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The Electricity and Gas Sector in the EU: the Dilemmas of Public Service Obligations in the Context of State Aid

Abstract: *Public service obligations (PSOs) are a common issue in the utility sectors of many Member States of the European Union, although the concept itself and the importance of PSO to the national authorities and the industry vary significantly. In fact there is no one precise Community definition of public service obligation, what perhaps can justify differentiated approach to PSO among Member States. Community secondary legislation, soft law and the case law of the European Court of Justice is somehow unclear in this regard, since it has used public service obligation, service of general economic interest and service of general interest to define the same notion. Therefore in reality it is difficult to present one clear concept of PSOs which would apply to all sectors of the Community internal market. In general public services – most typically but not exclusively network services such as telecommunication, electricity, gas, transport and postal services – are services of commercial character, which are considered essential to the general public. For this reason authorities impose public service obligations upon certain undertakings to guarantee that such services are provided according to the conditions specified by the authorities. Moreover most PSOs are not justified in economic or business terms, since they are burdened with losses. This means that under normal circumstances market would be very hesitant to provide them, or would not provide them at all. Therefore to ensure the availability of such services national/public authorities grant funding/compensation to the selected public service providers under certain conditions. This on the other hand raises the issue of compensation for PSOs vis-à-vis the EC State aid law, which aims to prevent distortion of competition by prohibiting State measures granting advantages to certain undertakings that have a negative effect on competition. It is thus natural to ask under what conditions EC State aid law is applicable to the State funding of the undertakings entrusted with the public service obligations and it will be the main focus of this paper.*

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1. The concept of public service obligations in the electricity and gas markets

In practice the classification of public service obligations is left, in accordance with the principle of subsidiarity, to the Member States. However secondary legislation[1] and soft law[2] laid fundaments for the common profile of PSOs and conditions/principles to be followed in setting the PSO scope. The Electricity and Gas Directives in their Article 3 allow Member States to impose on their electricity and gas undertakings public service obligations in the general economic interest. The scope of PSOs should comply with the specific criteria and objectives and should be strictly regulated. Article 3 para. 2 constitute:

"*Having full regard to the relevant provisions of the Treaty, in particular Article 86 thereof, Member States may impose on undertakings operating in the electricity (consequently gas) sector, in the general economic interest, public service obligations which 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 EU electricity (consequently gas) companies to national consumers. In relation to security of supply, energy efficiency/demand side management and for the fulfillment of environmental goals, as referred to in this paragraph, Member States may introduce the implementation of long*

[1] Directive 2003/54/EC of the European Parliament and Council concerning common rules for the internal market in electricity repealing Directive 96/92/EC (hereinafter Electricity Directive) O.J., L 176/37, 15.7.2003 and the Directive 2003/55/EC of the European Parliament and Council of June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC (hereinafter Gas Directive) O.J., L 176/57, 15.7.2003. Additionally the notion of PSOs and its importance for the Community has been recognized by the EC Treaty. Article 16 of the EC Treaty states: "*Without prejudice to Articles 73, 86 and 87, and given the place occupied by services of general economic interest in the shared values of the Union as well as their role in promoting social and territorial cohesion, the Community and the Member States, each within their respective powers and within the scope of application of this Treaty, shall take care that such services operate on the basis of principles and conditions which enable them to fulfill their missions*". Unfortunately Article 16 so far has not played a significant role in neither the practice of the European Commission nor the Community Courts. In addition Article 16 establishes a principle, but does not provide the Community with a specific means of action.

[2] DG TREN Interpretation Note on Public Service Obligations, Commission Green Paper of 21.05.2003 on services of general interest COM(2003)270 final, and Commission White Paper of 12.05.2004 on services of general interest COM(2004)374 final.

term planning, taking into account the possibility of third parties seeking access to the system".

All Member States in general include in their internal energy policies concern to guarantee certain public service objectives. These objectives have been grouped into three wide categories: universal service,[3] security of supply and protection of the environment.[4] The obligations imposed upon Member States (either on network operators or suppliers) within the first category – concept of universal service according to the Commissions Staff Working Paper – include in general: i) the right to be connected to the power grid/gas pipelines, ii) the right to be supplied electricity,[5] iii) the right to be supplied with high quality and appropriate quantity, iv) the right to be supplied electricity at reasonable and affordable prices, v) the right to receive high standards of customer service. Within the first category there is also obligation to take appropriate measures by the electricity and gas companies to protect final consumers, especially vulnerable customers and those living in remote or rural areas, including appropriate measures to help consumers to avoid disconnections.

Public service obligations also relate to security, including security of supply, and environmental protection, including energy efficiency and climate protection. The issue of security of supply *vis-à-vis* public service obligations demand particular attention since in the past the concept of security of supply as a public service obligation has been used as a legitimate justification for the adoption of the restrictive trade measures, which under normal circumstance would constitute violation of competition law.[6] Article 86(2) of the EC Treaty which exempts from the scope of the competition rules those undertakings entrusted with the provision of services of general economic interest is an area of some sensitivity in relation to the Internal Energy Market, since it raises the prospect of avoidance of market opening on the ground that this is necessary

[3] The concept of universal service is mainly considered for electricity rather than gas.

[4] For more on this see Commission Staff Working Paper on completing the energy internal market, SEC(2001)438 final, 12.03.2001, p.27-41.

[5] Contrary to the electricity, gas supply can not be considered a universal service according to the DG TREN Note on Directives 2003/54/EC and 2003/55/EC on the Internal Market in Electricity and Gas. Security of Supply Provisions for Gas. However if the Member State decides to cover gas supply with PSO, such PSO can not negatively affect trade and consequently the development of competition. Where gas could be economically and reasonably replaced by an alternative fuel, PSOs should not constitute any grounds for the restriction of competition.

[6] Case 72/83, Campus Oil Ltd. v. Minister for Industry and Energy, (1984) ECR 2727. See also: P.Cameron, *Competition in Energy Markets: Law and Regulation in the European Union*, Oxford University Press, Oxford 2002, p.236-238.

to protect security of supply or public security in general. However it should be clearly stated that implementation of security of supply obligations defined as PSOs must affect the development of trade and competition only in the least possible manner. One may assume that this is the case if and as long as there is no alternative solution reasonably and economically available. In addition the concept security of supply should be discussed separately in electricity and gas sector. In case of electricity, three aspects may be raised:[7]

a) System security in terms of safety of network infrastructure

It is actually for each Member State to take appropriate regulatory and monitoring measures to the security standards. Further on Directive 2005/89/EC[8] in Article 4 para. 1a) states that Member States "*shall ensure that the transmission system operators set the minimum operational rules and obligations on network security*". The "physical" security of network infrastructure is not or at least should not be affected by the creation of the internal market for energy. Although the creation of the Internal Energy Market raises question of congestion resulting from unscheduled electricity flows due to trade activities across electricity systems in Europe. For instance, on 14 July 1999 the Belgian TSO (transmission system operator) was faced with flows on its system exceeding those scheduled for this particular day. The TSO had to react immediately in order not to harm the entire system. Due to lack of information sharing between TSOs[9] and unaware of where those flows came from, Belgian TSO was legitimately obliged to limit scheduled dispatch. In 2003 similarly due to lack of information exchange between Italy and Switzerland the flow of electricity was blocked and the congestion problems appeared which had a negative outcome for the customers. Unfortunately the lessons from the 2003 Italian blackout have not been learned and on 4 November 2006 large pan-European blackout accrued again. These are only few examples of congestion problems, which fortunately were taken

[7] DG TREN (Directorate General for Transport and Energy) Note on Directives 2003/54/EC and 2003/55/EC on the Internal Market in Electricity and Gas. Measures to secure Electricity Supply.

[8] Directive 2005/89/EC of the European Parliament and of the Council of 18.01.2006 concerning measures to safeguard security of electricity supply and infrastructure investment O.J., L 33/22, 4.2.2006.

[9] Cooperation between national TSOs is crucial for the network security and internal market. This has been also pointed out by the recital 7 of the Directive 2005/89/EC which states "*cooperation between national transmission system operators in issues relating to network security including definition of transfer capacity, information provision and network modeling is vital to the development of a well functioning internal market and could be further improved. A lack of coordination regarding network security is detrimental to the development of equal conditions for competition*".

care of right away, though some major inconveniences for the customers were noticed. In general in electricity networks technical problems are unavoidable, and as such they have to be treated as priority for the sake of the overall system security. There is no doubt that the improvement of the co-operation between European electricity TSOs, which should be publicly accountable for their actions, is a necessity. Similar position was taken by the European Commission in its proposal on 3rd legislative package for the electricity and gas market.[10] The proposal envisage as one of the key elements of market integration the need of effective cooperation among transmission system operators in particular effective exchange of information between transmission system operators and a good coordination of new investments to increase interconnection capacities.

b) Supply security in terms of guaranteeing the existence of adequate generation capacity

It is for Member States to ensure that an appropriate level of generation capacity is provided.[11] Additionally it is also important to ensure full transparency of the capacity calculation and allocation procedure. Therefore it is for Member States to specify in advance the criteria for authorization procedure for a new generation capacity. Authorization may relate to number of issues specified in the Electricity Directive such as the safety and security of the electricity system, installations and associated equipment, safety and security and the nature of the primary energy source[12] – the body responsible for the authorization should be the National Regulatory Authority (NRA) or any equivalent not responsible directly for the generation, transmission, distribution, or supply of electricity.

c) Supply security in terms of the primary energy sources to generation (gas, coal, uranium, *etc.*)

At present the main concern in the EU in terms of primary energy sources generation is an excessive dependence on gas as a primary fuel for electricity generation. The growing dependence might produce potential threat to the electricity system within Europe. Therefore if the Member State assumes that installed capacity on the basis of a given primary source (in this case gas) is

[10] For more on this see Explanatory Memorandum on the proposal for a Directives of the European Parliament and of the Council amending Directive 2003/54/EC and Directive 2003/55/EC; on the proposal for a Regulations of the European Parliament and of the Council amending Regulation No. 1228/2003 and Regulation No. 1775/2005 and of the proposal for a Regulation establishing an Agency for the Cooperation of Energy Regulators, p.13-14.

[11] See for more on this recital 10 and Article 1 para. 1a) of the Directive 2005/89/EC.

[12] Electricity Directive – Article 6 para. 2.

exceptionally high, or is growing to rapidly, so it constitutes a threat to overall security of electricity supply it may on the base of Article 6 para. 2) g) of the Electricity Directive, refuse authorization for the construction of generating capacity on its territory. However the first step to deal with the issue of growing dependence on gas should be monitoring conducted both at the Community and domestic level. Afterward if it is determined, that certain actions must be taken to limit generation growth from a particular primary source, the Directive allows Member States to take appropriate measures.

In the gas sector the notion of security of supply is constructed somehow differently as in the electricity sector. The reason for this is simple. Whereas electricity can be generated in every country of the EU gas extraction can not. Natural gas belongs to goods which constitutes a major part of export policies of certain countries and as such belongs to the global trend of demand and supply.[13] Moreover the increased EU dependence on the gas supplies mainly from Russia, raise the question of security of the EU in relation to the internal market for gas. Therefore based on the DG TREN Note on security of supply[14] it is significant to draw the attention to two aspects of security of supply of natural gas:

A) Short-term security of supply

This involves creation of safeguards measures as defined by the Article 26 of the Gas Directive, against supply disruptions, which are necessary in the context of the internal gas market. Thus short-term security supply issue is a responsibility of each Member State, which needs to take all necessary regulatory measures to clearly define security objectives and assign and distribute responsibilities among market players in accordance to the defined security objectives. It is obvious that this shall be done without violating competition rules on the internal market.

B) Long-term security of supply

In contrast to the short-term security of supply, it involves strategic and geopolitical concerns at the EU level, with regard to providing adequate diversification of supplies and investments to meet growing demand for gas especially *vis-à-vis* growing dependence on Russian gas supplies.

[13] Of course there are other issues which should or could be taken under consideration when discussing demand&supply for gas such as for instance long term supply contracts or simply take-or-pay contracts. But this is issue for another discussion paper and as such it will not be cover in this paper.

[14] DG TREN Note on Directives 2003/54/EC and 2003/55/EC on the Internal Market in Electricity and Gas. Security of Supply Provisions for Gas.

Finally Article 3 of both Gas and Electricity Directives endow Member States with the possibility to introduce public service obligations which may *inter alia* relate to the environment protection. Consequently Member States are taking measures to ensure high environmental standards in gas and electricity production and supply, which also involve application of competition rules, and particularly those concerning State aids.

Articles 3 of the Directives also put forward the conditions/principles to be followed in setting the PSOs scope. Public service obligations shall be clearly defined, transparent, non discriminatory, verifiable and shall guarantee equality of access for EU electricity companies to national consumers. Unfortunately Directives remain vague as to what clearly defined, transparent or non-discriminatory in fact is. Thus in order to deal with the shortcomings of the Articles 3, a number of soft law instruments have been adopted. Additionally case law of the European Court of Justice has been seeking to clarify the limitation of PSOs.[15] DG TREN Interpretation Note on Public Service Obligations,[16] Green Paper on Service of General Interest[17] and White Paper on Services of General Interest,[18] although not binding on the Member States describe in more detail, among other things, what are the conditions to be followed when setting the scope of public service obligations. Generally speaking by clearly defined it is understood that: i) the PSOs imposed on the Member States have to be related to the supply of the service of general economic interest in question, ii) they have to contribute directly to satisfying this general economic interest, iii) they have to be imposed in such way in order not to affect the development of trade to an extent contrary to the interests of the Community. In order to be transparent, the Commission considers that the public service task must be assigned by way of an official public instrument that may take the form of a legislative or regulatory instrument or a contract or instruction.[19] This instrument must specify: "*1) the nature of the public service obligations, 2) the undertaking and territory concerned, 3) the responsibility for determining the undertaking's selling prices and the conditions for reviewing such prices, 4) the nature of any*

[15] Case C-393/92, Almelo v. Energiebedrijf Ijsselmij, (1994) ECR I-1477.

[16] Note of DG Energy&Transport on Directives 2003/54/EC and 2003/55/EC on the Internal Market in Electricity and Natural Gas. Public Service Obligations, 16.01.2004. Among other things the Note deals with the important issue of compensation for the costs relating to carrying out PSOs.

[17] Commission Green Paper of 21.05.2003 on services of general interest COM(2003)270 final.

[18] Commission White Paper of 12.05.2004 on services of general interest COM(2004)374 final.

[19] DG TREN Interpretation Note on Public Service Obligations, p.5.

exclusive or special rights assigned to the undertakings, 5) the amount of any compensation granted to the undertakings and any revision clauses, 6) the period covered by these obligations".[20] In the Commission's opinion the only way to effectively guarantee non-discrimination provided for in Article 3 is to use a tender procedure to carry out the public service obligations. It is also obvious that such call for tenders should be published in apparent way according to the related appropriate procedures of the interested Member State.

2. Public service obligations – dilemmas in a nutshell

Public service obligations although very important from the electricity and gas customer perspective may also be a source of potential breach of market rules, competition or business freedom.

First of all there is an element of conflict between the obligation to serve the public interest and the fundamental right of business freedom. Such conflict arises directly from the nature of those issues. Every obligation when it is imposed by the State on the enterprises following a top-down approach creates restraints to competition and entrepreneurship. On the other hand it is true that imposing "non-market" obligations on enterprises such as public service obligations is requirement if not derived from economic necessity than from political considerations. Level of economic and social development, which has been achieved in the EU, cause energy especially electricity to be a public good, pertained to every one, without differentiation on material status. At the same time, paradoxically energy is perceived as commodity in case law of the ECJ, and as such its price should be determined by the relation of supply and demand and not by other non-market factors. The European Court of Justice stated very early, much before proposals for Electricity and Gas Directive were discussed, that the energy products including electricity and gas were commodities that are subject to the rules of the EC Treaty on the free movement of goods and services as set out in Articles 28-31 of the EC Treaty.[21] Later on, when the outlines of the Directives were known the Court confirmed its opinion.[22] Therefore having goods which on one side are to be accessible for every one and on the other their price is or should be set by the market forces of demand and supply introduce vagueness to the theme.

[20] DG TREN Interpretation Note on Public Service Obligations, p.5.

[21] Case C-7/68, Commission v. Italy, (1968) ECR I-633, 642.

[22] See Case C-393/92, Almelo v. Energiebedrijf Ijsselmij, (1994) ECR I-1477 (para. 28); see also Case C-158/94, Commission v. Italian Republic, (1997) ECR I-5789.

Second of all Directives declare that *respect for the public service requirements is a fundamental requirement.*[23] PSOs are regarded thus, as necessity and their achievement cannot be left to the operation of the market itself. Such PSO requirements may be interpreted by the Member States taking into account national circumstances. This raises the fear that countries dominated by the vertically integrated undertakings, might rely on PSOs to limit the competition or slow down market opening. For instance gas system operators may refuse access to the system, if the access would prevent them from carrying out public service obligations or it would be dangerous to security of supply. Such activities are, though, possible especially given the lack of clarity between the public service obligation concept, the competition rules and Article 86 of the EC Treaty. Moreover after consulting Article 86 one might get the impression that it is possible for Article 86 to constitute an incentive for undertakings to accept public service obligations in order to obtain an exemption from the application of the competition rules under provisions of paragraph 2 of the same Article. Article 86(2) states: "*Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, **insofar as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them.** The development of trade must not be affected to such an extent as would be contrary to the interests of the Community*". However providers of public service obligations/service of general economic interest may be exempted from application of the Treaty rules only to the extent that this is strictly necessary to allow them to fulfill their general economic interest mission. In a nutshell the European Court of Justice in the Commission vs. the Netherlands[24] ruling upheld the exclusive rights of the Netherlands[25] on the ground of public service exceptions of Article 86(2) with regard that the trade will not be affected to such an extent as it would be contrary to the interest of the Community.[26] The Court phrased Article 86 para. 2 as follows:

"(…) *Paragraph 2 may be relied upon to justify the grant by a Member State, to an undertaking entrusted with the operation of service of general economic interest, of exclusive rights which are contrary to, in particular (Article 31) of the Treaty, to the extent to which performance of the particular*

[23] Electricity Directive - Recital 26; Gas Directive - Recital 27.

[24] Case C-157/94, Commission v. The Netherlands, (1997) ECR I-5699.

[25] In the Netherlands electricity could only by imported (for public supply) by Samenwerkende Elektriciteits Produktiebedrijven (SEP).

[26] For more on this see: M.Marquis, *Introducing Free Markets and Competition to the Electricity Sector in Europe*, Wisdom House Publications Ltd, 2001, p.205-211.

tasks assigned to it can be achieved only through the grant of such rights and provided that the development of trade is not affected to such an extent as would be contrary to the interests of the Community (…)".[27]

Unfortunately Article 82 in conjunction with Article 86 of the EC Treaty might create additional source of dilemma for the energy companies. It might happen that undertaking which has been granted by a government body exclusive right to transport and/or distribute electricity or gas in a given territory, based on the public service obligation (for instance relating to the security of supply, regularity of supply, quantity and prices of supplies, or environmental protection), might be regarded as being in a dominant position as compared to other undertakings, thus potentially breaching Article 82. Although prohibitions of Article 82(1) are designed to apply to all undertakings which hold or enjoy a dominant position, some of them may be exempted from it by the provisions of Article 86(2), which exempts from the scope of the competition Articles those undertakings entrusted with the provision of services of general economic interest.[28] This is an area of some sensitivity in relation to the Internal Energy Market since it raises the prospect of avoidance of market opening on the ground that this is necessary to protect security of supply or public security in general. Moreover such exemptions are source of constraint either actual or potential on actions to promote competition in the energy markets in the EU therefore vulnerable to scrutiny under Articles 81 and 82 of the EC Treaty. As a result on one side, Member States are allowed to establish exclusive and special rights. On the other, they must observe the rules of the Treaty, in particular the rules on free movement and competition. This balance was clearly established by the ECJ in the France v. Commission judgment relating to the regulation of telecommunication terminal equipment.[29]

Finally some of the Member States argue that liberalization of the sectors together with increased competition leads to cost cutting and consequently to a reduction in public service standards. This view is abounded in France where lawyers and interested parties argue the opposite that reformed and reinforced public service obligations were the main factor to ensure further liberalization in the energy sector in France.[30] Moreover second set of Gas

[27] See Case C-157/94, Commission v. The Netherlands, para. 32, (1997) ECR I-5699.

[28] Specific grounds for exemption include public policy and public security. Public security is also ground for exemption under Article 30. In general Member States can impose restrictions on import or export of energy if these restrictions can be justified under Article 30.

[29] Case C-202/88, France v. Commission (Telecommunications), (1991) ECR I-1223.

[30] T.Lauriol, *National Approaches to implementation–France* in: *Legal Aspects of EU Energy Regulation. Implementing the New Directives on Electricity and Gas Across Europe*, ed. P.Cameron, Oxford University Press, Oxford 2005, p.123-143. Moreover M.Mangenot in his book: *Public Administrations and Services of General Economic interest: What kind of*

and Electricity Directives underline the improved standards of public service obligations as compared to the first set.[31] Member States are under general obligation to notify all measures taken to fulfill PSOs, including consumer and environmental protection, to the Commission, with details of their possible effects on national and international competition.[32] Member States are also required to introduce appropriate measures to protect final customers (*e.g.*, protection of vulnerable customer, elderly, or unemployed) from unjustified disconnection and to protect final customers' basic rights (*e.g.* by requiring a minimum set of conditions for sale contracts, transparency of information, and a low cost and transparent dispute resolution procedure).

3. Financing of the PSO and the issue of State aids

The question of financing of the PSOs either in the form of State aid or exclusive rights is a matter which concerns all liberalised sectors (or being in the process) in the European Union (post, telecommunication, gas, electricity, air transport, *etc.*). Although Electricity Directive in Article 3 (4) stipulates that "(…) *when financial compensation, other forms of compensation and exclusive rights which a Member State grants for the fulfilment of the obligations set out in paragraphs 2 and 3 are provided, this shall be done in a non-discriminatory and transparent way* (…)", there is unfortunately lack of clarity within primary and secondary law, as to what are the conditions under which compensation for PSOs would fall into category of State aid? Certainly there are number of general requirements articulated in articles 87-89 of the EC Treaty, but sector specificity makes it somehow vague. The reference should be therefore made to the existing case law, secondary law and soft law taken on this subject matter.

According to the White Paper on Services of General Interest,[33] and the Green Paper on Services of General Interest,[34] the principle of the Member

Europeanisation? (2005) maintains that in the former centrally planed economies of some of the New Members of the EU, PSOs are perceived as less important factor of energy market liberalization, than in the Old Members (with France being the greatest enthusiast and supporter). The existence of authoritarian regimes in the Central and Eastern Europe with domination of Soviet Union legal doctrine harmed the entire legal structure of the CEE states, where public service obligations were treated as an issue of irrelevant importance.

[31] Directive 96/92/EC of the European Parliament and Council concerning common rules for the internal market in electricity O.J, L 27/1, 30.1.1997 and the Directive 98/30/EC of the European Parliament and Council concerning common rules for the internal market in natural gas O.J., L 204/1, 21.7.1998.

[32] Electricity Directive - Art. 3(9) and Gas Directive - Art. 3(6).

[33] COM(2004)374 final.

[34] COM(2003)270 final.

States autonomy to make policy choices as what is laid down within the scope of public service obligations applies to the financing as well. The financing mechanisms applied by the Member States include: direct financial support through the State budget (*e.g.* subsidies or tax reductions), special or exclusive rights (*e.g.* legal monopoly), and contributions by market participants (*e.g.* universal service fund), tariff averaging and solidarity based-financing (*e.g.* social security contributions). However as a general rule in the electricity and gas sector Member States can actually choose which financing instrument to use, though the requirement is that it can not distort competition within the common market and it should be with respect to the benefit of taxpayers and the economy at large.[35] Therefore in the electricity and gas industries Member States usually prefer to finance public service obligations through creation of specific funds financed by market participants or direct public funding through the State budget, as they are perceived the least distorting way of funding.

Unfortunately it has not been always clear, under what conditions compensation for PSOs would actually constitute State aid, and whether such aid could be considered compatible within the common market under Article 87 of the EC treaty. Therefore in order to increase legal certainty and transparency in the application of State aid rules to PSOs within the network industries number of legal instruments has been adopted.

The first main step to clear out the situation was the judgement in the Altmark case,[36] where the Court stated:

"(…) *Where a State measures must be regarded as compensation for the services provided by the recipient undertakings in order to discharge public service obligations, so that those undertakings do not enjoy a real financial advantage and the measure thus does not have the effect of putting them in a more favourable competitive position than the undertakings competing with them, such a measure is not caught by Article 87(1) of the EC Treaty* (…)".

Additionally for such compensation to escape classification as State aid four conditions must be met:

(i) There must be actual and clearly defined public service obligations.

"(…) *the recipient undertaking must actually have public service obligations to discharge, and the obligations must be clearly defined* (…)".

[35] White Paper on Services of General Interest, COM(2004)374 final, p.12.

[36] Case C-280/00, Altmark Trans GmbH and Regierungspräsidium Magdeburg vs. Nahverkehrsgesellschaft Altmark GmbH, (2003) ECR I– 7747.

(ii) The parameters for calculating the compensation payments must have been established in advance in an objective and transparent manner.

"(…) *the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner, to avoid it conferring an economic advantage which may favor the recipient undertaking over competing undertakings.* (...) *Payment by a Member State of compensation for the loss incurred by an undertaking without the parameters of such compensation having been established beforehand, where it turns out after the event that the operation of certain services in connection with the discharge of public service obligations was not economically viable, therefore constitutes a financial measure which falls within the concept of State aid and within the meaning of Article 87(1) of the Treaty* (...)".

(iii) Compensation payments must not exceed the net total costs (including return on capital *etc*.) caused by the public service obligations.

"(...) *the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the relevant receipts and a reasonable profit* (...)".

(iv) The beneficiary is chosen in a public tender or compensation must have been set on the basis of a cost analysis for a hypothetical well-run undertaking equipped with the means to provide the public service.

"(...) *where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant to a public procurement procedure which would allow for the selection of the tender capable of providing those services at the least cost to the Community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations* (...)".

The first three conditions are fairly unproblematic. It is more questionable whether a hypothetical test, as introduced in the forth condition, is suitable in all situations of public service financing, because of the special characteristics of PSOs. Nevertheless if these four conditions are met, public service compensation does not constitute State aid, and Articles 87 and 88 of the EC Treaty do not apply. As a consequence, compensation for public service provision does not have to be notified to the European Commission. However if the Member States do not respect at least one of these conditions than the

payment or other benefit granted out of State resources become State aid for the purposes of Article 87(1) and subject to the other provisions of Article 87 and as such it is prohibited unless it is permitted by Article 87(2) or a specific regulation; justified under Article 86 or cleared under Article 87(3) of the EC Treaty.

In general Altmark conditions are seen as a positive step towards ensuring required legal clarity on financing PSOs.[37] However the Altmark ruling determines when a measure is caught by the definition of a State aid, but it dose not determines the conditions under which compensation, if it is a State aid can be allowed. Therefore to diminish potential negative consequences of unclearness several additional measures have been adopted by the European Commission, that is: the Commission Decision on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation (hereinafter Decision[38]) and Community Framework for State aid in the form of public service compensation (hereinafter Framework[39]).[40] Both texts specify under which conditions the public service compensation constituting State aids is compatible with the Treaty, however with the only major difference lying in fact that the public service compensation covered by the Decision do not need to be notified to the Commission.

[37] For instance the Commission in the Commission Decision in case N 475/2003 – Ireland – Public Service Obligations in respect of new electricity generation capacity for security of supply, O.J., C 34/9, 07.02.2004, considered that the provision of new electricity reserve generation capacity in order to face electricity demand at any time of the year, including peak periods, was SGEI which was not considered to be a State aid. Moreover open, transparent and non-discriminatory competitive procedure which took place guaranteed that all conditions laid down by the Altmark decision were met.

[38] The Commission Decision 2005/842/EC on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of service of general economic interest O.J., L 312/67, 29.11.2005.

[39] Community Framework 2005/C 297/04 for State aid in the form of public service compensation O.J., C 297/4, 29.11.2005.

[40] The main substantial difference between the Altmark ruling and the Commission Decision and Framework concerns the amount/calculation of the compensation. According to the 4th criterion of the Altmark ruling, the amount of the compensation must be defined through open, transparent and non discriminatory public tender procedure, or through a procedure based on hypothetical test, in order not to constitute State Aid. Whereas according to the Decision, the amount of the compensation dose not necessarily have to be defined through a public procurement, or with the costs of a typical well run company (the abovementioned hypothetical test). As long as the authority may prove that the compensation allocated corresponds to the net costs estimated on the basis of the precisely defined parameters included in the act of entrustment and that there is no overcompensation, the compensation in question is considered as a State aid compatible with Treaty rules.

The Commission Decision specifies the conditions under which compensation to companies for the provision of public services is compatible with the State aid rules and does not have to be notified to the European Commission. The conditions to be met include the following: i) an act of entrustment specifying, in particular, the nature and duration of the public service obligation, the undertaking and territory concerned, the nature of any exclusive or special rights assigned to the undertaking, the parameters of calculating, controlling and reviewing the compensation, as well as the arrangements for avoiding and repaying any overcompensation; ii) funding proportionate to the actual costs of the services (what was underlined previously by the Altmark case), and iii) certain established thresholds are not exceeded. Accordingly Article 5(1) of the Commission Decision states: "*The amount of compensation shall not exceed what is necessary to cover the costs incurred in discharging the public service obligations, taking into account the relevant receipts and a reasonable profit on any own capital necessary for discharging those obligations. The compensation must be actually used for the operation of the service of general economic interest concerned, without prejudice to the undertaking's ability to enjoy a reasonable profit*". Further on in the second clause, Article 5 deals with the issue of "reasonable profit" and with all benefits granted by the State which amount to compensation. "*The amount of compensation shall include all the advantages granted by the State or through State resources in any form whatsoever. The reasonable profit shall take account of all or some of the productivity gains achieved by the undertakings concerned during an agreed limited period without reducing the level of quality of these services entrusted to the undertaking by the State*".

In regard to thresholds the Decision is applicable to compensation of less than 30 million euro per year provided its beneficiaries have an annual turnover before tax of less than 100 million euro during the two financial years preceding that in which the service of general economic interest was assigned.[41] As soon as the criteria of the Decision are met, the Member State concerned may grant the compensation. However when the conditions of the Decision are not met (for example compensation exceeds the above mentioned thresholds) the compensation must be notified in advance to the Commission so it can check whether the State aid concerned is compatible with the provisions of the Framework which are analogous to the conditions of the Decision. Notification dose not mean that the compensation is automatically not compatible with the Treaty, but because of the high amount of aid concerned and thus due to the higher risk of distorting the competition

[41] There are few others conditions, but they do not apply to the electricity and gas sector *e.g.* compensation to hospitals and social housing irrespective of the amount.

on the common market, the aid must be checked by the Commission in order to ensure that all conditions for compatibility are fulfilled. The general meaning of the Framework is that the compensation which goes beyond the costs of the public service obligation, or is used by companies on other markets open to competition, is not justified, and thus, assumed incompatible with the Treaty's State aid rules.

The main advantage of the abovementioned package of measures is that it reduces the administrative burden for small and local services. Most small-scale public services are exempt from the notification requirement, provided that the compensation for the PSOs only covers the real costs of providing the service plus of course a reasonable profit margin.

Last but not least Commission Transparency Directive[42] which enhances transparency of financial relations between Member States and public undertakings is applicable to compensation of the PSOs. The Directive among other things clarifies that companies receiving compensation dealing with public service obligations and other market actions irrelevant to PSOs must have separate accounts for their different activities. In other words internal accounts of the undertakings entrusted with PSOs must, in particular, show separately the costs and receipts associated with the PSO and those of other services (which they provide), as well as the parameters for allocating the costs. Calculation of costs must be based on generally accepted cost accounting principles. Accordingly Article 1(2) of the Transparency Directive requires Member States to "*ensure that the financial and organisational structure of any undertaking* (...) *is correctly reflected in the separate accounts, so that the following emerge clearly: a) the costs and revenues associated with different activities; b) full details of the methods by which costs and revenues are assigned or allocated to different activities*".[43]

Certainly drawing up and keeping separate accounts for the public service obligations should be seen as a step forward in clearing rather complex matter of compensation calculation.

[42] Commission Directive 2006/111/EC on the transparency of financial relations between Member States and public undertakings as well as on financial transparency within certain undertakings O.J., L 318/17, 17.11.2006.

[43] Different activities are defined by the Article 2(1)e) of the Transparency Directive stating that: "*<different activities> means on the one hand, all products or services in respect of which a special or exclusive right is granted to an undertaking or all services of general economic interest with which an undertaking is entrusted and, on the other hand, each other separate product or service in respect of which the undertaking is active*".

Conclusions

There is no one clear definition of the public services obligations. Potential step forward was envisaged to be produced by the version of what was Article III-6 of the draft Constitution for Europe[44] which dealt with PSOs or to be precise Service of General Economic Interest (SGEIs). This Article or in general the Constitution aimed to confer legislative power on the Union to define the principles and conditions under which PSO could be provided. The final version in the new Constitution however contains amendment which explicitly reserves the right to the Member States to organize, provide and finance their PSOs. The final text of Article III-122 states:

"*Without prejudice to Articles I-5, III-166, III-1678 and III-238, and given the place occupied by services of general economic interest as services to which all in the Union attribute value as well as their role in promoting its social and territorial cohesion, the Union and the Member States, each within their respective competences and within the scope of application of the Constitution, shall take care that such services operate on the basis of principles and conditions, in particular economic and financial conditions, which enable them to fulfill their missions. European laws shall establish these principles and set these conditions without prejudice to the competence of Member States, in compliance with the Constitution, to provide, to commission and to fund such services*".

As a result in line with the subsidiarity principle, it is for the Member States to define the PSOs. However the present package of case law, secondary law and soft law instruments require that the scope of public service obligations is clear and transparent, so that it is possible to assess whether the compensation paid is in accordance with defined State aid rules or not. Nevertheless, the fact that a public service compensation constitutes a State aid does not *per se* mean that it is not allowed, since that compensation may be compatible with the relevant Treaty rules when the conditions specified in the Decision or the Framework are met.

Unfortunately the matter of compensation is fairly complex, thus some further dilemmas are unavoidable.

Finally, apart from coming back questions as to financing, PSOs may also serve as an instrument of supervision where authorities exercise potentially large measures of control over the natural monopoly elements of an energy industry – irrespective of the form and pattern of ownership that is chosen.

[44] Draft Treaty establishing a Constitution for Europe, The European Convention, 18 July 2003, CONV 850/03.