does limit the price regulation of temporary customers with existence of public interest, but this is left very broad and not necessarily related to existence of public interest related to electricity supply, but as the law amendments show, related to purchase of raw materials from another country.

²⁵⁸ Wholesale Market Opening Study, p.68

for imported electricity. This means that they are not made responsible to pay for the whole generation portfolio used to satisfy their needs. The distribution and transmission tariffs are also not complying with the principle of cost-reflectivity as embedded in Energy Community law. The regulators should work on developing better cost-reflective regulation. Finally, until costs of supply per customer are not known, the supply component in the end-users' prices cannot fully reflect the costs for its provision.

The Wholesale Market Opening Study observed that even though the Contracting Parties have formally opened their end-user markets, there has been no or limited market entry, and the low regulated tariffs have been considered an important barrier for market opening in addition to the lack of unbundling between supply and distribution.²⁵⁹ The Study found that as long as end-users' prices regulated below the cost for new entrants are available to the eligible customers effective market opening would be very difficult to achieve.²⁶⁰ Relying on the IPA Tariff Study as updated by ECRB, the Secretariat concludes that in most of the Contracting Parties the transmission and distribution tariffs are not fully reflecting the costs, and are thereby not complying with the cost-reflectivity principle. Therefore, establishing end-users' prices of electricity for the tariff customers that reflect the costs of the tariffs, and of the two competitive activities – generation and supply, is one of the first issues to be addressed.

Finally, even though all Contracting Parties contain provisions in their primary and/or secondary legislation prohibiting cross-subsidies, the analysis above based on the IPA Tariff Study has shown that in practice most of them maintain cross-subsidisation between the different customers' categories since the difference in costs for customers supplied at same voltage levels (households and commercial customers for instance) could hardly be explained by the difference in costs for supplying those two categories. Existence of cross-subsidisation represents a source of discrimination between the different customers' categories by treating them in a different manner. Cross-subsidisation should be phased out, and clear roadmaps for doing so shall be developed by the Contracting Parties.

The situation in the Contracting Parties is thus not different from that in the EU Member States against which the European Commission initiated infringement proceedings related to regulation of end-users' electricity price. Namely, most of the Contracting Parties maintain end-users' price regulation without justification for all customers' categories, including the medium and large industries, or they link it with supply at certain voltage level. They moreover entrust the incumbent generators and the incumbent public supplier with providing Public Service Obligation (supply of tariff customers under regulated prices) without a transparent tendering procedure. Finally, the end-users' price regulation is not limited in time and there is no proof that is considered a temporary measure. All these issues are indicative that end-users' price regulation deserves the full attention and concrete action of the Energy Community institutions.

5. Recommendations for Reform

In order to stimulate such action, the Secretariat proposes, in the following, a number of concrete steps towards tackling the fundamental problems stemming from regulated and/or non-cost-reflective prices and tariffs. As has been set out extensively in the above, these problems jeopardize several of the key objectives of the Treaty, including the establishment of competitive markets, regional integration, the security of supply, attraction of investment and environmental sustainability. Given the universal dimension of the problems, the Secretariat would prefer joint action and a common approach over taking individual action based on non-compliance with the Treaty. Taking into account the social dimension of the problem, the proposals also limit themselves to what the Secretariat considers indispensable for the attainment of the Treaty's objectives, to stimulate further opening of the wholesale and retail electricity markets, and to ensuring long-term supply security to all customers in the Energy Community. Depending on the response of the Permanent High Level Group, the Secretariat will consider casting these recommendations in the form of a proposal for a Decision based on Articles 31 and 32 of the Treaty.

It goes without saying that the Secretariat is available to assist all Contracting Parties in all steps of the process of price reform.

²⁵⁹ Wholesale Market Opening Study, p.65

²⁶⁰ Wholesale Market Opening Study, p.69

Recommendation 1: All Contracting Parties to ensure that **eligibility** is defined in line with Article 21 of Directive 2003/54/EC, i.e. as the full and unconditional right to choose a supplier for all non-household customers. This requires in particular:

- (a) a clear and compliant definition in primary law;
- (b) the removal of all conditions and requirements other than the status of being a non-household customer, including references to voltage levels or electricity consumption;
- (c) the removal of all administrative obstacles to exercising eligibility such as discretionary or conditional approval by regulatory authorities or market operators, registration requirements, etc.;
- (d) ensuring that the right to switch supplier can be exercised continuously (not only by one particular reference date) and swiftly;
- (e) the inclusion of resellers in the category of eligible customers, including public suppliers and suppliers of last resort, and the removal of all explicit or structural barriers for them to exercise their eligibility.

The Secretariat considers that this task can be achieved immediately by all Contracting Parties except Moldova which benefits from an extended deadline. The Contracting Parties shall notify the Secretariat of the steps undertaken.

Recommendation 2: All Contracting Parties to ensure that the electricity prices for all customers falling within the category defined for the purposes of universal service provision in the first sentence of Article 3(3) of Directive 2003/54/EC ("**small and medium customers**") subject to price regulation are cost-reflective. Cost-reflectivity must extend to the real costs of electricity supply, including the costs of generation (short run marginal cost), reflecting the full generation portfolio, necessary investments/an appropriate rate of return, the costs of imports, the costs of supply services and bad debts.

As a prerequisite, this requires full accounting unbundling between regulated and non-regulated activities, as well as between generation/supply and distribution.

The Secretariat considers that this task can be achieved by 31 July 2012. The Contracting Parties shall notify the Secretariat of the steps undertaken and submit to it all methodologies for review. If need be, the Secretariat may propose the introduction of model methodologies based on best practices.

The national regulatory authority should be entitled and obliged to carry out annual reviews of the methodologies and the end-user price level adopted, as well as of the continuing necessity of price regulation for certain customer categories based on the public service objective pursued. These reviews shall be submitted to the Secretariat which, based on an analysis of the regional market, may propose further measures for phasing out regulated prices in certain categories.

Recommendation 3: All Contracting Parties to ensure the cost-reflectivity of **network tariffs**.

The Secretariat considers that this task can be achieved by 31 July 2012. The Contracting Parties shall notify the Secretariat of the steps undertaken and submit to it all methodologies for review. If need be, the Secretariat may propose the introduction of model methodologies based on best practices.

Recommendation 4: All Contracting Parties to define clearly and by law the **public service objectives pursued** by price regulation as well as the notions of **vulnerable customers** subject to special protection or support. First, this has to involve a reflected definition of vulnerable energy customers addressing the *real* economic support needs and, secondly, has to move protection schemes from the energy sector to national social welfare systems and, in particular, the Social Action Plans of the Contracting Parties.

The Secretariat considers that this task can be achieved by 31 December 2012. The Contracting Parties shall notify the Secretariat of the steps undertaken and on the protection/support measures in place for the defined categories of customers. If need be, the Secretariat may make recommendations based on best practices.

Recommendation 5: All Contracting Parties to ensure that the electricity prices for all customers not falling within the category defined for the purposes of universal service provision in the first sentence of Article 3(3) of Directive 2003/54/EC ("**large customers**") are not subject to price regulation as a matter of principle, i.e. they should not be considered as tariff customers. They should be prevented from switching back to the regulated tariff system.

The Secretariat considers that this task can be achieved by 31 December 2012. The Contracting Parties shall notify the Secretariat of the steps undertaken. They shall send to the Secretariat a list of large customers in the Contracting Party, to be updated annually.

Recommendation 6: All Contracting Parties to ensure that the **market design** does not impede the goals of market opening and price reforms. To that end, the possibility for public supply must be limited to small and medium customers. Furthermore, there must be no legal obligation for the public supplier to buy exclusively from one single generation company or wholesale supplier. Moreover, the function of supplier of last resort must be (re-)designed in a way that it does not become the default supplier for customers not exercising their right to change supplier, but is limited to ensuring continuous supply, for a limited period time and – to the extent it may supply commercial customers – at prices reflecting the cost of that service. The Secretariat considers the Croatian solution a benchmark.

In line with the recommendations of the Wholesale Market Opening Study, full supply contracts should be replaced by base load contracts covering a certain share of tariff customers' yearly energy consumption, and the volumes of those base-load contracts should be reduced year by year. Incumbent generators should be entitled to sell not only excess electricity to the market, but also to put certain volumes of their generation at the disposal of the regional market, including on the short-term market.²⁶¹ The national regulatory authority should require incumbent generators to implement capacity release programmes for that purpose if necessary.

The Secretariat considers that this task can be achieved by 31 July 2013. The Contracting Parties shall notify the Secretariat of the steps undertaken.

ⁱ The designation throughout this document is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo declaration of independence.

²⁶¹ Wholesale Market Opening study, pp.28-32, and pp.132-134