

GETTING THE DEAL THROUGH

Gas Regulation

in 33 jurisdictions worldwide

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Description of domestic sector

- 1 Describe the domestic natural gas sector, including the natural gas production, liquefied natural gas (LNG) storage, pipeline transportation, distribution, commodity sales and trading segments.

The Czech Republic is strategically important in the European natural gas market as it transits natural gas from Russia to Western Europe.

The natural gas sector has undergone a tremendous change in the past decade. Within a few years following the end of the communist regime in 1989, the regional natural gas distribution companies formerly owned by the state were privatised. In 2002, RWE Gas won the tender for the privatisation of state-owned Transgas, a natural gas transportation company, which owned the pipeline by which natural gas is transported from Russia, and also acquired the majority interest in six of the regional natural gas distribution companies. The remaining two natural gas distribution companies are controlled today by E.ON. As a result of unbundling requirements, RWE Transgas has spun off its transportation activities in a separate company RWE Transgas Net and the regional distribution companies have split into separate natural gas trading and distribution entities. In 2007, RWE TG voluntarily implemented the unbundling of its gas storage business, based on which it spun off its gas storage activities into a separate company, RWE Gas Storage. In addition to the eight regional natural gas distribution companies, there are another approximately 125 local distribution companies.

Prior to 2000, Czech energy-related legislation was incompatible with Directive 96/92/EC on joint rules of the internal electricity market and (at that time applicable) Directive 98/30/EC on joint rules of the internal natural gas market (replaced by Directive 2003/55/EC), in particular on the level of harmonisation with the *acquis communautaire* of the European Communities. The absence of rules for opening or liberalising the electricity and natural gas markets (ie, ensuring the principle of choice by the supplier of the relevant energy) and non-existence of certain legal institutions and state administrative bodies in the energy sector proved so significant that in 2000, the Czech parliament adopted Act No. 458/2000 Coll on the Conditions for Business Activities and Performance of State Administration in Energy Sectors (the Energy Act), which took effect on 1 January 2001.

In 2004, the Energy Act was amended to provide for the liberalisation of the natural gas market in a similar way to the electricity market (ie, in accordance with the concept of third-party access and Directive 2003/55/EC). Since 1 January 2006, any customer (save for households) is treated as an eligible customer who has the right to choose their natural gas supplier. The Czech natural gas market has been fully liberalised since 1 Janu-

ary 2007, when all customers, including households, fell into the category of eligible customers.

Policy and legal framework

- 2 What is the statutory framework for the domestic natural gas sector?

The statutory framework is set by the following acts:

- the Energy Act (see question 1);
- Act No. 406/2000 Coll on Energy Management;
- Act No. 526/1990 Coll on Prices;
- Act No. 44/1988 Coll on the Protection and the Use of Mineral Resources (the Mining Act); and
- Act No. 61/1988 Coll on Mining Activities.

In addition, there are several important secondary regulations relating to the natural gas sector implementing specific provisions of the Energy Act, for example:

- Decrees of the Ministry of Industry and Trade No. 245/2001 Coll on details of granting state authorisation for construction of certain natural gas plants, and changes, extension or termination thereof (the Decree of Granting State Authorisation) and No. 251/2001 Coll setting out Operation Rules of the Natural Gas Transportation System and the Distribution Systems (the Operation Rules); and
- Decrees of the Energy Regulatory Office No. 524/2006 Coll on the Rules for Organising the Natural Gas Market (the Rules for Organising the Gas Market) and No. 545/2006 Coll on the Quality of Natural Gas Supplies and Associated Services in the Natural Gas Industry.

Also, certain constituents of the price for natural gas are regulated by the Energy Regulatory Office by means of issuing price decisions.

In addition, the conditions for supply of transportation, distribution and storage services are specified in the Operational Codes of the Operator of the Transportation System, the Operators of the relevant Distribution Systems and the Operator of the Underground Storage Facilities.

- 3 What is the government's policy for the domestic natural gas sector and which bodies set it?

The policy of the Czech government was and remains aimed at compliance with the relevant EU legislation, in particular, at the liberalisation of the natural gas market, which was fully implemented on 1 January 2007. The government wishes to ensure, given the basic division of the natural gas market between two big players, that the liberalised market is fully functional and that

the eligible customers are able to choose a natural gas supplier based on competitive and non-discriminative conditions.

The most important bodies are:

- the Ministry of Industry and Trade (MTI), which, among others, provides consent with construction of new natural gas plants, prepares the state energy conception, decides on the construction of new natural gas pipelines and storage facilities, etc;
- the Energy Regulatory Office (ERO), which is technically independent of government. ERO, for example, regulates certain natural gas price components and creates rules related to natural gas market and together with the Antimonopoly Office supports competitive market, grants or withdraws licenses for business in the natural gas sector, formulates rules for organising the natural gas market, promotes economic competition and protection of the interests of end-users in areas such as energy business, where competition is not possible, etc.;
- the State Energy Inspectorate, which oversees compliance with laws by the market participants; and
- the Czech Mining Office (heading nine local Mining Offices) which is also technically independent of government. The Czech Mining Office has competences in the area of mining activities.

Regulation of natural gas production

- 4 What percentage of the country's energy needs are met directly or indirectly with natural gas and LNG? What percentages of the country's natural gas needs are met through domestic production and imported production?

In 2006, the Czech Republic produced 96 million cubic metres of natural gas annually, which have been all used up by local customers. This represents approximately 1 per cent of the total domestic consumption and, therefore, practically all natural gas is imported – three-quarters from Russia and one-quarter from Norway. Approximately 17 per cent of the Czech Republic's energy needs are met through natural gas. LNG is not used in the Czech Republic.

- 5 What is the ownership and organisational structure for production of natural gas (other than LNG)?

The most significant producer of natural gas is privately owned oil and gas mining company Moravské Naftové Doly, which is also active in other countries in Europe and, among other, in Russia, Pakistan, Yemen and Sudan. All other natural gas is imported by RWE Transgas from Russia and Norway (see above).

- 6 Describe the regulatory framework and any material governmental or administrative authorisations applicable to natural gas exploration and production.

Natural gas is a reserved mineral and exploitation is strictly regulated. Reserved mineral mining is restricted to individuals or legal entities with government authorisation in the form of a licence for mining activities, granted by the relevant local Mining Office, and only on the mining areas approved by the relevant local Mining Office. An application for mining area approval is processed by the relevant local Mining Office only with the consent of the Ministry of the Environment and the Ministry of Industry and Trade. The licence shall be granted on the basis of a written application and the relevant local Mining Office makes its decision on an assessment of the degree to which the specified

conditions underlying the granting of the licence have been met. Administrative proceedings concerning establishment of the mining areas and issuing licences for mining activities follow rules stipulated by the Mining Act, the Act on Mining Activities and the Administrative Code; any party to such proceedings can file an appeal against the issued administrative decisions to the Czech Mining Office, which is the supreme body of the Czech state mining administration.

- 7 How does the government derive value from natural gas production?

The Mining Act specifically sets forth the amount of fees to be paid for the use of the mining area and the minerals mined.

Regulation of natural gas pipeline transportation and storage

- 8 What is the ownership and organisational structure for pipeline transportation and storage of natural gas?

RWE Transgas Net is the only owner of the main pipelines used for transit and transportation. RWE Gas Storage is the owner and the operator of the six main underground storage tanks. The two remaining main underground storage tanks are each owned by one of the following companies: Moravské naftové doly or SPP Bohemia.

- 9 Describe the regulatory framework and any material governmental or administrative authorisations applicable to the construction, ownership and operation of natural gas transportation pipelines and storage facilities.

Construction of any natural gas transportation pipeline and any natural gas storage facility with a capacity above 10 cubic metres requires authorisation from the MTI. Compliance with the general rules stipulated in Act No. 183/2006 Coll on land planning and the building code (the Building Code) is also required during construction of gas transportation pipelines and storage facilities; the relevant administrative proceedings are held by the respective building offices.

A licence is required from the ERO in order to operate a natural gas transportation pipeline and storage facilities. For more details, see question 3.

- 10 How does a company obtain the land rights to construct a natural gas transportation or storage facility?

Under the Energy Act, a company licensed for natural gas business (eg, distribution or transportation) may construct a natural gas transportation or storage facility on third-party land pursuant to a valid zoning and construction permit, and may enter this third party land in order to establish, reconstruct, repair and operate natural gas facilities. However, the Energy Act also requires that a valid easement be concluded with the owner of the land in order to exercise the rights mentioned above. If such owner is unknown or an agreement is impossible to reach, the relevant construction authority will establish the easement.

- 11 How is access to the natural gas transportation system and storage facilities organised?

The natural gas market in the Czech Republic is currently organised on the basis of third-party access to the transportation system, distribution systems and underground natural gas storage facilities. The operator of the natural gas transportation system

must accordingly connect to the transportation system any party upon its request, which complies with the conditions stipulated by the Operation Rules and at the same time ensure for non-discriminatory conditions for such access to the transportation system. Details are set forth by the Operation Rules (which specify, for example, the conditions for connection to the transportation system and details of the agreement on connection to the transportation system), the Rules for Organising the Gas Market and the Operational Code of the Operator of the Transportation System. Similarly, the operator of the underground storage facilities has a duty to grant access to the relevant storage facility under the conditions in the Operation Rules and Operational Code of the Operator of the Underground Storage Facilities.

As a result of this principle, an eligible customer has, in accordance with section 62 of the Energy Act, the right to connection to the transportation (or distribution) system provided that the Operation Rules are complied with, to choose its natural gas supplier, and for the transportation of an agreed volume of natural gas provided such customer has concluded an agreement to this effect with a operator of the transportation system (or the relevant distribution system) and if this is permitted by the technical conditions of the transportation (or relevant distribution) system. An entity trading with natural gas is similarly entitled to access to transportation (or distribution) system, provided such entity is a party to a relevant written agreement; also, any participant to the Czech gas market gas is entitled to use underground storage facilities, provided that there is free storage capacity in the respective underground gas storage facility and such entity is a party to a relevant written storage agreement.

Balanced, safe and reliable operation of the natural gas system is ensured by the dispatching of the natural gas entrepreneurs, which must coordinate and cooperate in accordance with Dispatching Rules of the natural gas system of the Czech Republic. The quality of supplies of natural gas and related services is determined by the ERO.

- 12** To what degree are pipeline systems interconnected with one another and by what means is cooperation between such systems established?

There is a single natural gas transportation system in the Czech Republic (see also question 1); eight regional natural gas distribution systems connect to the natural gas transportation system. In addition, there are 125 local natural gas distribution systems. Under the Operation Rules, the above systems may be inter-connected upon compliance with stipulated conditions, such as free capacity at the connection point and technical feasibility of the connection. Coordination between operators of the transportation and distribution systems is achieved by the dispatching of relevant natural gas entrepreneurs pursuant to the Dispatching Rules of the natural gas system in the Czech Republic.

- 13** Can customers, other natural gas suppliers or an authority require a pipeline or storage facilities operator to expand its facilities to accommodate new customers? If so, who bears the costs of interconnection or expansion?

An operator of a natural gas transportation system or storage facilities cannot be required to expand its facilities to accommodate new customers.

- 14** Describe any regulation of the prices or terms of service for pipeline or storage services.

One of the tasks of the ERO is to regulate energy prices where

appropriate pursuant to Act No. 526/19910 Coll on Prices. The ERO does this issuing Pricing Decisions. As of 1 January 2007, the natural gas market in the Czech Republic is fully liberalised, and the price of natural gas for any end-user consists of prices regulated by the ERO (usually once a year) – ie, price for transportation and distribution of natural gas – and of the non-regulated price of the natural gas energy and the price for storage of natural gas in underground facilities. The price of natural gas supplied by the ‘last resort’ supplier (who has a duty under the Energy Act to supply natural gas to households and other small customers) is also regulated by the ERO.

- 15** Describe any statutory and regulatory requirements applicable to the processing of natural gas to extract liquids and to prepare it for pipeline transportation.

LNG is not used in the Czech Republic. The requisite technical requirements are not subject to special energy laws, only Czech technical standards.

- 16** Describe the contractual regime for transportation and storage.

The agreements between the natural gas market participants are governed by the Energy Act and corresponding secondary legislation (eg, by the Rules for Organising the Gas Market). There are several basic types of agreements, eg on the supply of natural gas, joint services of natural gas supply, transportation or storage of natural gas. A transportation agreement, in particular, must include an obligation for a transportation system operator to transport, for a regulated price, for a natural gas producer, trader or eligible customer the agreed volume of natural gas.

Agreements that provide for transportation and storage do not require approval from the regulator. For details, see questions 11 and 14.

Regulation of natural gas distribution

- 17** What is the ownership and organisational structure for the local distribution of natural gas?

Many end-users receive natural gas directly from the eight regional distribution companies. In addition, as already mentioned above, there are over 100 local distributors of natural gas on the Czech market. For details, see question 1.

- 18** Describe the regulatory structure and governmental or administrative authorisations required to operate a distribution network. To what extent are gas distribution utilities subject to public service obligations?

A licence from ERO is required to operate a distribution network; for more details, see questions 3 and 9.

In the event of a pressing need and in the public interest, distribution utilities are obliged to ensure for distribution of natural gas above the extent provided by its distribution licence upon a decision of the ERO and in accordance with section 12 of the Energy Act.

- 19** How is access to the natural gas distribution grid organised?

See question 11, which also applies to access to the distribution grid and system.

- 20** Describe any regulation of the prices for distribution services. In which circumstances can a rate or term of service be changed?

See question 14. If the rate is not regulated, it can be changed pursuant to an agreement between the parties. Terms of the service may be changed by mutual agreement any time.

- 21** May the regulator require a distributor to expand its system to accommodate new customers? May the regulator require the distributor to limit service to existing customers so that new customers can be served?

Operators of the natural gas distribution systems cannot be required to expand their facilities in order to accommodate new customers; however, see question 11. The regulator does not have the right to limit services to existing customers so as to serve new customers.

- 22** Describe the contractual regime in relation to natural gas distribution.

See question 16, which also applies to natural gas distribution agreements.

Regulation of natural gas sales and trading

- 23** What is the ownership and organisational structure for the supply and trading of natural gas?

There are many natural gas trading companies in the Czech Republic, the largest derived from the eight regional distribution companies, who have spun-off their distribution assets to subsidiaries in accordance with the unbundling requirements set forth by the respective EC Directives and the Energy Act. RWE Transgas is the largest natural gas trader and supplies gas to these eight regional gas trading companies, which in turn supply natural gas to the end-users.

- 24** To what extent are natural gas supply and trading activities subject to governmental oversight?

The ERO, among others, monitors compliance of the licence holders stipulated by the Price Act and initiates investigations by the State Energy Inspection in certain instances and penalises non-compliance with laws of the licence holders.

In addition, the Balancing Centre established by the natural gas transportation system operator, operators of the underground storage facilities and operators of distribution systems monitors the planning, production, supplies and consumption of natural gas, capacities and output of the transportation and distribution systems and underground storage facilities.

- 25** How are physical and financial trades of natural gas typically completed?

The trading process of natural gas is rather complicated and is described in the Energy Act (as well as the basic terms for natural gas supply agreements); details are stipulated for instance in the Rules for Organising the Gas Market.

Currently, all trades take place at a 'virtual purchase point', where participants on the gas market (the subjects of subsequent balancing of fluctuations in natural gas supplies) make their offers to supply natural gas into the natural gas system or requests to take natural gas from the natural gas system. Subsequent balancing of fluctuations in natural gas supplies also takes place at the virtual purchase point.

- 26** Must wholesale and retail buyers of natural gas purchase a bundled product from a single provider? If not, describe the range of services and products that customers can procure from competing providers.

Distribution and transmission is purchased as a bundled product. Natural gas as a product (medium) may be purchased alone, or together with natural gas distribution, transmission and storage pursuant to a joint services agreement under section 72 of the Energy Act.

Regulation of liquefied natural gas (LNG)

- 27** What is the ownership and organisational structure for LNG, including liquefaction and export facilities and receiving and regasification facilities?

Given the conditions for transportation and transit of natural gas in the Czech Republic, LNG is not used.

- 28** Describe the regulatory framework and any material governmental or administrative authorisations required to build and operate LNG facilities.

As mentioned above, LNG is not used in the Czech Republic. The Energy Act, however, stipulates that the construction of LNG storage facilities exceeding 10 cubic metres requires special authorisation from the MTI (in addition to all usual permits required under the Building Code). For information regarding relevant governmental or administrative authorities see also question 6.

- 29** Describe any regulation of the prices and terms of service in the LNG sector.

There is no special regulation of prices and terms of service in the LNG sector.

Mergers and competition

- 30** Which governmental body may prevent or punish anti-competitive or manipulative practices in the natural gas sector?

On the national level, the only administrative body responsible for anti-competitive practices is the Office for the Protection of Economic Competition (the Antitrust Office). If trade between member states can be affected, the European Commission may act in parallel with the Antitrust Office.

- 31** What substantive standards does that governmental body apply to determine whether conduct is anti-competitive or manipulative?

There are no sector-specific provisions governing anti-competitive practices in the natural gas sector and the Antitrust Office applies the relevant provisions of the Act No. 143/2001 Coll on the Protection of Economic Competition, as amended (the Antitrust Act). If trade between member states may be affected, the Antitrust Office can also apply articles 81 and 82 of the EC Treaty.

- 32** What authority does the governmental body have to preclude or remedy anti-competitive or manipulative practices?

The Antitrust Office has the power to initiate an investigation upon receipt of a complaint or at its own instigation. It can request information necessary for conducting the investigation from any entity operating on the market or from state bodies (eg, ERO).

Upon completion of proceedings, the Antitrust Office may issue a decision prohibiting further performance of an anti-com-

petitive agreement or practice or a decision prohibiting to continue abusive behaviour. The Antitrust Office is further empowered to impose fines or remedial measures. In certain circumstances, the Antitrust Office can terminate the proceedings by imposing on the parties to the proceedings commitments proposed thereby, provided they are sufficient for the protection of competition and the harmful situation would be eliminated by their fulfilment.

As already mentioned, the Antitrust Office is empowered to apply articles 81 and 82 of the EC Treaty, in which case the Antitrust Office can require that an infringement be brought to an end, order interim measures, accept commitments, or impose fines.

33 Does any government body have authority to approve or disapprove mergers or other changes in control over businesses in the sector or acquisition of production, transportation or distribution assets?

All transactions that are considered concentrations within the meaning of the Antitrust Act (ie, mergers, acquisitions of control over another undertaking or another undertaking's enterprise or a part thereof, establishment of joint control over an undertaking that performs on a lasting basis all functions of an autonomous economic entity) fall under mandatory notification with the Antitrust Office, provided the parties to such transaction meet either of these two turnover thresholds: the total net turnover of all undertakings concerned achieved in the last accounting period in the market of the Czech Republic exceeds 1.5 billion korunas (approximately €60.3 million) and each of at least two of the undertakings concerned achieved in the market of the Czech Republic in the last accounting period a net turnover exceeding 250 million korunas (approximately €10 million); or the net turnover achieved in the last accounting period in the market of the Czech Republic in case of a concentration in the form of:

- a merger – by at least one of the parties to the merger;
- acquisition of control over an enterprise or part thereof – by the acquired enterprise or part thereof;
- acquisition of control over another undertaking – by the undertaking over which control is acquired; or
- establishment of joint control over an undertaking that performs all functions of an autonomous economic entity on a lasting basis – by at least one of the undertakings establishing the joint venture exceeds 1.5 billion korunas and at the same time, the worldwide net turnover in the last accounting period of another undertaking concerned exceeds 1.5 billion korunas.

There is no time limit for notification, but a concentration that requires mandatory notification to the Antitrust Office cannot be implemented before the date on which the approval decision becomes final (ie, the shares or enterprise or joint control over a fully functioning joint venture cannot be acquired and control cannot be exercised).

After the initiation of proceedings, the Antitrust Office first assesses whether the notified concentration is subject to its approval. If the concentration is not subject to approval by the Antitrust Office, a decision to that effect should be issued within 30 calendar days of the initiation of proceedings. In cases where the concentration is subject to approval but will not result in a substantial distortion of competition, the Antitrust Office shall issue a decision approving the concentration within the aforementioned deadline. In the event that the Antitrust Office finds that the concentration raises serious concerns as to a significant impediment to competition, in particular because it would cre-

ate or strengthen a dominant position of the undertakings concerned or any of them, the Antitrust Office informs the parties to the proceedings of this fact within the stipulated deadline and informs them that it is continuing the proceedings. If the Antitrust Office informs in writing the parties to the proceedings that it is continuing the proceedings, it shall be obliged to issue a decision within five months of the initiation of proceedings. If the Antitrust Office does not issue a decision on the concentration notification within the stipulated deadlines, or fails to inform the parties in writing that it is continuing the proceedings, the Antitrust Office shall be deemed to have approved the concentration upon the lapse of the aforementioned deadlines.

Mergers in the gas sector (like other mergers) require final approval from a commercial court to ensure compliance with general Czech corporate laws.

34 In the purchase of a regulated gas utility, are there any restrictions on the inclusion of the purchase cost in the price of services?

There are generally no applicable rules; please note, however, that any entity operating in the regulated sectors, including certain areas of the gas market, must set its prices in full compliance with the relevant decisions and methodology issued by the sector regulator, ie, by the ERO in the case of energy sector.

35 Are there any restrictions on the acquisition of shares in gas utilities? Do any corporate governance regulations or rules regarding the transfer of assets apply to gas utilities?

Apart from the above-mentioned rules governing merger control and rules arising from the general Czech corporate laws, there are no specific rules governing acquisition of shares in gas utilities or corporate governance regulations on asset transfers applicable to gas utilities.

International

36 Are there any special requirements or limitations on foreign companies acquiring interests in the natural gas sector?

Foreign companies enjoy the same treatment as local entities when acquiring interests in Czech gas utility companies.

37 To what extent is regulatory policy affected by treaties or other multinational agreements?

The Czech Republic is an EU member state and therefore its regulatory policy is mainly influenced by EU legislation.

38 What rules apply to cross-border sales or deliveries of natural gas?

There is no special legislation pertaining to cross-border natural gas transactions. Cross-border sales and deliveries of natural gas are transacted pursuant to bilateral agreements between the parties and the availability of cross-border capacity. Also, the Rules for Organising the Gas Market and the Operational Code of the Operator of the Transportation System (which set out, for instance, rules for nomination of the amount of natural gas to be supplied into or taken from the transportation system) are important.

Update and trends

Owing to the continuing increase in the price of oil, the lack of confidence of the public in nuclear energy and the decrease of coal reserves, together with the costs associated with CO₂ emissions allowances, there are plans within the Czech electricity market that consider construction of several new gas power plants, which would not be operated as peaking plants (several power plants using gas as the main fuel are already being operated in the Czech Republic in

the peaking regime and used primarily for the provision of grid support services), but in the 'base load' regime. If such gas power plants are actually installed and operated, the operation of certain out-of-date coal power plants would probably be terminated; on the other hand, the strategic dependence of the Czech Republic on import of gas would be thus further increased.

Transactions between affiliates

39 What restrictions exist on transactions between a natural gas utility and its affiliates?

As in all transactions between affiliates, under Czech corporate laws (in particular the Commercial Code) and Czech tax laws, transactions between a natural gas utility and its affiliates must be at 'arm's length'.

40 Who enforces the affiliate restrictions and what are the sanctions for non-compliance?

The breaches of obligations or restrictions concerning transactions between affiliates arising from Czech corporate laws and Czech tax laws are stipulated especially in the Czech Commercial Code and the relevant Czech tax regulations. See question 32 for powers of the Antitrust Office to preclude or remedy anti-competitive practices of natural gas utilities.

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