EXPLANATORY NOTE

on the Draft Procedural Act on establishing a method for calculating penalty payments under Article 92' of the Treaty establishing the Energy Community

I. The need for penalty payments in the Energy Community

The purpose of the amendments to the Energy Community Treaty is to enhance the Energy Community's ability to achieve its main objectives, namely effective energy sector reform in the Contracting Parties in line with EU principles and rules, and the integration of regional and pan-European energy markets. The amendments proposed address shortcomings of the current Treaty. One of those shortcomings is the need to enhance the implementation of Energy Community rules and to improve the enforcement system in order to ensure that Contracting Parties fully apply and implement Energy Community law, on a similar level as the EU Member States subject to enforcement procedures in the European Union.

According to Article 89 of the Treaty, Parties shall implement Decisions addressed to them in their domestic legal system within the period specified in the Decision. Experience has shown that in most cases, the Contracting Parties fail to implement Decisions taken under Article 91 following a dispute settlement procedure by remedying the breaches identified. As a consequence, the Energy Community produces an increasing backlog of cases formally closed but never remedied. Experience has shown that even the political measures under Article 92 (the existence of a serious and persistent breach by a Party of its obligations under the Treaty) are not deterrent enough to ensure the implementation of Energy Community law in an effective and proportionate manner.

Against this background, the newly-introduced Article 92'of the Treaty constitutes an important step in the Energy Community's hierarchy of measures aimed at improving Contracting Parties' record in complying with the *acquis*. It addresses cases when a Contracting Party fails to take the necessary measures to comply with a decision of the Ministerial Council under Article 91 within the deadline set, and has further been subject to a decision by the Ministerial Council determining a serious and persistent breach. Evidently, both decisions (under Article 91 and Article 92, respectively) should concern the same subject-matter.

II. The relevant legal framework

According to Article 92' of the Treaty, if a Party, the Secretariat or the Energy Community Regulatory Board (ECRB) consider that the Contracting Party concerned has not taken the necessary measures to comply with a decision establishing a serious and persistent breach with the deadline set, it may bring the case before the Ministerial Council again and request the imposition of penalty payments. This will be the third time that the Ministerial Council has dealt with the matter.

In some respects, Article 92' of the Treaty mirrors its EU-law counterpart. In European Union law, Article 260 TFEU contains provisions on penalty sanctions meant to motivate Member States to comply with EU law. Article 260(2) gives the European Commission the right, in case it considers that a Member State has failed to take the necessary measures to comply with a decision of the Court of Justice of the European Union, to bring the case again before the Court of Justice and ask the Court to order the Member State to pay a lump sum or a penalty payment which it considers appropriate in the circumstances.

Commented [A1]: Incorrect. Article 92' makes a reference to Article 92 and not Article 91!

Commented [A2]: A serious and persistent breach is foreseen in Article 92 of the Treaty (and not Article 91). However, the draft PA on sanctions incorrectly takes Article 91 as relevant.

Commented [A3]: In cases concerning State aid, the EC acts in accordance with Council Regulation (EU) 2015/1589 on laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the EU, Article 18 of this Regulation stipulates penalties and periodic penalties

Commented [A4]: General observation: Proposed Article 92' fails to mirror the EU law in a crucial element and that is judicial review. As quoted later in this paragraph it is the CJEU and not the Commission that takes decisions on whether a Member State is subject to a lump sum or penalty payment. In the absence of judicial review in the context of the Energy Community Treaty we would be introducing a dangerous precedent and giving a political body (such as the Ministerial Council) the right to give its final word on penalties. This would be a solution which is far away from what is established in the legal framework of the EU, establishing a parallel and non-comparable system of penalties for the EU Member States and the Contracting Parties.

Specifics: The proposed penalty system only covers the situation of breaches of the Treaty by Contracting Parties. However, the Treaty is multilateral and on one side has the EU (and its Member States), and on the other the Contracting Parties. The situation of breaches by EU (Member States) is in a legal void and this has to be remedied. The TFEU does give space for introducing judicial oversight in relation to international agreements of the EU. Namely, on the one hand Article 216-218 provide the basis for the EU to enter into international agreements with one or more third countries, including those containing reciprocal rights and obligations. Article 272 of the TFEU states that "The Court of Justice of the European Union shall have jurisdiction to give judgment pursuant to any arbitration clause contained in a contract concluded by or on behalf of the Union, whether that contract be governed by **public or private law**." These provisions, taken in their ...

Commented [A5]: Article 260 of the Treaty on the Functioning of the European Union (TFEU) (ex Article 228 of the Treaty establishing the European Community - TEC) 1. If the Court of Justice of the European Union finds that a Member State has failed to fulfil an obligation under the Treaties, the State shall be required to take the necessary measures to comply with the judgment of the Court. 2. If the Commission considers that the Member State concerned has not taken the necessary measures to comply with the ...

Commented [A6]: Seems as an article relating to general non-compliance in any context. It applies to State aid only after the abovementioned articles of the Council Regulation have been exhausted and the case is closed in the Court of Justice.
Not to State aid only after the abovementioned Articles of the Regulation Chamber have been exhausted but also when the case is sent to the court of justice

Unlike in the EU, where both daily payments and a lump sum could be proposed, Article 92' of the Energy Community Treaty refers only to imposing daily penalty payments. It also envisages significant additional time to comply between the establishment of a breach (Article 91), the establishment of a serious and persistent breach (Article 92), and the time periods set by the respective Decisions.

The proposed draft Procedural Act is based on the explanatory documents for the Article 260 TFEU procedure and the European case-law, at the same time respecting the particularities of the Energy Community and the realities (especially budgetary constraints) of the Contracting Parties.

III. The procedure for the imposition of penalty payments

The pre-requisite for the initiation of the penalty payment procedure is the existence of a Decision by the Ministerial Council (under Article 91 of the Treaty) on the existence of a breach by a Party of its obligations, and a Decision by the Ministerial Council (under Article 92 of the Treaty) on the existence of a serious and persistent breach. Both Decisions must concern the same subject-matter.

The Contracting Party against which Article 92' procedure is initiated is given the opportunity to submit its position. First, before the initiation of the procedure on penalty payments, the Secretariat or the Regulatory Board will request the Contracting Party to submit information on compliance with the Decisions of the Ministerial Council under Article 91 and Article 92. If the Secretariat or the Regulatory Board are not satisfied with the information provided by the Contracting Party or information is not provided within a specified time-limit, they may initiate the procedure on penalty payments before the Ministerial Council by way of a request. The Contracting Party may then submit its observations on the request within two months. Additionally, Contracting Parties have the right to demonstrate compliance with the Decision of the Ministerial Council and to rectify the breach established at any time before the Ministerial Council adopts a (third) Decision under Article 92', which shall in all cases result in the withdrawal of the request by the initiator.

The request on penalty payments, similarly to the EU procedure, shall include the amount of penalty payments requested calculated using a clear and uniform method, as defined by a Procedural Act. The Ministerial Council is not bound by the suggested amount.

Penalty payments accrue by day of delay, so that the non-implementation of a Decision of the Ministerial Council under Article 91 is sanctioned gradually, for each day in which the Decision is not implemented.

Two dates are relevant for the calculation of penalty payments: (1) the deadline set in the Decision of the Ministerial Council under Article 91: from this day onwards the coefficient for duration is calculated (see below); and (2) the date set in the Decision of the Ministerial Council on imposition of penalty payments (Article 92'), as from this day onwards the penalty payments are due. The penalty payments accumulate from the date set in the Ministerial Council decision under Article 92', until compliance with the Ministerial Council Decision on the breach is achieved.

In order to ensure that the obligation of the Contracting Parties to pay terminates when they comply with the (first) Decision of the Ministerial Council based on Article 91, the Ministerial Council may also adopt Decisions by correspondence,[1] if they concern the discontinuation of

[1]In accordance with Articles 23-27 (Rules for Decision-Making by correspondence) of the Rules of Procedure of the Ministerial Council of the Energy Community Procedural Act 2006/01/MC-EnC of 17 November 2006 on

Commented [A7]: Who determines what and when a breach of the Treaty occurs in the case of state aid EnC does not have the authority to interfere with the merits of decisions or actions of the competent authority, so it can only inform the competent authority, which can examine whether there is a distortion of competition in terms of state aid

Commented [A8]: Who determines what and when a breach of the Treaty occurs in the case of state aid EnC does not have the authority to interfere with the merits of decisions or actions of the competent authority, so it can only inform the competent authority, which can examine whether there is a distortion of competition in terms of state aid

Commented [A9]: Incorrect. Should be Article 92.

the payments. Such a Decision shall be adopted upon notification by the Contracting Party and after receiving the Secretariat's assessment.

The penalty payments are proposed to be collected in a special budget line of the Energy Community budget and will be earmarked for funding projects of interest to the Contracting Parties, related to infrastructure, energy efficiency, environmental issues or technical assistance for regional projects, as decided by the Ministerial Council.

Commented [A10]: What criteria will be used to determine which projects are of interest and for which Member State ?? !!

IV. The method for calculating penalty payments

a. As a general rule, penalty payments in the Energy Community should follow the EU approach

Following EU case law, penalty payments are to be calculated on a daily basis using the following criteria: the seriousness of the infringement, the duration, as well as the need to ensure that the penalty is a deterrent for future infringements. Penalty payments shall also be proportional and appropriate to the circumstances, and should be high enough to maintain sufficient pressure on the Contracting Party concerned.

Commented [A11]: State aid must be excluded from these penalties !!! This would mean that one does not notify state aid on time, that the Secretariat learns of it and imposes penalty to the state for breach of Treaty, while the EC itself introduces sanctions and penalties exclusively in the state aid assessment process when it requires the submission of data, which again excludes the EnC Secretariat because it cannot implement proceedings related to state aid cases of RS (only only Commission for State Aid Control)

Where is the level of seriousness of the infringement of the Treaty described

In accordance with the Commission Communication on the application of Article 228 of the EC Treaty,[2] penalty payments are calculated using the following formula:

$$\mathbf{Dp = (Bfrap \times Cs \times Cd) \times n}$$

Hence, the daily penalty payment is based on a flat-rate amount (**Bfrap)**, identical for all Contracting Parties, multiplied by a coefficient for seriousness (**Cs**) and a coefficient for duration (**Cd**). In this way, the more important the Energy Community rule breached, and the longer the non-implementation of the Decision of the Ministerial Council establishing the breach (Article 91), the higher the daily penalty payment. The result is then multiplied with an **n-factor**, which represents the Contracting Party's ability to pay. The same formula could be used for calculating penalty payments in the Energy Community, albeit with important adaptations to reflect the economic discrepancies between the EU Member States and the Energy Community Contracting Parties (see below).

The coefficient for seriousness is determined on the basis of the gravity of infringement and it is applied on a scale between a minimum of 1 and a maximum of 20. As in the EU, an infringement of the principle of non-discrimination is always regarded as very serious and will lead to a coefficient of 20 applied to the standard flat-rate amount. The coefficient for seriousness may also increase (however, not higher than 20) if the Decision by the Ministerial Council under Article 91 shows a pattern of non-compliance with regard to the respective Contracting Party. Seriousness shall be assessed on a case-by-case basis by the Ministerial Council. In applying this criteria, regard should be had in particular to the effects of failure to comply on private and public interests and to the urgency of getting the Contracting Party concerned to fulfil its obligations.[3] The effective steps and measures that the Contracting Party has undertaken to comply with the Decision should be taken into account when assessing the seriousness of the infringement[4].

Commented [A12]: Where is the level of seriousness of the infringement of the Treaty described

adoption of internal Rules of Procedures of Ministerial Council of Energy Community as amended by Procedural Acts 2013/01/MC-EnC of 24 October 2013 and 2015/02/MC-EnC of 15 October 2015 amending Procedural Act of the Ministerial Council 2006/01/MC-EnC of 17 November 2006).

[2] SEC(2005) 1658, Section 18.2

3 Case C-387/97 Commission v Greece, par.92; Case C-304/02, Commission v French Republic, par.104

4 C-177/04, Commission v France, cited n 48 supra, at 65–67

The coefficient for duration is a multiplier between 1 and 3, calculated at a rate of 0.10 per month from the expiry of the deadline set in the Decision by the Ministerial Council under Article 91. The minimum coefficient for duration that can be applied is 1, therefore a minimum of 10 months of non-compliance with the decision of the Ministerial Council under Article 91 will have to lapse until the imposition of penalty payments. This translates into additional time for the Contracting Party concerned to implement the Decision of the Ministerial Council establishing the breach (Article 91). The maximum coefficient for duration, like in the EU, is 3. Hence the lack of implementation of a Decision of the Ministerial Council under Article 91 for a longer time than 30 months will not be penalised additionally.

In order to ensure that the sanctions of breaches of Energy Community law are proportionate to the gravity and the length of time in which the CP refuses to implement decisions of the Ministerial Councils, both the coefficient for seriousness and the coefficient for duration must be part of the formula for calculating penalty payments in the Energy Community. In the EU, this final amount is then multiplied with an n-factor which represents the Member State's capacity to pay, and which is the geometric mean calculating the square root of the product of the factors based on Member States' GDP and the weighting of the votes in the Council. The n-factor ensures that the penalty payment is proportional for each Member State, while remaining dissuasive. The formula in the EU is the following:

$$\sqrt{\frac{GDP_{n}}{GDP_{Lux}} \times \frac{Votes_{n}}{Votes_{Lux}}}$$

At Energy Community level, where, unlike in the EU, each Party has one vote, any formula for the n-factor should take into account the GDP only (whether overall GDP or GDP *per capita*).

b. However, penalty payments for the Energy Community Contracting Parties should reflect their economic situation

There are several ways in which the calculation of penalty payments in the Energy Community can be adapted to the economic situation of the Contracting Parties, without losing the deterrent effect.

(i) One way to make the penalty payments less burdensome is **to lower the standard flat-rate**. The standard flat-rate amount is the fixed amount to which the multiplier coefficients are applied, and its purpose is to penalise the violation of the principle of legality and the failure to implement a decision of the Ministerial Council establishing a serious and persistent breach. Currently in the EU the standard-flat rate amount is EUR 690, and the European Commission adjusts it with inflation every third year. The proposed standard flat-rate amount for the Energy Community is EUR 100 This amount can be subject to further discussions and shall be adjusted every three years, like in the EU.

(ii) Another way to ensure that penalty payments are proportionate to the economic situation in the Contracting Parties is by **adapting the n-factor**. There are several options for calculating the n-factor in the Energy Community, balancing the budgetary constraints of the Contracting Parties with the need to have deterrent penalty payments.

(1) The first option is not to have an n-factor at all (or to consider the n-factor as 1). With this approach, and using a flat-rate amount of EUR 100, the minimum daily penalty rate would be EUR 100, and the maximum one EUR 6000 (for a standard flat rate of

EUR 100, maximum coefficient of duration of 3 and maximum coefficient of seriousness of 20).

However, this proposal seems not proportionate and fair to the Contracting Parties, as it does not take into account the Contracting Parties' economic situation in a differentiated manner.

(2) The second option is to calculate the n-factor by mirroring the initial EU formula, without taking into account voting rights. In the EU, Luxembourg was chosen as a reference country at a time when it had the lowest GDP. The equivalent of Luxembourg in the Energy Community is Montenegro, the Contracting Party with the lowest GDP.

The GDPs used for calculations are the GDPs at current prices published by the National Accounts Section of the United Nations Statistics Division. The GDPs statistics relevant for the calculation of the n-factor shall be the one established two years before the year of revision of n-factor ("n-2 rule") (for example, for an Article 92' decision taken in 2019, the year relevant for the GDP data will be 2017).

In this case, the formula for the n-factor would be square root of the fraction between the respective Contracting Party's GDP and the GDP of Montenegro:

$$\sqrt{\frac{\mathbf{GDP\ (CP)}}{\mathbf{GDP\ (MNE)}}}$$

With this approach, the minimum and maximum daily penalty payments would be as follows:

CP	n-factor	min	max
AL	1,64	164	9840
BiH	1,92	192	11520
GE	1,76	176	10560
K	1,22	122	7320
MNE	1	100	6000
NM	1,52	152	9120
MD	1,29	129	7740
RS	2,92	292	17520
UKR	4,81	481	28860

This option has the advantage of being the closest to the EU approach. However, the formula is more advantageous for the smallest Contracting Parties, which also have the smallest overall GDP, and puts a heavy financial burden on the larger Contracting Parties such as Serbia or Ukraine. Unlike in the European Union, in the Energy Community larger countries are not also stronger politically. Therefore, taking into account the overall GDP, while perhaps appropriate at European Union level, would lead to unfair treatment in the Energy Community.

(3) The third option is to calculate the n-factor as the square root of the fraction between the respective Contracting Party's GDP and the GDP of Albania.

Albania was chosen as a reference country, since, when classifying the Contracting Parties according to their GDPs from 2017, Albania has the middle position (with Ukraine, Serbia, Bosnia and Herzegovina and Georgia having higher GDPs, and North Macedonia, Moldova, Kosovo* and Montenegro having lower GDPs). Therefore, for the year 2019, the n-factor of Albania would be 1. Nonetheless, if a Contracting Party other than Albania should take the middle reference position within the Energy Community Contracting Parties, it would replace the reference position of Albania.

The formula for the n-factor will thus be:

$$\sqrt{\frac{\mathbf{GDP\ (CP)}}{\mathbf{GDP\ (AL)}}}$$

With this option, the minimum and maximum daily penalty payments would be:

CP	n-factor	min	max
AL	1	100	6000
BiH	1,18	118	7080
GE	1,07	107	6420
K	0,74	74	4440
MNE	0,6	60	3600
NM	0,93	93	5580
MD	0,68	68	4080
RS	1,78	178	10680
UKR	2,93	293	17580

This option is has similar effects to No (2) above as it takes into account the overall GDPs of the Contracting Parties and it is therefore not suitable for the Energy Community Contracting Parties.

(4) Another method of calculating the n-factor would be using the GDP per capita as opposed to the Contracting Party's overall GDP, as the GDP per capita better reflects the economic strength of a country, and compare it with the average GDP per capita in the EU, so that the overall result will show the appropriate penalty payment each Contracting Party has to pay, and which is proportionate to its economic state. This way of calculating the GDP will ensure that the economic burden of a penalty payment would be more or less the same for the Contracting Parties and the EU Member States.

The formula for the n-factor would be square root of the fraction between the respective Contracting Party's GDP per capita and the average GDP per capita in the European Union (currently 38500).

$$\sqrt{\frac{\mathbf{GDPpc(CP)}}{\mathbf{GDPpc(EUav)}}}$$

However, since the n-factor has been calculated in a way that takes into account the economic discrepancies between the Contracting Parties and the EU Member States,

the standard flat rate will not be decreased, but kept at the same level as in the EU (EUR 690). With this approach, the minimum and maximum daily penalty payments would be:

CP	n-factor	min	max
AL	0.33	227.7	13662
BiH	0.36	248.4	14904
GE	0.31	213.9	12834
K	0.32	220.8	13248
MNE	0.44	303.6	18216
NM	0.37	255.3	15318
MD	0.22	151.8	9108
RS	0.39	269.1	16146
UKR	0.25	172.5	10350

In the view of the Secretariat, this fourth option for calculating the n-factor is the most suitable for the Energy Community Contracting Parties. By adjusting the daily penalty with an n-factor which reflects the economic differences between the each Energy Community Contracting Party and the EU average, and by keeping the standard flat rate and the two coefficients unchanged when compared to the EU formula, the daily penalty payment reflects accurately the Contracting Party's capacity to pay, while remaining deterrent. From all the options analysed by the Secretariat, this is the one which ensures the highest level of fair treatment not only between Contracting Parties, but also between Contracting Parties and EU Member States.

The European Commission has recently developed a new formula for calculating the n-factor, by taking into account the Member State's number of seats in the European Parliament and its overall GDP.[5] As discussed above, any option of calculating the n-factor which takes into account the overall GDP as opposed to the GDP per capita does not properly reflect the economic situation of the Contracting Parties of the Energy Community in relation to the EU Member States.

[5] COMMUNICATION FROM THE COMMISSION, Modification of the calculation method for lump sum payments and daily penalty payments proposed by the Commission in infringements proceedings before the Court of Justice of the European Union, Brussels, 20.2.2019, C(2019) 1396 final, OJ 2019/C 70/01