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**PUBLIC SERVICE OBLIGATIONS: HOW TO REALISE THEIR POTENTIAL IN THE EUROPEAN ENERGY INDUSTRY?**

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### **Overview**

The liberalisation of the European electricity and gas industries has not only required a complete restructuring of the industries, but has also necessitated to develop new approaches to securing the public policy goals for electricity and gas supply. Whereas before liberalisation government could implement its policy goals rather directly by imposing them upon the vertically integrated ‘monopolist’ utility, in the current situation government needs instruments which allow the achievement of the policy objectives concerned *within a market environment*.

For this purpose, the concept of a *public service obligation* (PSO) may be a very useful instrument in the market context (Knops and Hakvoort 2002). PSOs have been labelled ‘a key element’ (EC 2001) and ‘one of the pillars of the European model of society’ (EC 2004). Essentially, the concept of a PSO provides, pursuant to Article 86(2) of the EC Treaty, an opportunity to derogate from the strict European rules on free trade and competition in so far as such a derogation is necessary for the effective fulfilment of a service of general economic interest.

In the liberalised electricity and gas industries, PSOs can play an important role to secure policy goals in the competitive parts of the industries. For example, in the electricity generation market PSOs can be used to secure security of supply or to promote the production of electricity from renewable sources; or in the energy supply markets to protect the customers (e.g. through a ‘supplier of last resort’).

PSOs are right in the middle of the ‘triangle’ of policy, law and economics: a public policy objective needs to be involved, it has legal relevance as it allows for a derogation of the rules, while the economic analysis governs to a large extent the scope and application of that PSO derogation. In recent years, the (European) legal regime for PSOs has been clarified in case law of the European Court of Justice (ECJ), and documents as well as decisions from the European Commission.

The purpose of this paper is to analyse the potential of PSOs as an instrument to implement public policy goals within a market environment in the European electricity and gas industries. First, the position of PSOs within the larger problem of the (re)design of the legal organisation of the energy industries will be sketched. PSOs appear to be a way to reconcile market freedoms and competition, on the one hand, with the effective fulfilment of services of general economic interest, on the other hand. Second, the relevant issues concerning PSOs which need to be studied in more detail, need to be identified. These concern in particular the issue what room EU member states have to impose PSOs, and the relation of PSOs with the European rules concerning state aid. Third, the general (European) legal regime for PSOs can be analysed, with a particular focus on the most relevant issues identified before. From an analysis of (European) case law and other ‘European’ decisions and documents, the conditions under which the ‘PSO derogation’ may be successfully applied, can be determined, as well as the criteria for any (financial) compensation for PSOs. Fourth, the focus will be on the energy industries: for what issues could PSOs there be an option? This question will be answered based on the general analysis of PSOs and on some ‘energy examples’ from practice. Fifth and finally, it can be concluded what potential there is for PSOs as an instrument to im-

plement public policy goals in competitive energy industries, and under what conditions such PSOs may actually be realised?

## Methods

For the analysis of the position of PSOs within the larger problem of the (re)design of the legal organisation of the energy industries the framework of the so-called *Function-Based Legal Design & Analysis* method (abbreviated: FULDA-method (Knops *et al.* 2005)) is used. This method provides a systematic approach to the problem of analysing and/or designing the legal organisation of complex industries such as the electricity and gas industries.

The analysis of the legal regime for PSOs is based on a literature study of relevant legislation, regulation, documents of several authorities concerned with PSOs, case law and (Commission) decisions, as well as scholarly literature concerning PSOs.

## Results

The special regime the EC Treaty allows for PSOs, makes a PSO an instrument for (national) governments to reconcile market freedoms and competition, on the one hand, with the effective fulfilment of services of general economic interest (intended to secure public policy goals), on the other hand.

Governments of EU member states have in principle a wide margin of discretion in the definition of PSOs, with the exception of the sectors in which there are Community rules governing the matter.

The exception from the EC Treaty rules which Article 86(2) EC provides for for PSOs, is only applicable if four criteria are met. First, there must be act of entrustment by which the state concerned has explicitly imposed a certain PSO upon one or more undertakings. Second, the obligation imposed should concern a real *public* interest. Third, the exception from the general EC Treaty rules which is sought, has to be necessary for the performance of the PSO assigned and proportional to that end. Fourth, the development of trade must not be affected to such an extent as would be contrary to the interests of the Community.

As PSOs are imposed if the 'market' is not expected to provide that (level of) public service by itself, it can be expected that in most cases the imposition of PSOs must be accompanied by the payment of some compensation to the undertakings entrusted with the PSO concerned. Such compensation is *not* considered to be state aid if four criteria are met, which follow from the *Altmark Trans* judgment of the ECJ. (Within the EU it is in principle prohibited to provide state aid.)

If not all four of the *Altmark Trans* criteria are met, the compensation for a certain PSO can still be allowed, as the European Commission has made clear in recent documents. The criteria formulated by the Commission include conditions for the specification of the PSO, as well as the rule of thumb that compensation may not exceed what is necessary to cover the costs incurred in discharging the PSOs, taking into account the relevant receipts and reasonable profit for discharging those obligations.

In the liberalised energy industries, PSOs can play an important role to secure policy goals in the competitive parts of the industries. This has been acknowledged in the European energy directives (2003/54/EC and 2003/55/EC), which explicitly refer to the possibility of the imposition of PSOs. PSOs may prove a powerful instrument to, for instance, ensure security of supply in the electricity generation market, as the example from Ireland shows (EC 2003). Moreover, PSOs can be used for the promotion of renewable energy sources or consumer protection.

However, in all these instances, the *economic* assessment of the situation remains highly relevant. First, to show that it is necessary to derogate from the general free trade and competition rules, and, second, to demonstrate that the compensation granted for discharging the PSOs is just the compensation for the ‘extra costs’ incurred for the PSO concerned.

## **Conclusions**

The special (European) legal regime of PSOs allows governments to derogate, under strict conditions, from the free trade and competition rules of the EC Treaty if necessary for the effective fulfilment of services of general economic interest. PSOs thus may provide a useful instrument to implement public policy goals in a market environment, for example in the European energy industries, where the market itself is not expected to secure that policy objective sufficiently.

The derogation allowed for PSOs is, however, constrained by the conditions under which PSOs (and possible compensation for discharging them) can be allowed. Among these conditions are *economic* criteria which are such that they ought to achieve that the imposition of a PSOs does not distort the market or competition.

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