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A SURVEY OF CURRENT ISSUES IN THE EUROPEAN ENERGY SECTOR

THE EUROPEAN
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2015

SECTOR SURVEY
NINTH EDITION



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THIRD ENERGY PACKAGE

Throughout this publication, we refer to the two Directives and three Regulations adopted by the European Council and the Parliament on 13 July 2009 as the "Third Energy Package". For ease of reference, the Directives and Regulations adopted as part of the Third Energy Package: EU Directives 2009/72/EC, 2009/73/EC and Regulations (EC) No 713/2009, No 714/2009 and No 715/2009 are referred to as the "Third Electricity Directive", the "Third Gas Directive", the "ACER Regulation", the "New Electricity Regulation" and the "New Gas Regulation", respectively. Where the context so requires, we refer collectively to the two Directives as the "Third Electricity and Gas Directives" and to the Regulations as the "New Electricity and Gas Regulations", as appropriate.

CLIMATE CHANGE PACKAGE

We refer to the four Directives, one Regulation and one Decision adopted by the European Parliament on 17 December 2008 and the European Council on 6 April 2009 as the "Climate Change Package". For ease of reference, throughout this publication, we refer to EU Directives 2009/29/EC, 2009/28/EC, 2009/31/EC and 2009/30/EC as the "New EU ETS Directive", the "Renewable Energy Directive", the "CCS Directive" and the "Biofuel Directive" respectively. Further, we refer to EU Decision No 406/2009/EC and Regulation (EC) No 443/2009 as the "GHG Reduction Decision" and the "Emissions Standards Regulation", respectively.

Where required, we have referred to the previous internal energy market directives 1996/92/EC and 1998/30/EC as the "First Electricity Directive" and the "First Gas Directive", respectively and to Directives 2003/54/EC and 2003/55/EC as the "Second Electricity Directive" and the "Second Gas Directive", respectively.

Throughout the publication, we refer to Transmission System Operators as "TSO" and to Distribution System Operators as "DSO".

We use the following abbreviations for the various unbundling models:

FOU: Full Ownership Unbundling;

ITO: Independent Transport Operator;

ISO: Independent System Operator

LEGAL ADVICE

Please note that the content of this publication does not constitute legal advice and should not be relied upon as such. Specific legal advice should be sought for your specific circumstances.

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INTRODUCTION

I am delighted to introduce the 2015 edition of "The European Energy Handbook" which provides an in-depth survey of current issues in the energy sector in 42 European jurisdictions.

This year's edition focuses on recent legal and commercial developments in each jurisdiction and covers issues as diverse as the design of electricity markets, the reform of the support schemes for renewable electricity, new cross-border interconnections, new state aid guidelines, taxation issues for the upstream sector and significant commercial transactions and privatisations in the energy sector.

In addition to contributions for the European Union, Belgium, France, Germany, Spain, Russia and the United Kingdom from our own offices, this year we have contributions from Schönherr (Albania, Austria, Bulgaria, Croatia, Czech Republic, Hungary, Montenegro, Romania, Serbia, Slovakia and Slovenia), Peterka & Partners (Belarus), Karanovic-Nikolic (Bosnia and Herzegovina and the Former Yugoslav Republic of Macedonia), S. A. Evangelou & Co LLC (Cyprus), Kromann Reumert (Denmark), Raidia Leijns & Norcoux (Estonia, Latvia and Lithuania), Roschier (Finland), Kyriakides Georgopoulos & Daniolos Issaias (Greece), Arthur Cox (Ireland), Studio Legale Legance (Italy), Signum (Kazakhstan), Arendt & Medernach (Luxembourg), Buttigieg, Refalo & Zammit Pace Advocates (Malta), Nauta Dutilh (the Netherlands), Arntzen de Besche Advokatfirma AS (Norway), WKB Wierciński, Kwieciński, Baehr (Poland), Esquivel Advogados (Portugal), Mannheimer Swartling (Sweden), Homburger (Switzerland), Kolcuoğlu Demirkan (Turkey), BBA//Legal (Iceland) and Sayenko Kharenko (Ukraine).

Whilst 2014 was supposed to be the year in which the internal market for energy would be completed, not all Member States have transposed the Third Energy Package into national law and the European Commission has referred a number of Member States to the European Court of Justice for either partial or complete failure to implement the same.

2015 will see intensified efforts to integrate the European energy market and is set to be an important year for the electricity market as the EU Target Model for electricity market integration is expected to be fully implemented this year.

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The gas markets are likewise anticipating further changes: In January, ACER published its updated Gas Target Model, which covers matters such as security of supply, the future of wholesale markets, the role of gas in complementing power generation from renewables, and new development along the gas value chain.

The security of gas supply is another topic which is likely to receive a lot of attention in 2015 as the European Commission has, in January 2015, opened a new consultation seeking views on EU rules to guarantee the security of gas supplies, in a bid to further improve Europe's resilience to gas supply disruptions. This follows stress tests carried out in October last year which showed that better cooperation and coordination between EU Member States was desirable.

In short, 2015 will be another busy year for the European energy sector.

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ENERGY LAW IN THE EUROPEAN UNION

Recent developments in the European Union energy market

Silke Goldberg, counsel, Herbert Smith Freehills

This article provides an overview of significant and recent developments in the European energy market since January 2014. For more detail on how individual countries have adopted and implement EU-wide initiatives, please consult the relevant national chapter.

NEW EUROPEAN COMMISSION AND DIRECTOR GENERAL ENERGY

Internal EU politics were, throughout much of 2014, dominated by elections to the European Parliament and the appointment of a new Commission. In addition to policies on jobs and investment and a digital single market, the energy sector featured high on the agenda of the new Commission who stated that the creation of an Energy Union and tackling climate change would be at the heart of its decision-making.

The Commission set out four key objectives for its term until 2019, chief amongst which is (i) the creation of an Energy Union, followed by (ii) the diversification of energy sources; and (iii) a reduced energy import dependency for the EU as a whole. The fourth objective is linked to the EU's climate commitments and aims to make the EU a leader for renewable energy and the fight against global warming.

The importance of the internal energy market and climate issues for the Commission is also reflected in the appointment of not only a Commissioner (in the person of Miguel Arias Cañete) for Climate Action & Energy, but also a Vice President of the Commission with a specific remit for the Energy Union (in the person of Maroš Šefčovič).

Whereas Commissioner Cañete's brief includes

- increasing Europe's energy security by diversifying sources of energy imports and uniting Europe's negotiating power in talks with non-EU countries;
- selecting energy infrastructure projects to help establish a European Energy Union;
- proposing new EU laws and rules to implement the 2030 climate and energy framework and steering negotiations with the European Parliament and national governments;
- further developing an EU policy for renewable energy to make the EU the world leader in the sector; and
- strengthening and promoting the Emissions Trading System,

Vice-President Šefčovič has been tasked with

- establishing a European Energy Union by connecting infrastructures, enforcing legislation and increasing competition to help drive down costs for citizens and businesses and boost growth;

- working to prevent energy shortages, diversifying sources of energy imports and ensuring a united European voice in negotiations to improve our energy security;
- helping to mobilise additional investment in power grids, renewable energy installations and other energy infrastructure;
- improving energy efficiency, especially for buildings; with a binding target of 30% less energy use by 2030; and
- Coordinating the Commission's efforts to ensure the EU reaches its climate and energy targets for 2020 and 2030.

Another new senior appointment on the civil service side of the European Commission saw Dominique Ristori appointed as the new Director General of DG Energy to succeed Philip Lowe following the latter's retirement. Prior to his appointment, Mr Ristori was a key player in shaping and preparing the first Directives on energy internal markets, as well as launching the Madrid and Florence Fora.

ENERGY UNION

In his July 2014 speech to the European Parliament, the now President of the European Commission, Jean-Claude Juncker set out his vision for a European Energy Union. In recognition of Europe's reliance on imports of gas and other fuels, Mr Juncker stated that an energy union must be achieved with the pooling of both power and infrastructure resources, a statement which points back to the roots of the European Union in the Schuman plan for the pooling of French and German energy resources in the nascent ECSC.

Senior commentators such as Donald Tusk have noted that the EU is still made up of a patchwork of inefficient "energy islands" and have expressed the hope that a functioning internal energy market would reduce wastage and lower prices as well as generate savings of up to €40 billion a year by 2030 if the EU energy grids were fully integrated.¹

2030 CLIMATE AND ENERGY FRAMEWORK

The 2030 framework for climate and energy (the "2030 Framework") as proposed by the Commission in January 2014 draws on the experience and lessons of the 2020 climate and energy framework. It builds on the longer term perspective set out by the Commission in 2011 in the Roadmap for moving to a competitive low carbon economy in 2050, the Energy Roadmap 2050 and the Transport White Paper. This suite of documents reflects the EU's objective of reducing greenhouse gas emissions by 80-95% below 1990 levels by 2050 as part of the effort required from developed countries as a whole.

At its core, the 2030 Framework consists of the following key elements which will in due course be reflected in legislative initiatives or regulatory decisions:

- a binding greenhouse gas reduction target

- an EU-wide binding renewable energy target
- an improvement in the level of energy efficiency
- a reform of the EU emissions trading system ("ETS")
- secure energy supplies that are also affordable and competitive; and
- a new governance system for the energy sector.

The 2030 Framework aims to make the European Union's economy and energy system more competitive, secure and sustainable and also sets a target of at least 27% for renewable energy and energy savings by 2030 and a greenhouse gas reduction target of at least 40% compared to 1990. The 2030 Framework is also trying to achieve greater regulatory certainty for investors and a coordinated approach among Member States as it looks at policy targets over a longer period of time.

NEW STATE AID GUIDELINES

In July 2014, the European Commission published updated guidelines on "State aid for environmental protection and energy 2014 - 2020," and these became applicable from 1 July 2014. A main tool proposed by the Commission is requiring Member States to set out the likely scenario "but for" the grant of aid. This scenario is then used to judge whether the aid is merited.

Once the notification threshold is passed, the Commission's assessment of the application has two parts: what the aid is for, and the overall effect of how it is given. In terms of assessing the support scheme and compatibility, the project must meet all of these criteria:

- Incentive effect;
- Contribution to a well-defined objective of the common interest;
- Need for state intervention;
- Appropriateness of the aid;
- Proportionality of the aid;
- The extent to which it affects competitiveness between Member States; and
- The transparency of the aid.

Given the current focus at an EU-wide level is on the increased generation and use of renewable energy, the Guidelines include a stand-alone section on how aid for renewable energy is to be treated. Furthermore, a separate section for aid given to energy infrastructure, with the exception of oil infrastructure, is included. The common interest criteria will be fulfilled as such projects are considered to be of benefit to the internal market. The need for aid, on the other hand, must be met by demonstrating that tariff financing would be insufficient to support the project.

BRIDGE 2025

On 23 September 2014, ACER published its "A Bridge to 2025" document which sets out a summary and analysis of the challenges likely to face the energy industry in the coming years and on the responses necessary to tackle these.

In addition to looking at the challenges facing Europe, Bridge to 2025 also sets out five objectives to be achieved over the coming decade:

- establishing a liquid and competitive wholesale energy market;

- improving security of supply;
- transitioning to a low carbon economy and increasing the use of renewable energy;
- developing a retail market that benefits consumers; and
- building stakeholder dialogue, cooperation and new governance arrangements.

As well as setting out ACER's vision for challenges and the regulatory landscape, A Bridge to 2025 also looks at the make-up, technology use and market structure. Market integration is seen as cornerstone in improving liquidity, competition and cooperation with the EU's neighbours (with some already committed to adopting energy *acquis*).

In addition to the above objectives, the report also sets out proposals for the implementation of existing regulation and additional supporting regulatory initiatives. As such, ACER intends to

- implement fully the Third Energy Package, which is hoped will encourage the formation of competitive and liquid markets;
- develop and set out EU-wide criteria (to combat the issue of national regulators having different policies and support schemes). This is to be achieved via a Roadmap to 2025;
- develop and update (the update having now been published) the GTM with a focus on security of supply and ways to deal with potential disruptions - such as those looked at in the European stress tests;
- encourage the development of flexible responses (including DSR);
- encourage new service providers to enter the market and preventing the DSO market becoming monopolistic;
- enhance consumer protection;
- establish and engage with stakeholder panels (including consumers) so any discussions on the future of European energy markets can be undertaken in an open, "holistic" and constructive way;
- improve regulatory oversight of ENTSOs and other energy bodies; and
- encourage the participation of and cooperation with third party countries and their regulatory agencies - Norway is presented as an example.

Of note is that ACER believes it should be given the power to issue binding decisions in relation to ENTSOs "core" tasks. This could be seen as an indication of future trends, however, it remains to be seen whether this suggestion will be reflected in EU legislation.

PROJECTS OF COMMON INTEREST

To further the vision of an integrated market, in November 2014 the Commission announced €647million would be allocated to Projects of Common Interest (PCI). In order to qualify as a PCI, the project must:

- Contribute to market integration and increase/ further competition
- Improve security of supply
- Reduce CO₂ emissions

The money will go toward energy infrastructure projects, including the works for the Poland-Lithuania interconnection (gas); and works for the North Atlantic Green Zone Project (a UK and Ireland project) which will enhance grid control and improve demand side management; and various studies on the feasibility of interconnections.²

A consultation was launched on 23 December 2014 and will run until 13 March 2015. The objective of the consultation is to gather views and contributions on the need for gas and electricity projects that will further the above three objectives.³

MARKET COUPLING AND INTERCONNECTORS - AN INTERNAL ENERGY MARKET

The Commission has explained that the most efficient way to an integrated energy market is through regional cooperation and initiatives. In February 2014, 14 Member States⁴ established the day-ahead market coupling. This mechanism is designed to ensure energy flows between Member States in the best way possible - minimising loss and bringing prices closer together. Furthermore, in May 2014, the South-West market coupled with the North-West. This mechanism is only for electricity flows.

A similar scheme for gas had also been developed over the course of 2013 and 2014. The PRISMA platform, established in 2013, allows for the auctioning of capacity along interconnectors in a uniform manner. So far, this platform is used by 28 TSOs who are responsible for transporting 70% of Europe's gas.

ACER has started to release Progress Reports on the status of the Electricity and Gas Regional Initiatives (ERI/GRI). The ERI report released in October 2014 (the most recent to date), sets out the progress of the day-ahead market coupling mechanism. Broadly, progress has been heralded as a positive, but the "Central Southern Europe" ("CSE") region has pushed back the launch date to February 2015.⁵

From 27 to 28 November 2014, the Florence Forum considered, inter alia, whether the EU is moving any closer to an Internal Electricity Market ("IEM"). Broadly, the project has been viewed as a success. However, the report into the IEM made it clear that further work is still required. In particular, the Commission highlighted the need for more grids and better rules, in the form of network codes and PCIs. In addition, the report drew attention to a number of problems and threats to the IEM project. Mention is made of the difference in national policies regarding renewable energy sources and nuclear power - such as Switzerland's plan to decommission nuclear power plants versus the UK's encouragement and development of new nuclear builds. In order for there to be a true IEM, it is envisaged that policy convergence, to an extent, must occur.

The internal market progress report pointed to a number of steps that needed to be taken to ensure completion of the IEM. Further investment is necessary in energy infrastructure, such as smart grids and ending the de facto isolation of Baltic States from gas markets. The report set a target for 2020 that three quarters of PCIs should be completed. Harmonised rules were considered essential, but that these must be balanced so as to ensure that national governments do not intervene unnecessarily. In addition, although wholesale prices came down, little impact was seen on a retail level. The report pointed out that the wholesale price and retail price for energy must become more closely linked to ensure that consumers reap the benefits of lower wholesale prices.

In November 2014 the Commission published a press release announcing the signing of an agreement between the Association of the Mediterranean Energy Regulators (MEDREG), the Directorate-General for Energy and the Association of Mediterranean Transmission System Operations (Med-TSO) which hopes to establish a platform on electricity markets. The agreement is in the form of a Memorandum of Understanding.

TARGET MODEL

The ERI report of October 2014 also discusses the progress of the Intraday European target model. The initial deadline for its implementation throughout Europe was the end of 2014, but this has since been pushed back. In the implementation of the European target model for electricity, the Capacity Allocation and Congestion Management Regulation ("CACM") has a key role. The CACM Regulation was adopted by Member States in Comitology on 5 December 2014. CACM will now go through scrutiny from the European Parliament and Council and its definitive adoption is expected in early 2015.

On 8 January 2015 ACER published the updated Gas Target Model ("GTM"). The updated model focuses on: competitive markets, wholesale markets, self-evaluation, gas's role in complementing renewable generation, and new developments.

Competitive markets

It is ACER's position that competitive markets will enhance security of supply. The view taken is that the more diverse the supply is (and as a result more competitive) the less Europe will rely on a narrow base of gas suppliers. The updated GTM reinforces this, and recommends improving "market-based measures" in an effort to bring more suppliers into the market.

Wholesale markets

While there is some forward trading present in the EU, ACER believes that it is far below the necessary level to ensure the effective functioning of wholesale markets. The revised GTM therefore focuses on an assessment of these markets at a national level to develop assessment criteria as a means of establishing whether a market is well-functioning.

Self-evaluation

National Regulatory Authorities are also encouraged to "self-evaluate" and assess the current status of their gas markets with a view to ensuring they will meet the new GTM criteria by 2017.

The role of gas in complementing renewable generation

Although the general theme is to encourage and focus on increasing the use of renewable energy, it is appreciated that gas-fired plants are a necessary back-up. ACER proposes, therefore, that an obligation should be placed on gas and electricity TSOs to work more closely with one another.

New developments in the gas supply chain

Such developments include the intensification of LNG and CNG use in the transportation sector. The updated GTM states that national regulators allow for the use and development of these new uses by intervening where appropriate.

REMIT AND MIFID2

The Regulation on wholesale energy market integrity and transparency ("REMIT") is intended to increase transparency and confidence in wholesalers. ENTSO-E expects to publish a central information database for the publication of electricity market information by early 2015.

In December 2014, the REMIT Implementing Act was published in the Official Journal of the European Union.⁶

The Directive on Markets in Financial Instruments ((MIFID2) will "go live" on 3 January 2017. Up to this point, energy firms have fallen under a number of exemptions, a result of which means these firms have not required authorisation for their trading activities. However, MIFID2 is aimed at, inter alia, tighter regulation of such and firms and trades and is designed to bring more of these trades within the regulatory ambit. Amendments have also been made to the definition of financial instruments, thereby catching a wider range of trading activities, such as commodity derivatives that can be physically settled and are traded on an organising trading facility in addition to such things as emission allowances.

On 19 December 2014, the European Securities and Markets Authority (ESMA) launched a consultation on the implementation of MIFID2, which also includes (in draft) technical standards and methods for calculating thresholds which will close in March 2015.

CLIMATE CHANGE

2014 saw significant EU develops in the effort to combat climate change. As recently as December 2014, the Commission and the European Investment Bank (EIB) announced the introduction of a financing instrument to support projects that promote the preservation of "natural capital". Also in December 2014, the Commission released a statement informing that it would contribute €15 million to the NAMA Facility.⁷ The Commission joined the UK, Germany and Denmark in its financial assistance.

In October 2014, the Commission released the annual report on progress that is being made toward meeting climate targets. According to the report, the EU is on target to make the 2020 targets, but it envisages that stronger efforts will be need in order to meet the more ambitious 2030 target.⁸

ENFORCEMENT

Over the course of 2014, a number of countries have been referred to the European Court of Justice or formally requested by the Commission to transpose EU legislation and full comply with directives and regulations on energy. To date, infringements have involved Member States not complying with their obligations relating to security of gas supply, failing to transpose fully the Energy Efficiency Directive and failing to bring national law in line with the Energy Services Directive.

In November 2014 the European Commission published the most recent requests to countries who have not fully complied with EU rules. Romania was asked to comply with the Regulation on EU Security of Gas Supply. The request follows the fact that Romania had not informed the Commission of the adoption of the Preventative Action Plan or an Emergency Plan as required under the Regulation. The date for such adoption was 3 December 2012. Romania has two months to comply, or she risks being referred to the Court of Justice.

Greece was requested to comply with the Directive concerning the energy performance and efficiency of buildings. The deadline for compliance was 30 June 2012, although this was later moved to

21 March 2013 due to a delegated regulation on cost optimal methodology being published. Greece received a reasoned opinion from the Commission.

Bulgaria and Hungary were also the subject of Commission requests in relation to their transposition, or lack thereof, of the energy efficiency directive. The deadline for transposition was 5 June 2014, and after this date the Commission wrote to Bulgaria and Hungary asking for their notifications on how the directive had been transposed into their national law. In July 2014, infringement proceedings were commenced against 24 European countries for failures to notify the Commission.

Earlier in the year, Cyprus was referred to the Court of Justice for its failure to transpose into national law the Directive on Oil Stocks. This directive aims to tackle security of supply issues by imposing minimum stock levels of crude oil (amongst other petroleum products). The deadline for transposition was 31 December 2012. Security of supply is very much a hot topic, particularly in light of the stress tests referred to above so it is likely that any further infringements will be dealt with swiftly and firmly by the Commission.

OUTLOOK FOR 2015

2015 will be a busy year given the challenges the Commission has set itself in its work programme as well as the various policy documents released in 2014. In 2015, it is likely that the European legislator will look to translate the policy objectives into implementing legislation, either in form to amendments to existing legislation or further secondary legislation such as Commission Regulations.

As part of the efforts towards the creation of the Energy Union, the EU Council is calling for the removal of so-called Energy Islands by the end of 2015. This will entail the improvement of energy integration for those countries and regions with limited interconnection capacity.

It is hoped that 2015 will bring about more investment in infrastructure, supported by the EU PCI fund, as well as seeing an end to the isolation of the Baltic States.

ACER's Work Programme for 2015 sets out four main focus areas until 2017:

- the post-2014 completion of the internal energy market;
- Work on the "infrastructure challenge", ie, the removal of energy islands and improvements of interconnections throughout the EU;
- the monitoring of wholesale energy markets (including the full implementation of REMIT)
- The longer-term regulatory challenges

ACER also highlights the importance of the smooth and comprehensive implementation of REMIT and the introduction of its market monitoring framework.

On 15 January 2015, ACER opened a new consultation on boosting the security of gas supplies for Europe, in the wake of current and anticipated disruption in the future. The consultation comes after EU-wide stress tests on the likely effects of disruption of Russian gas supplies to Europe.⁹ The consultation will close on 18 March 2015.

From 20 to 21 April 2015, the Madrid Forum will take place with a view to discussing the establishment of an internal gas market.

ENDNOTES

1. See, for instance, "Europe needs the will to build an energy union", Financial Times of 21 October 2014 <http://www.ft.com/cms/s/0/b8727392-592b-11e4-a722-00144feab7de.html#axzz3Q1DYMpC3>
2. A full list is available here: http://ec.europa.eu/energy/infrastructure/pci/doc/20141121_cef_energy_lists.pdf
3. Consultation webpage: http://ec.europa.eu/energy/infrastructure/consultations/pci_list_new_en.htm
4. Belgium, Denmark, Estonia, Finland, France, Germany, Austria, UK, Latvia, Lithuania, Luxembourg, the Netherlands, Poland and Sweden. (Norway - non Member State).
5. A table setting out progress in full can be found here http://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Publication/1st%20ERI%20Progress%20Report.pdf
6. It can be found here http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_363_R_0009&from=EN
7. This is an instrument to support projects aimed at reducing CHG in emerging and developing countries
8. EU Gears up for 2030 Targets: http://ec.europa.eu/clima/news/articles/news_2014102801_en.htm
9. Details on the Energy Security Strategy page: <http://ec.europa.eu/energy/en/topics/energy-strategy/energy-security-strategy>

ENERGY LAW IN SERBIA

Recent developments in the Serbian energy market

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ENERGY SECTOR REFORMS

In 2014 the efforts of Serbia to reform its energy sector and to bring it in line with the Third Energy Package have continued at a faster pace.

However, the progress has not been uniform and has mostly related to the electricity sector while gas sector reforms lagged behind especially in terms of reforming the heavily-indebted state-owned integrated gas company, Srbijagas.

ELECTRICITY SECTOR DEVELOPMENTS

Market Liberalisation

Serbia is currently in the final stage of the electricity market liberalisation process.

The Energy Act from 2011 has provided for a three-phase market liberalisation process:

First phase

As of 1 January 2013, every end customer connected to the transmission system, which accounted for 9.5% of total consumption, had the right to be supplied by the public supplier Elektroprivreda Srbije ("EPS") at regulated tariffs.

Nonetheless, out of 27 large industrial consumers, only one, the German "Messer" plant, has opted to change its supplier.

Second phase

This phase has become effective as of January 2014. In this second phase only the households and small commercial customers kept the right to be supplied by the public supplier (EPS) at regulated tariffs.

In other words, customers who have:

- (i) at least one place of delivery at medium voltage (voltage level below 1kV), and
- (ii) all delivery places on the low voltage (0.4kV), if they have more than 50 employees or total annual revenue of more than €10 million,

no longer have the right to be supplied by the public supplier and are from now on supplied on the open market. As of June 2014, 300 customers connected to the distribution system and two large customers connected to the transmission system had opted to change their supplier.

Third phase

As the last phase in the liberalisation process, households and small commercial consumers will be able to freely choose their

supplier as of 1 January 2015. However, no significant engagement of other suppliers is expected, given that currently EPS supplies these customers pursuant to prices below market value.

In order to benefit truly from the competition in the electricity sector, Serbia will need to put further efforts in price deregulation.

Generation

In general, electricity generation from local sources in Serbia is capable of meeting the domestic electricity demand. To that extent, it is recorded by the Energy Agency that the total net import of electricity in 2013 was 2,152GWh whereas the total net export amounted to 4,475GWh. The predominant use of coal explains this relatively low import dependency and also relatively high CO₂ emission.

Generation from hydro power plants amounts to approximately 30%, while generation from thermal power plants ("TPPs") amounts to approximately 70% of the total electricity generated in Serbia. In 2013, power plants in Serbia had generated electricity in the total amount of 37,537GWh¹, out of which 70.3% was produced in TPPs, 28.4% in hydro power plants, 1.1% in thermo-heating power plants and 0.2% in other small, mostly hydro power plants.

Serbia is under an obligation to close part of its thermal capacities pursuant to the EU Directive on the Large Combustion Plants ("LCP Directive"). The deadline for this has been extended from 2017 to 2023 by the Ministerial Council of the Energy Community. Serbia has to shut-down all power blocks of less than 300MW which are not subject to the projects of mitigation of emissions of hazardous substances. In other words, the total capacity to be closed until 2023 amounts to approximately 1,100MW.

Trading

Approximately 80 market players engage in wholesale electricity trading, including EPS, the public enterprise engaged in electricity generation, distribution and supply services, which was, until 1 January 2015, the only entity holding a licence to supply consumer tariffs (ie households and small consumers). Other licensed traders are active mainly in resale and cross-border trade, while only six of them are currently supplying final consumers.

The reason for such a low participation rate in the supply segment of electricity market is that the electricity prices in Serbia remain traditionally low for social policy reasons. Consequently, prices in Serbia are 30-40% lower than electricity prices in south east Europe.

Unbundling

The Public Enterprise Elektromreže Srbije (EMS), the Serbian TSO (also licensed as the electricity market operator), is the only legally unbundled entity. The remaining electricity sector in Serbia is organised and operated under the umbrella of EPS.

Modernisation of the Distribution Network

As of November 2014, Serbia has joined the paths of the USA, Italy, Canada, Sweden and Denmark in application of the modern equipment and solutions regarding the management of the electricity distribution network. In this respect, EPS has signed a letter of intent with "Schneider Electric", a European multinational corporation specialised in energy management, with an ultimate aim of reducing the losses on the distribution grid, which are estimated at 14.9% of the total electricity produced in 2013, and enhancing its reliability.

Forming a Power Exchange

The announced formation of the South East European Power Exchange (SEEPEX), expected to commence in the second half of 2015, will present a significant push towards receiving benefits from a true competitive market.

EMS (Serbian TSO), as one of the founders, has announced that SEEPEX will be based on the price market coupling model and the spot trading principle, which will enhance its capacity and productivity. Further, SEEPEX will increase the transparency of the energy market, gradually reduce electricity prices and, most importantly, it will attract new investors to construct new generation and transmission capacities.

In May 2014, EMS found a strategic partner in European exchange "EPEX SPOT" that will assist in the financial aspect of SEEPEX's functioning. EPEX SPOT now holds a minority 25% stake in SEEPEX. It is expected that after the adoption of the necessary legal acts (pursuant to the new Energy Act), SEEPEX will become fully operational in the third quarter of 2015.

GAS SECTOR

State-owned integrated company Srbijagas is the key player in the Serbian gas market. Serbiagas supplies all retail suppliers in Serbia with gas at an identical wholesale price. Srbijagas obtains all its gas from the Gazprom Neft. The only entry gas entry point in Serbia is at the Hungarian border. The only natural gas producer in Serbia is NIS, the Serbian national oil company which is majority owned by Gazprom Neft.

Srbijagas is licensed for gas transmission, distribution and supply, as well as being the supplier of last resort.

With respect to gas-market liberalisation, as of 1 January 2015 the right to be supplied by the public supplier pursuant to prescribed tariffs will only be granted to households and small consumers.

NEW CAPACITIES

Completed Projects (small hydro and PV)

Serbia has significant energy potential from renewable energy sources which is estimated to be over 4.3 million tonnes of oil equivalent ("TOE") annually of which 2.7 million toe per annum lies in the production of biomass, 0.6 million toe per annum in potential hydro-energy, 0.2 million toe per annum in existing geothermal sources, 0.2 million toe in wind power and 0.6 million

toe per annum in solar. The utilisation of the available sources of renewable energy is one of the top priorities set out in the Serbian Energy Strategy.

According to the Renewable Energy Directive the national target for the share of renewable energy sources ("RES") in gross final energy consumption in Serbia for 2020 is 27%, out of which, 22% was achieved by 2014. Although the general climate in Serbia vis-à-vis RES investments is positive, up until now the only significant investments have been in small hydropower plants ("SHPP"). To that extent, the Serbian Government has launched a tender for the construction of the SHPPs on 143 different locations, for which over 400 investors have applied. Currently, the hydro energy potential in Serbia amounts to approximately 7,000GWh, whereas more than a quarter of that lies in the SHPPs of up to 10MW.

Currently, there are 44 SHPPs with the total power of 33.2MW that have the privileged producer status and are availing of the feed-in tariffs.

In addition to the SHPPs, one noteworthy RES project would be a 2MW solar power plant commissioned in November 2014. This is the biggest solar project in Serbia to date.

Stagnation in Wind Projects

The investments in the wind projects have stagnated for a number of years. At the heart of the problem lie permit issues and issues relating to the offtake agreement. Furthermore, there is an overall cap of 500MW for all wind-park capacity in Serbia which may benefit from feed-in tariffs. Given the cap, the investors need to be able to secure the use of feed-in tariffs at an early stage of the project (ie before significant costs are incurred).

It is expected that the new Energy Act, planned to be enacted by the end of 2014, will overcome these difficulties and resolve currently existing bankability issues.

2014 FLOODS

In May 2014 Serbia suffered disastrous floods and landslides that, *inter alia*, caused substantial damage and losses to electricity generation activities, social services and infrastructure. The estimated total damage amounts to €1.7 billion, out of which, 32% was suffered by the energy/mining sector of approximately €500 million.²

Overflowing water from Kolubara River and its tributaries have flooded the open-pit mines Tamnava Zapad, Veliki Crljeni, as well as fields B and D in the Kolubara coal basin. Overall, these open-pit mines amount to about two thirds of the coal produced in the country. By June, fields B and D were recovered, whereas Tamnava Zapad and Veliki Crljeni, in which volume of the water amounted to 200 million m³, are still in the recovery process.

LAW ENFORCEMENT ACTIVITIES BY COMPETITION AUTHORITY

During 2014, the Serbian Commission for Protection of Competition ("Commission") did not initiate any proceedings in the energy market. However, it has continued the activities of reporting and conducting inquiries in oil and oil derivatives market (the latest report was published in December 2013). Although the Commission has not yet identified any infringements of competition law, in April 2014, it has reviewed the coal sales process conducted by subsidiaries of EPS, ie RB "Kolubara" d.o.o.

Lazarevac and "Termoelektrane i Kopovi" Kostolac d.o.o. that took place during 2010-2013.

In the information published on its website, the Commission has identified eight key characteristics that indicate potential limitations of competition, and that consequently may lead to infringements of competition law. Those characteristics relate to, *inter alia*, rigid application criteria that are to a great extent based on the previous cooperation with the seller. The Commission has expressed concerns that such mechanisms develop into the formation of the "favoured purchasers circle". Further, the coal sales process priority has been given to the state entities, irrespective of the number of points collected based on the criteria for participation, thus resulting in the discrimination toward the private purchasers. Lastly, the mechanism of coal selling, on the market where demand exceeds the offered quantities, facilitates attainment of the "extra profit" in the resale process, i.e. the Commission believes that direct purchasers and later their customers are setting the unreasonably high resale prices with unreasonably high margins.

For the said concerns, the Commission announced that it will proceed with monitoring activities of RB "Kolubara" d.o.o. Lazarevac and "Termoelektrane i Kopovi" Kostolac d.o.o., so that any potential restrictive behaviour may be prevented. So far, no measures have been taken in this respect.

PRIVATISATION

The Serbian government has announced that it intends to seek a strategic partner for EPS during 2015. The privatisation model would be based on the sale of a minority stake and a potential transfer of management rights to the strategic partner. The government has not yet decided on the terms and conditions for the tender procedure.

The announced model resembles the one undertaken in privatisation of Montenegrin electric integrated utility in 2009. The state of Montenegro transferred a minority stake and management rights to Italian investor A2A S.p.A.

INFRINGEMENTS OF THE INTERNATIONAL COMMITMENTS

Non-participation of EMS in Regionally Coordinated Capacity Allocation

By not adopting the common coordinated congestion management method and procedure for the allocation of capacity to the market, EMS is not participating in the regionally coordinated capacity allocation mechanism, and thus Serbia is currently in breach of Article 3 of the Regulation (EC) 1228/2003. In this respect, a concern has been expressed that such behaviour prevents the forward trading rules and that it contradicts the obligations undertaken by entering into the Energy Community Treaty and general EU trading criteria.

Consequently, the Energy Community Secretariat has ordered EMS to submit by the end of July 2014 a roadmap with concrete actions and timelines for participation in any regional body performing long-term capacity allocations, in order to achieve a forward trading mechanism by December 2014. Although EMS has submitted the roadmap, the Energy Community Secretariat was not satisfied with the level of detail.

If Serbia does not meet the said requirements on allocation of the capacity by December 2014, there is a reasonable chance

that the Energy Community Commission will open the infringement proceedings.

Non-Compliance with Sulphur in Fuels Directive

In 2013, Serbia was accused that it hadn't yet transposed and implemented the requirements set forth by Directive 1999/32/EC and Annex II of the Energy Community Treaty, with regards to the aim of reducing the emissions of sulphur due to combustion of heavy fuel oils and gas oils. In this respect, the Energy Community Secretariat has issued an opening letter and is currently preparing a reasoned opinion against Serbia in Case ECS-4/13.

No Unbundling in Gas Sector

After the failure to remedy the breaches with respect to the two vertically integrated gas undertakings, i.e. Srbijagas and Yugorosgaz that do not comply with the unbundling requirements, Serbia has been found to be in the breach of the Second Energy Package as well as the Energy Community Treaty in 2014. The decision of Ministerial Council in this respect is expected.

SOUTH STREAM

History and Suspension of Development

Gas consumption in Serbia amounts to approximately 2.5 billion m³/a, the majority of which is imported from Russia, whereas the local production satisfies approximately 15% of the total gas demand.

In 2009, Serbia and Russian Federation signed an international bilateral agreement, regulating the following three ventures: (i) sale of 51% stake in NIS (Serbian integrated oil company) to the Russian conglomerate Gazprom Neft; (ii) formation of large gas storage capacity in the north of Serbia i.e. Banatski dvor and lastly, (iii) the construction of the South Stream gas pipeline that will *inter alia* pass through Serbia.

To date, NIS has been sold to Gazprom Neft and the gas storage Banatski dvor has been constructed.

The South Stream gas pipeline is a project for construction of the gas pipeline for the transport of the Russian natural gas under the Black Sea to Bulgaria and on to Greece, Italy and Austria, passing through, *inter alia*, Serbia. The total estimated value of the South Stream project exceeded €20 billion pursuant to the newest estimates, whereas the value for the 400km of the pipeline's section that is envisaged to pass through Serbia was estimated at €2.1 billion.

The project is of great significance for Serbia mainly because (i) the estimated annual income of Serbia from the gas transit is €250 million, (ii) the project provides gas-supply security, (iii) it would attract the new investments in the sector and (iv) the works on the project would engage approximately 25,000 employees and a significant number of local companies. Up to now, Serbia has invested approximately €30 million in the South Stream project.

However, after the European Commission has reviewed the bilateral agreements signed between Russia on the one side and Bulgaria, Serbia, Hungary, Greece, Slovenia, Croatia and Austria on the other side, it has pushed for suspension of implementation on the basis of a breach of the EU law (unbundling issues). Many signatory countries have suspended the works on the project and EU has required further renegotiation and amendments to the agreements so as to make them compliant with EU law.

Simultaneously, Bulgaria has blocked the construction works on the part of the pipeline on the Black Sea. Thereafter, at the beginning of December 2014, Russian Federation announced the cancellation of the project.

Alternative

An alternative for Serbia with regards to gas security would be the Trans Adriatic Pipeline ("TAP"), ie the approximately 870km long gas pipeline that connects Greece, Albania and Italy, and secures gas from Azerbaijan. Consequently, the Ministry of Energy has announced that the works on the gas pipeline Niš-Dimitrovgrad, the necessary link for accessing TAP, will be accelerated. This link would also enhance the possibility that Serbia has the potential to connect to the recently announced Russia-Turkey gas pipeline.

NEW LEGISLATIVE DEVELOPMENTS

New Energy Act

With regards to the EU energy rules, Serbia has not yet streamlined its energy rules with the Third Energy Package. This is intended to be accomplished with the new Energy Act planned to be adopted in December 2014 or the beginning of 2015.

The novelties introduced by the new Energy Act will facilitate planned investments in the trans-Balkan energy corridor, which is a condition for forming the new high-voltage transmission network for transport of electricity from Eastern European Countries to Italy.

The new Energy Act is also expected to resolve bankability issues with respect to larger RES projects.

New Energy Strategy

At the beginning of 2014, the former Serbian Government has adopted a draft of the new Energy Strategy of the Republic of Serbia until 2025, with projections until 2030. The adoption of the Strategy was postponed after the parliamentary elections held at the beginning of 2014.

The new Strategy is expected to be adopted at the beginning of 2015, after the adoption of the new Energy Act.

Pursuant to the existing draft of the new Strategy, Serbia shall invest approximately €9 billion in the development of the electricity sector until 2030 (€5.3 billion until 2020).

ENDNOTES

1. Data obtained from the Serbian Energy Agency.
2. Pursuant to a report from the World Bank.

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