

COMPETITION AND REGULATION IN THE EU ENERGY MARKET

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Abstract. *When prices are high and public service obligations are not properly fulfilled, consumers wonder if they obtain what they need from the market. In electricity and gas markets of the EU Member States, apart from the persistence of high, non-transparent regulated prices, a number of shortcomings have been identified by the European Commission, such as a less than optimal network use for energy transmission, a lack of coordination and cooperation across borders by transmission system operators and national authorities, and a lack of transparent and simple procedures for dealing with consumers' complaints. These are the main elements of the infringement proceedings that the European Commission decided to launch on 25 June 2009 against 25 Member States for non-compliance with certain Community provisions in the Second Internal Energy Market Package, which entered into force on 1 July 2007. Quite emblematic is the fact that it occurred the same day as the adoption of the Third Internal Energy Market Package aiming to ensure a proper functioning of the EU energy market. We intend to analyse what has happened in the recent years at the EU level in order to liberalise and remove the significant remaining obstacles to competition in the energy market.*

Keywords: competition, regulation, deregulation, unbundling, energy market

JEL: L5, Q4

1. Introduction

In the 1980s already, states began to deregulate a number of sectors considered as natural monopolies, such as telecommunications, energy, transport, postal services¹. There were basically three types of determinants that led to a reviewing of the relationship between the state and the natural monopolies. The

first one was economic. These sectors did not have good performance results under state ownership and management and a single, vertically-integrated state-owned monopoly was considered as being less efficient than a market structure with more players. The second one has a more technological nature, implying that monopoly does not favour innovation. The third one is political and refers to the

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¹ See M. Thatcher, 'From Industrial Policy to Regulatory State: Contrasting Industrial Change in Britain and France' in J. Hayward and A. Menon (eds.) *Governing Europe* (Oxford: Oxford University Press, 2002) and P. D. Cameron, *Competition in Energy Markets: Law and Regulation in the European Union* (Oxford: Oxford University Press, 2002), Chapter 1

shift in the conception of the role of the state in the market.

The story of liberalising the EU energy market is interlinked with one of the objectives of EU energy policy, that of ensuring the EU security of supply.² Bearing in mind that EU imports 54% of its energy, it is a must that the EU improves the infrastructure required in order to transport energy as efficiently as possible, to make the market accessible for all suppliers and eliminate barriers to cross-border trade.

We intend firstly to clarify the terms competition, regulation, and deregulation, based on different theories in order to better analyse the specificities of the process of liberalisation of EU energy market, as well as the progress achieved until now.

2. Competition and regulation: some theoretical considerations

There are different meanings of **regulation**³, as this concept may imply, on the one hand, the legal specific mechanisms to remedy some deficiencies or to limit the abuses of some producers or services suppliers and, on the other hand, the legal regime for a certain economy.⁴

We would make reference in this paper to the more specific significance, which is the control exerted by a public agency on the activities which are considered desirable for the society.⁵ We will focus on the regulations which have had as a purpose the remedy of the imperfections of a market in a certain sector or industry. The most evident imperfection is the existence of a natural monopoly.⁶ In this situation, the regulation of prices or of production may represent a necessity in the sense that it must be ensured that the company which has the monopoly does not earn abnormal profits or that the services it provides are at a level compatible with public interest.

There can also be distinguished different possible conceptions of **competition**.⁷ First, it is the natural and classical meaning of the word, as envisaged by Adam Smith in the eighteenth century, of a **rivalry** between the participants on the market. This dynamic process between competing sellers was considered to induce the changes to the price of the products in response to the market conditions and, eventually, to lead to the effective allocation of resources in an economy.⁸ However, it was argued, the rivalry on the

² See Communication from the Commission adopted on 13 November 2008, *Second Strategic Energy Review, An EU energy security and solidarity action plan*, COM(2008) 781 final

³ For an overview on regulation, see Leveque, F. (2003), *Economie de la réglementation* (Paris: La Decouverte)

⁴ Begg, I. (1996), "Introduction: Regulation in the European Union" in *Journal of European Public Policy* (London), No. 3(4), p. 528

⁵ Selznick, P., "Focusing Organizational Research on Regulation" in Noll, R.G (1985), *Regulatory Policy and the Social Sciences* (Berkeley, University of California Press), pp. 336-7; Majone, G (1990), *De-regulation or Re-regulation? Regulatory Reform in Europe and the United States* (New York, Pinter, pp. 1-6)

⁶ The natural monopoly represents that situation in which the scale economies are so big that the existence of a firm is viable. The distribution of gas, electricity, water or telecommunications are examples generally accepted by natural monopoly.

⁷ For an overview, see Combe, Emmanuel 2002, *La politique de la concurrence*, Ed. La Decouverte, Paris, p.12-25 and Cook, Kirkpatrick, 2001, *Competition, Regulation and Regulatory Governance*, p.5-17

⁸ See Whish, R., *Competition Law*, 5th edn (London: Lexis Nexis, 2003), p. 2

market does not necessarily imply that the market is competitive, as it depends on the **market structure**. The neoclassical economists emphasized the importance of the level of concentration on the market to the encouraging of an anticompetitive behaviour. The monopoly and oligopoly market structures are less efficient than market structures with more players.

In contrast to advocating the dilution of the power on the market, the Chicago School of Antitrust⁹ challenges the idea that market behaviour would be strictly linked to market power and introduces the notion of **economic efficiency**. For example, in case of a natural monopoly, it would be inefficient to encourage the multiplication of the number of producers. Furthermore, industrial concentration seems to be the result of selection of the most efficient companies, with an innovation capacity high enough to face competition that has an increasing market share and high profits.

From the point of view of **social-institutionalists**, markets are conceived as social institutions governed by a set of rules: 'The markets are created by governments, regulated by institutions, and supported by regulations.'¹⁰ The key problem is not if the markets should be regulated, but the modality and the subject to regulate. For this school of thought, competition and regulation are complementary and not alternatives. Furthermore, the purpose of regulation is

'fair competition', a social construction, rather than 'free competition', which would mean a competition without regulation. The regulatory framework for fair competition would be cooperation, legitimacy and trust. According to Wilks, „any regulation is based on the voluntary cooperation of the regulating targets by respecting the legitimacy of the regulations, and trust in the procedures of the regulators.”¹¹ However, legitimacy, he argues further, cannot be obtained, but through a democratic process of implying all the actors, and the trust cannot be generated, other than via common norms and repeated contracts.

For **neoliberals**, competition is always preferable to regulation, pleading for 'competition where possible, regulation where necessary'. Furthermore, the first purpose of regulation is, in their view, ensuring free competition, regulation being necessary in the case of a market failure.¹² In spite of that, 'the existence of a free market does not eliminate the need for governmental intervention. On the contrary, the government is essential as a forum to establish the rules of the game, as well as a referee for the interpreting and implementing the rules agreed upon. What the market does is to significantly reduce the spectrum of issues to be politically decided upon, thus minimising the extent to which the government needs to take part directly to the game.'¹³

⁹ For a succinct review of the Chicago position, see H. Hovenkamp 'Antitrust Policy after Chicago' (1985) 84 Michigan Law Review 213, 226-9

¹⁰ Wilks, S., "Regulatory Compliance and Capitalist Diversity in Europe", *Journal of European Public Policy*, No. 3(4), 1996, p. 538

¹¹ GWilks, op.cit.

¹² The concept of market failure refers to the situation when the link is broken between the following of private interests of the consumers and producers and the satisfying of general interest, which happens for externalities, natural monopoly, and collective goods.

¹³ Friedman, M.(1962), *Capitalism and Freedom*, (Chicago: University of Chicago Press), p.15

Deregulation¹⁴ has become a process destined to improve the efficiency and competition, by which governments remove, reduce or simplify restrictions on business and individuals to encourage the good functioning of the markets. The general economic idea behind deregulation is the neoliberal point of view that only on the completely deregulated markets competition is possible. In market economies, the decisions taken individually and decentralised are coordinated by the market, through prices, which signal the demand and the offer, as well as the rarity of goods on the market. The real competition is considered by the neoliberals as being the best option to supply efficient services and to reduce the governmental control. Deregulation represents, in fact, reform that includes not only government regulatory controls of the behaviour of the firms, but also the liberalisation of the entries on the market, and, in several countries, the privatisation of the assets of the state. In a broader meaning, it represents one of the major political-economic phenomena of the last decades, being the manifestation and the basis of the globalisation of the economy. In a restricted sense, the regulation term is improper, as deregulation does not signal the end of regulation, the deregulation measures could be accompanied by more explicit regulating structures.

3. Liberalising EU energy market – progress achieved and specificities of the process

The energy market has some specificities. Thus, the electricity market consists of four vertically interdependent markets: generation of electricity, transmission of electricity through high voltage grids, distribution through lower voltage grids, and supply to final customers. Of these markets, the transmission and distribution systems are natural monopolies. Competition is possible at the generation and supply ends of the market provided that generators and suppliers have access to the network. In most Member States, the four sectors were vertically integrated with local or national monopolies designed to maintain security of supply and public service obligations¹⁵. As in the case of electricity, both transmission and distribution of gas are considered to be natural monopolies. Transmission refers to the transport of natural gas through a high pressure pipeline network other than an upstream pipeline network with a view to its delivery to customers, but not including supply. Distribution means the transport of natural gas through local or regional pipeline network with a view to its delivery to customers, but not including supply. As compared to electricity, the gas network also has the storage function which is also part of the natural monopoly.

In the 1990s, the European Union has been quite active in liberalising the

¹⁴ See Noll, R., Owen, G.B. (1983), *The Political Economy of Deregulation- Interest Groups in the Regulatory Process*, (Washington: American Enterprise Institute for Public Policy Research)

¹⁵ L. Hancher, 'Slow and Not So Sure: Europe's Long March to Electricity Liberalisation' (1997), *Electricity Journal* 92, 93

energy sector by adopting the Directives in 1996¹⁶ on electricity and in 1998¹⁷ on gas which partially opened the market to competition by allowing large users to choose their suppliers and trying to ensure that vertically integrated operators would not discriminate against new entrants or create new entry barriers. However, liberalisation seemed not to proceed swiftly enough, further measures being necessary in order to complete the internal energy market.

There were voices that criticised these first directives for allowing some liberalisation at national level, but failing to create the conditions for an internal market.¹⁸ Furthermore, in 2004, there was only 4 per cent increase of cross-border trade since 2000.¹⁹ Lacks of proper unbundling and of interconnection capacity were the main reasons to explain the fragmentation of the energy markets.

A second legislative package of gas and electricity directives²⁰ was adopted in June 2003. The pieces of legislation provided for unbundling, whereby energy transmission networks have to be run independently from the production and supply side. Each Member State had to nominate a Transmission System Operator (TSO) and a Distribution System Operator (DSO), having as a main task the maintenance and monitoring of electricity flows. The concerned companies had to

create separate legal entities for network activities, but also divide executive management and decision-making as regards the operation, maintenance and development of the network. At the same time, all system users were supposed to be treated alike, including as regards access to information. A timetable to fully open electricity and gas markets to competition was provided for. Thus, markets for all non-household gas and electricity customers are to be liberalised by July 2004, and for private households, by July 2007.

However, the results were not necessarily satisfactory and the market for industrial consumers did not seem to function properly, as a 2005 Sector Inquiry into the European gas and electricity sectors concluded. The preliminary sector report described high concentration in both gas and electricity markets, uncompetitive wholesale markets caused by vertical integration, barriers to transmission across national borders, and imperfect information. Additional barriers to competition were found in the failure of some Member States to implement the liberalisation directives. Some problems areas were identified in the electric and gas markets in Spain and Luxembourg, electricity markets in Greece and Portugal, and gas markets in Estonia and Ireland. In

¹⁶ Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity (OJ L 27, 30.1.1997, p.20-29)

¹⁷ Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 concerning common rules for the internal market in natural gas (OJ L 204, 21.7.1998, p. 1-12)

¹⁸ B. Eberlein, 'Regulation by Cooperation: The 'Third Way' in Making Rules for the Internal Energy Market' in P. D. Cameron (ed.) *Legal Aspects of EU Energy Regulation* (Oxford University Press, 2005), p. 64

¹⁹ *Report on Progress in Creating the Internal Gas and Electricity Market* COM (2005) 568 final p. 5

²⁰ Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC (OJ L 176, 15.7.2003, p. 37-56); Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC (OJ L 176, 15.7.2003, p. 57-78)

the gas sector, there was lack of access to transmission networks, pipeline capacity, and storage facilities. Cross-border transmission of electricity lacked transmission capacity and incentives to build additional capacity, discriminatory allocation of transmission capacity, and poor management of congestion. (European Commission Energy Sector Inquiry, Preliminary Report, Frequently Asked Questions (2006)).

As a consequence, the Commission has initiated infringement proceedings in April 2006 by sending letters of formal notice to Austria, the Czech Republic, France, Ireland, Italy, Poland, Slovakia and Spain, followed by reasoned opinions, in December 2006, as a second stage in the infringement procedure²¹.

The Energy Sector Final Report²², issued on 10 January 2007, concluded that even though energy markets have become more open to competition, there is still no competitive European energy market and that the most leading national firms in gas and electricity markets do not attempt to compete across their national borders. Furthermore, there was a continued risk that the vertically integrated companies would use the control over the network to make market entry and expansion of their competitors in the supply markets difficult.

The extent to which the national regulator could verify whether the unbundling provisions are respected in practice was unsatisfactory, due to

mainly lack of resources and appropriate powers. The role of the national regulator in the energy field is quite important, while the decision of the governments to delegate regulation to an independent authority can derive from a number of reasons. Firstly, the agency can specialise and gain expertise in the sector, making thus a better regulation. Secondly, the agency is the one having the main responsibility as regards the functioning of the liberalised market. Thirdly, it is a signal of the commitment to efficient markets.²³

Deeper regulatory efforts seemed to be necessary in order to create competition, either by unbundling generation and transmission, and forcing generators to compete, or by increasing interconnections between Member States. It seemed unlikely that single-market project will progress further merely through episodic challenges under the competition rules.

4. The Third Internal Energy Market Package

In September 2007, the European Commission decided to set specific goals for a third package of measures for energy liberalisation²⁴: separating production and supply from transmission networks (ownership unbundling), facilitating cross-border trade in energy, increasing the powers of national regulators and establishing a European regulator for

²¹ In accordance with the European Commission's Press Release IP/06/1768

²² Communication from the Commission (COM (2006) 851 final): "Inquiry pursuant to Article 17 of Regulation (EC) No 1/2003 into the European gas and electricity sectors (Final Report)" and its Technical Annex (2006) 1724.

²³ M.Thatcher, 'Delegation to Independent Regulatory Agencies: Pressures, Functions and Contextual Mediation' (2002) 25 *West European Politics* 125, 133

²⁴ See Commission's Press Release, 'Energising Europe: A real market with secure supply', Brussels, 19 September 2007, MEMO/07/361, and Questions and Answers on energy policy, Brussels, 19 September 2007, MEMO/07/362

cross-border issues, promoting cross-border collaboration and investment, greater market transparency on network operation and supply, as well as increased solidarity among the EU countries.

It is no surprise that central to the Third Internal Energy Market Package is the creation of an European Agency for the Cooperation of Energy Regulators (ACER). This body is intended to take the place of the European Commission's independent advisory group, the European Regulators Group for Electricity and Gas (ERGEG). It complements the work of the existing regulators. ACER has to ensure that the regulatory functions performed by national regulatory authorities under EU's internal market package are 'properly coordinated and, where necessary, completed at EU level. The Council has insisted that these monitoring tasks do not duplicate or hamper monitoring by national authorities, in particular national and EU competition authorities.'²⁵ Furthermore, the agency has a role in developing, analysing and monitoring the non-binding 'framework guidelines' by which network codes must abide. This means that interested parties should be consulted with regard to tariff structures, grid connection and access, capacity allocation and congestion management, security and reliability rules, emergency procedures, and transparency. It is worth mentioning the individual decisions that the agency has the power to adopt on technical issues, such as the regulatory regime for electricity interconnectors and new gas infrastructure.

Moreover, the most important remedy that the Commission proposed in order

to break up big companies altogether was the ownership unbundling that provided for the complete separation of ownership of generation assets from ownership of transmission assets. European Commissioner Neelie Kroes explained: 'Owners and operators of critical networks often compete with companies that need to have access to the same networks. Can we expect such integrated companies to treat competitors in a fully fair manner? Their own self-interest would suggest not.'²⁶

However, the discussions which took place in the working group on energy in the Council led the Commission to the conclusion that it must propose other options so that all Member States could accept the legislative package. The first alternative they came up with ISO – Independent System Operator, according to which vertically-integrated forms are allowed to retain ownership of their pipelines and storage assets, but they are obliged to entrust the management to a separate legal entity ISO. ISO will still maintain loose ties to the original owner, but the funding for operations would come from the parent company, ISO deciding the timing and the destinations of the investments.

However, during negotiations in the Council, it appeared that at least France and Germany, and several other Member States were not satisfied with the ISO option, as it would have meant dismantling national champions such as EDF, GDF, E.ON, RWE. The displeased EU ministers managed to introduce in November 2008 a third option, the ITO model (Independent

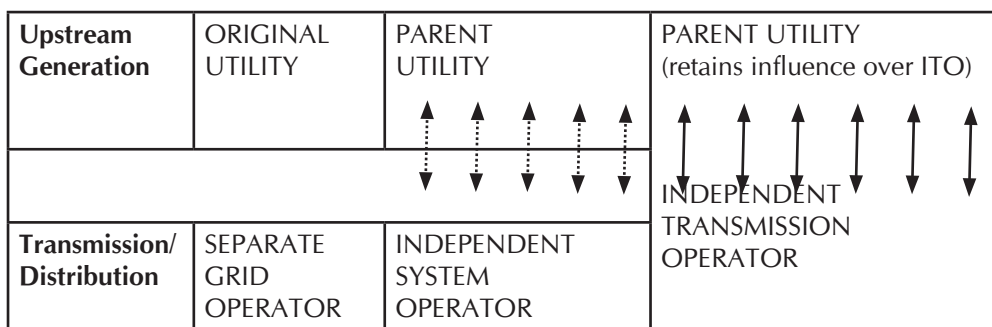
²⁵ *Europolitics*, 'Energy Liberalisation. The Makings of an Energy Watchdog', Tuesday, 31 March, no. 3725, p. 10

²⁶ As quoted on www.euractiv.com, 'Liberalisation of the EU gas sector', published on 26 March 2008 and updated on Friday 26 June 2009

Transmission Operator). This option allows energy companies to own both supply and transmission companies, but the transmission system operator has to operate independently from the mother company. A ‘compliance officer’ is responsible for monitoring the implementation of a programme of measures to prevent discriminatory conduct as well as abuse of dominant market position whereby new entrants are denied capacity on transmission systems so as to favour the dominant mother company. The difference from the ISO arrangement is that it allows significantly closer integration between the parent utility and the supposedly independent network operator. 50% plus one-vote majority on the operator’s supervisory board is what the parent firm can hold. Furthermore, the parent firm is entitled to guide investment strategy, although under some regulatory supervision.

oligopolistic electricity and gas market, it came naturally that the European Commission inserted in the draft energy liberalisation package a ‘level playing field clause’ in order to allow countries that have fully unbundled (such as Spain, Netherlands or United Kingdom) to block the acquisitions of more vertically integrated companies (from France or Germany).²⁷ Furthermore, a reciprocity clause, so called the Gazprom clause, was included. According to its provisions, foreign companies have to comply with the same unbundling requirements at home before making acquisitions in the European Union.

On 12 January 2009, the EU Council of Ministers in its energy format adopts common position on third energy liberalisation package. Two months later, on the night of 23-24 March, the representatives of the European Parliament reach an informal compromise on the



Source: Datamonitor, 2009

Months of negotiations followed. This legislative package arrived in the context of a European energy market dominated by a few cross-border giants, such as France’s EDF, Germany’s E.ON and RWE, and Italy’s Enel. In an

package with the Czech Presidency²⁸. The Parliament had given up its demands for ownership unbundling as the sole option for electricity companies, in exchange of a few concessions from the Council on strengthening powers

²⁷ *The Economist*, ‘The final shape of the European energy market is emerging: an oligopoly’, February 26, 2009

²⁸ *Europolitcs*, ‘Energy markets. EP letting go on ownership unbundling’, 20 March 2009, No. 3718, p. 7 and *Europolitcs*, ‘Energy liberalisation. MEPs trade in ownership unbundling’, 25 March 2009, No. 3721, p. 1, 5

and independence of national energy regulators, the European ACER, energy consumers' rights and smart meters. The compromise offered both gas and electricity companies the three options of separating supply and production activities from network operations: full ownership unbundling, independent system operator (ISO) and independent transmission operator (ITO).

The compromise agreement is endorsed by the Parliament in its plenary session on 22 April 2009, and on 25 June 2009²⁹ the Council, in its Environment format, adopts the internal energy market package. The package contains a Directive on the internal market in electricity, a Regulation on conditions for access to the network for cross-border exchanges in electricity, a Regulation establishing an Agency for the Cooperation of Energy Regulators (ACER), a Directive on the internal market on natural gas and a Regulation on conditions for access to the natural gas transmission networks.

However, on 25 June 2009, the same day as the adoption of the package, the European Commission decided to launch infringement proceedings³⁰ against 25 Member States for non-compliance with certain Community provisions in the second Internal Energy Market Package, which entered into force on 1 July 2007. The purpose of the Commission's action was to draw attention to the implementation of the existing regulations (the second legislative package), as a precondition for implementing the third legislative package. It concentrated, mainly, on fields where regulations

have been systematically infringed: lack of transparent and simple procedures regarding the consumers' complaints, lack of transparency on the conditions and cross-border access capacity, as well as the market distortion caused by regulated prices on energy. Furthermore, the interconnection congestions have to improved North West and North East of Europe, as well as in South West and South East. The Commission draws attention to the fact that a system of sanctions for non-observing the regulations has to be put in place, together with increasing the role of national authorities in ensuring conformity with the Community legislation in the field of energy. The 25 Member States have two months' time, until the end of August 2009 for adopting the measures needed and transmitting the requested information.

5. Concluding remarks

Competition and regulation are rather complementary than substitutes. Government establishes the rules of the game, as a referee for the interpreting and implementing the regulations agreed upon. In this context, deregulation does not mean, however, the end of regulations, as this process could imply liberalisation followed by more explicit regulating structures. In the 1980s already, states began to deregulate a number of sectors considered as natural monopolies, such as telecommunications, energy, transport, postal services. Along these lines, in the energy market, competition is possible at the generation and supply

²⁹ To be published in the Official Journal in August. Member States will have 18 months to transpose the new rules into the national law.

³⁰ See Commission's Press Release IP/09/1035, Brussels, 25 June 2009, Commission acts to ensure effective and competitive energy market across Europe

ends, provided that generators and suppliers have access to the network, while transmission and distribution systems are natural monopolies.

The narrative of liberalisation of the EU energy market is an interesting example in this respect. The real process of liberalisation began in the 1990s, by adopting two directives on gas and electricity which partially opened the market to competition especially at national level and allowed large users to choose their suppliers. Nevertheless, further regulatory measures were necessary in order to complete the internal energy market and create competition, such as proper unbundling generation and transmission, and improvement of interconnection capacity between Member States.

In this context, it came as no surprise the adoption in June 2003 of a second legislative package of gas and electricity directives. It provided for unbundling, whereby energy transmission networks have to be run independently from the production and supply side. Separate legal entities had to be created for network activities, but also executive management and decision-making had to be divided as regards the operation, maintenance and development of the network. In addition, all system users were supposed to be treated alike, including as regards access to information. The full opening to competition of the electricity and gas markets was supposed to be done by July 2004, for all non-household gas and electricity customers, and by July 2007 for private households.

However, the results achieved in implementation were not satisfactory, as the infringement procedures for non-compliance of certain provisions, launched twice by the Commission, in

2006 and later on, in 2009, were to prove it. The EU energy market is an oligopolistic one, still dominated by a few cross-border giants, such as France's EDF, Germany's E.ON and RWE, and Italy's Enel.

The adoption of a third legislative package was considered vital for the Commission. Proposed in 2007, the concerned pieces of legislation aimed to further liberalise the energy market by offering ownership unbundling as the sole option for energy companies. The opposition of certain Member States led to a compromise which offered both gas and electricity companies the three options of separating supply and production activities from network operations: full ownership unbundling, independent system operator (ISO) and independent transmission operator (ITO). Nevertheless, in exchange, strengthened powers and more independence had to be conceded to national energy regulators, as well as to a newly-created European Agency for Cooperation of Energy Regulators. At the same time, two clauses were inserted. One of them is the 'level playing field clause' in order to allow countries that have fully unbundled (such as Spain, Netherlands or United Kingdom) in order to block acquisitions by more vertically integrated companies (from France or Germany). The other one is the reciprocity clause, or the so called 'Gazprom clause', according to which, foreign companies have to comply with the same unbundling requirements at home before making acquisitions in the European Union.

This new package will have to be transposed by the Member States until the end of 2011. Its implementation will reveal if another, fourth legislative package of liberalising the internal energy market is necessary.

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