

UNBUNDLING OF TRANSMISSION SYSTEM OPERATORS – THE GENERAL EUROPEAN UNION POLICY AND THE CASE IN GEORGIA

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ABSTRACT

Georgian Transmission System Operator has been certified and nominated as the sole transmission licensee in Georgia upon the specific conditions. Therefore, with the fulfillment of all criteria, the main objective of ownership unbundling (prevention of discrimination, optimization of the use of infrastructure, incentivizing economic investment) can be reached. However, in case of non-compliance with the unbundling ownership requirements and, thus, re-certification of Georgian TSO, the Government of Georgia shall consider the costs of such procedure for the country and, precisely, the state-owned company.

Therefore, the responsible public entities shall work with the Regulatory Commission and the Transmission System Operator to ensure timely and proper planning and implementation of necessary activities to meet unbundling ownership requirements.

Keyword: European Union, Transmission System, unbundling, Government of Georgia, Regulatory Commission, ownership

Energy Community

Association Agreement between the European Union and the European Atomic Energy Community and their Member States and Georgia was signed in June 2014 and entered into force in July 2016. The Association Agreement strives for political association and economic integration between the EU and Georgia. With its ratification, the Association Agreement has officially become a primary legal framework for Georgia's new and higher level of cooperation with the European Union. Among others, the document sets the obligations for implementing EU legislation in the field of energy and environment, including the terms for harmonizing Georgian Energy legislation with the European "Third Energy Package" (Third energy package).

After three years after the ratification of the Association Agreement, Georgia has taken a significant step forward in EU integration by signing the Protocol Concerning the Accession of Georgia to the Treaty Establishing the Energy Community (Protocol Concerning the Accession of Georgia to the Treaty Establishing the Energy Community) on the 14th Energy Community Ministerial Council on 14th of October 2016. The Parliament of Georgia ratified the Protocol in April 2017.

The Energy Community is an international organization that brings together the European Union and its neighbors to create an integrated pan-European energy market. The Energy Community is based on the liberalized market paradigm, which aims to extend the EU internal energy market rules and principles to countries in South East Europe, the Black Sea region, and beyond (Energy Community).

Accessing Georgia to the Energy Community Treaty as a full-fledged member was an important milestone in bringing Georgia closer to the EU. To achieve the goals and mission of the Energy Community, its activities include the implementation by the Contracting Parties of the *acquis communautaire* on energy, environment, competition, and renewables and the setting up of a specific regulatory framework permitting the efficient operation of Network Energy markets across the territories of the Contracting Parties and part of the territory of the European Community (Energy Community, Article 3).

Membership of the Energy Community means the process of implementation of significant reforms in the energy sector, including the open and competitive energy market, the separation of production/supply activities from transmission/distribu-

tion activities, the legal regulation of public service obligations, protection of vulnerable customers, development of renewable energy sources and facilitation of energy efficiency.

The terms and conditions under the Protocol of Accession

According to the Protocol on the Accession of Georgia to the Energy Community Treaty, Georgia has committed to implement several EU directives and regulations related to electricity, natural gas, energy efficiency, renewable energy, and energy statistics. The deadlines for implementation of the Energy Community acquis on electricity were defined by Accession Protocol (Compliance with the Energy Community Acquis, Energy Community Secretariat, July 2017, p. 11).

Georgia is the first Contracting Party not to border the EU internal market or any other Energy Community Party. Therefore, the Protocol takes into account that Georgia is not directly interconnected to the energy network of any Contracting Party or Member State of the European Union and defines that the provisions included in the *acquis communautaire* concerning cross-border energy exchanges with a Contracting Party or a Member State of the European Union, shall apply whenever it is physically interconnected to the energy network of any Contracting Party or Member State of the European Union (Accession Protocol, Annex, point 1).

Energy transition: Alignment with the EU acquis

Introducing and implementing the basic standards of European energy policy at the national level is an important step forward for our country. However, the ongoing energy-legal reform in the country poses a significant practical challenge, as Georgia's energy sector is not aligned with the principles of modern European energy regulation (Samkharadze, July 2019, p.16).

In parallel with the steps taken in recent years, the reforms carried out, and the legislative changes, the complete transformation of the energy sector requires the effective and practical implementation of the legislative framework, which is an essential part of the ongoing reforms in the industry.

2.1. New Law of Georgia on Energy and Water Supply

Adopting the Energy and Water Supply Law compliant with the Third Energy Package at the end of 2019 paved the way for the liberalization of the electricity and gas markets in the country (Report on Compliance with the Energy Commu-

nity Acquis, November 1, 2020. p. 63). Adopting the new Law was a landmark development in Georgia's electricity market reform. The Law transposes obligations on unbundling, third-party access, wholesale trade, retail trade, public service obligation, and regional cooperation and defines concrete timelines for their implementation.

The new Law aims to ensure the creation, opening, and development of a fair, transparent, and competitive electricity market in Georgia. It defines a new legal framework for electricity generation, transmission, distribution, dispatch, supply, and trade and provides guidelines for the transition period. One of the main principles introduced by the new Law is the unbundling of supply and distribution activities from production and trading activities (Galt & Taggart, 2019a; TBC Capital, 2019).

Unbundling requirements for Transmission System Operators

One of the European Union's main strategic goals is to create a competitive single electricity market. In the regulation of network industries, like electricity or gas, unbundling requirements refer to the separation of the activities potentially subject to competition (such as production and supply of energy) from those where the match is impossible or allowed (such as transmission and distribution).

The potential for discrimination will always exist where a vertically integrated company undertakes both competitive and monopolistic businesses. Therefore, the preferred market structure is ownership unbundling, where the network assets are owned by a regulated company performing all of the network activities and with no interest in the competitive markets of production, generation, or supply (3rd Legislative Package Input, June 2007, p. 9).

It has been mentioned in the academic literature that the main objective of the unbundling ownership model is to prevent discrimination, optimize the use of infrastructure, incentive economic investment, and enable effective regulatory oversight of monopolistic activities (3rd Legislative Package Input, June 2007, p. 7).

Separation within the State

In some Member States, vertically integrated companies are still wholly or partially state-owned. Electricity Directive opens up the possibility, within the unbundling ownership model, of the State controlling transmission activities, as well as generation, production, and supply activities, provided, however, that the individual actions are exercised by separate public entities (Article 9(6) of Electricity Direc-

tive). Such separation can be considered effective if supply or production activities are in public ownership, but the independence of a publicly owned transmission system operator is still guaranteed. For the rules on ownership unbundling, two separate public bodies should be seen as two distinct persons and should be able to control generation and supply activities on the one hand and transmission activities on the other (Commission Opinion of 9.1.2012, No 714/2009; Article 10(6) of Directive 2009/72/EC, p. 4). In such cases, demonstrating that these public bodies are not under the joint influence of another public entity is of utmost importance to avoid violating the rules on ownership unbundling.

As the effectiveness of unbundling in publicly owned companies depend on the degree of management independence, it shall be assessed on a case-by-case basis. Therefore, analysis of several decisions and opinions of the European Commission and Energy Community Secretariat as regards the practical issues related to separation within the State and interpretation and an explanation of EU requirements of ownership unbundling is of utmost importance.

- a) Danish Transmission System Operator is wholly owned by the Danish State, which also owns the majority of the company, which is active in generating, producing, and supplying electricity and gas. However, the ownership of these two companies is administered by the different ministries.

In its opinion, the Commission considered that two separate Ministries controlling, on the one hand, the transmission of electricity and gas and, on the other hand, activities of production, generation, and supply of electricity and gas could, under certain circumstances, constitute bodies with a sufficient degree of separation as required by Electricity Directive (Commission Opinion of 9.1.2012, No 714/2009; Article 10(6) of Directive 2009/72/).

In the case of certification of the Danish transmission system operator, the Regulatory Commission of Denmark and the European Commission undertook an in-depth evaluation of the degree of separation between the two Ministries concerned, focused on legal traditions and constitutional theory, and assessed independent powers of the Ministries in the decision-making process in the areas for which they are responsible. In addition, the Commission identified several other elements in the Danish case which strengthen the separation between the handling of the transmission activities and the production, generation, and supply interests, including whether the independence of the individual Ministers in the areas of competence also precludes the Prime Minister from giving orders or instructions as regards the Minister's responsibilities in the transmission of electricity and gas.

- b) The Commission took the same approach when assessing the preliminary decision of the Swedish Regulatory Commission on the certification of the Swedish Transmission System Operator. The transmission company and the company providing generation and supply activities fall within the competence of two Ministries. Unlike the Danish case, the Commission confirmed that a sufficient degree of separation exists between the two Ministries regarding transmission activities and generation and supply interests, as required by Electricity Directive, particularly regarding day-to-day decisions. However, regarding the non-day-to-day choices, the Commission noted that the ability to make decisions independently, without being influenced or controlled by other Ministries or any overarching public authority, needed to be sufficiently demonstrated. This assumption was based on the fact that the Swedish Government establishes every year the Regulation Letter, where the Government describes the goals and assignments the authority has and how much money it plans to use from the state budget (Detailed information on Regulation Letter). The Commission noted that it does not become clear how the fact that the Swedish government establishes every year several detailed conditions regarding investments by transmission companies can be considered compatible with the requirement of independence of the relevant Ministry and how it is ensured that such a decision is not influenced by the interests of the Swedish State in supply and generation company (Commission Opinion pursuant to Article 3(1) of Regulation (EC) No 714/2009; Article 10(6) of Directive 2009/72/EC).
- c) In the case of certification of the Transmission System Operator of Albania, the Commission, in addition to its views and approaches expressed in previous decisions, noted that the entire achievement of the unbundling ownership requirements set by the Electricity Directive to prevent potential and actual conflicts of interest and to ensure unbundling of undertakings controlled by public bodies on equal footing with private projects, Electricity Directive cannot be interpreted in a formalistic manner. The separation of control between the two public bodies in question must be effective because it ensures the complete independence of the public body controlling the transmission system operator of any other entity controlling generation and supply activities (Opinion 1/17, No 714/2009; Article 10(6) of Directive 2009/72/EC, p. 6).

The Secretariat outlined one of the main approaches that are of utmost importance for the assessment of practical independence, namely *de jure* and *de facto*

independence between the two public bodies tasked to exercise control over the state-owned undertakings in question, including the prevention of any common influence of a third public or private entity (Section 2.2, p. 10 Commission Staff Working Paper – Interpretative Note on Directive 2009/72/EC; Directive 2009/73/EC, January 22, 2010).

In its decision, the Energy Community made a detailed and in-depth evaluation of the requirements of the Constitution of Albania and legislation to determine the individual and exclusive powers of the Ministries and the quality of their independence in the decision-making process, as well as the possibility of exercising control. The Energy Community also established the necessity of amendments to primary and secondary legislation. Furthermore, the assessment included an evaluation of the influence of third parties, such as the prime minister or the President, on the independence of the relevant Ministries.

Certification of electricity Transmission System Operator in Georgia

a) Legal basis for certification of TSO

The Law of Georgia on Energy and Water Supply sets out, *among other things*, the obligation of certification of a transmission system operator, the rules, procedures, and deadlines for accreditation, as well as the authority of the Regulatory Commission in the process of certification of a transmission system operator. One of the core aims of the Law is to ensure the proper implementation of the independence and unbundling of transmission system operators.

The Law establishes the general rule for unbundling the transmission system operator and defines the authority of the Regulatory Commission to approve the relevant legislative act (The Law of Georgia on Energy and Water Supply, Article 50). Based on this, the Regulatory Commission approved the Transmission System Operator Certification Rules by Resolution N9 of 27 March 2020 (Georgian National Energy and Water Supply Regulatory Commission Resolution N9 On Approving Transmission System Operator Certification Rules, March 27, 2020), which sets out the procedure for unbundling of transmission system operators, including the list of documents and information to be submitted by the Applicant and the process and deadlines for reviewing the application by the Regulatory Commission.

After adopting all relevant regulatory acts, JSC Georgian State Electric System (GSE) applied for certification as Georgian Transmission System Operator. The

shareholder of GSE is the National Agency of State Property¹. In 2020, the National Agency of State Property transferred the rights and obligations associated with shareholding to the Ministry of Economy and Sustainable Development. Under the transfer agreement, the shareholder's consent is needed only for decisions concerning the alienation of shares, the liquidation of the company, the disposal, pledging, or transfer of assets, and withdrawal and contributions to the share capital.

By the time of submission of the application, GSE, together with the JSC United Energy System Sakrusenergo,² provided transmission services on the territory of Georgia based on the transmission licenses issued by the Regulatory Commission. Therefore, following the requirements for unbundling and independence, GSE concluded a lease agreement with Sakrusenergo³.

Following the requirements of the Law on Energy and Water Supply (The Law of Georgia on Energy and Water Supply, Article 44, paragraph 1), the Government of Georgia adopted the Unbundling Plan (The Resolution of Georgian Government N682, November 13, 2020). The Resolution provides a detailed list of the measures and the deadlines for their implementation that constitute the responsibility of the relevant public and private entities to implement the presented unbundling model effectively.

Pursuant to Energy Community requirements and the Law of Georgia on Energy and Water Supply, the preliminary decision made by the Regulatory Commission was notified to Energy Community Secretariat to examine the informed initial decision and deliver its opinion on the compatibility of the decision with the EU requirements.

a) Ownership of the electricity transmission system

Directive 2009/72/EC requires that “*each undertaking which owns a transmission system acts as a transmission system operator*” (Article 9(1)(a), Electricity Directive). This means, in principle, that the undertaking applying for certification is the transmission assets (system) owner. However, only in exceptional cases the

¹ Under the Law on State Property, the shares are considered state-owned assets and are administered by the National Agency of State Property, unless transferred to another body;

² The shares of Sakrusenergo are owned 50% by the State of Georgia, represented by the Ministry of Economy and Sustainable Development of Georgia;

³ Agreement “On Transfer of the Electricity Transmission Lines and their Components Owned by JSC UES Sakrusenergo to JSC Georgian State Electrosystem (Transmission System Operator) with the right of use with for the unspecified term (by Lease) and for the Provision of Accompanying Repair and Maintenance Services”;

European Commission and the Secretariat have accepted that a TSO's right to use, manage and dispose of the transmission system through arrangements such as a lease or concession agreements may be considered equivalent to ownership (Commission's Opinion on URE's, 9 April 2014 (C(2014) 2471; Commission's Opinion on certification of *REN Rede Electrica Nacional S.A.* and *REN Gasodutos S.A.*, C(2014) 3255; Commission's Opinion on the certificate of *Transelectrica D.A.*, C(2015) 7053; Secretariat's Opinion 1/20 of 5 February 2020). Moreover, in each case, they thoroughly examined whether the applicant's rights were equivalent to ownership rights.

a) Separation of control over a transmission from generation/supply

Control over GSE and the several undertakings active in generating and supplying electricity and natural gas is exercised by the public body exercising the respective shareholding rights, the Ministry of Economy and Sustainable Development of Georgia. By the Order of the Ministry of Economy and Sustainable Development of Georgia Order dated 2 December 2020, different departments within the Ministry have been entrusted with the exercise of rights and obligations associated with shareholding in the TSO, on the one hand, and the other undertakings active in generation and supply of electricity and natural gas, on the other hand.

The separation of control within the State in line with Article 9(6)⁴ of the Electricity Directive read in conjunction with Article 9(1)(b) and (c)⁵ in the Georgian case has not taken place even in its most basic requirement, the designation of two public bodies. The formal separation of competencies between public bodies constitutes a *sine qua non* for unbundling of a state-owned TSO (Opinion 1/21

according to Article 3(1) of Regulation (EC) No 714/2009; Article 10(6) of Directive 2009/72/EC – Georgia – Certification of GSE). The separate departments

⁴ "...two separate public bodies exercising control over a transmission system operator or over a transmission system on the one hand, and over an undertaking performing any of the functions of generation or supply on the other, shall be deemed not to be the same person or persons";

⁵ "(b) the same person or persons are entitled neither: (i) directly or indirectly to exercise control over an undertaking performing any of the functions of generation or supply, and directly or indirectly to exercise control or exercise any right over a transmission system operator or over a transmission system; nor (ii) directly or indirectly to exercise control over a transmission system operator or over a transmission system, and directly or indirectly to exercise control or exercise any right over an undertaking performing any of the functions of generation or supply; (c) the same person or persons are not entitled to appoint members of the supervisory board, the administrative board or bodies legally representing the undertaking, of a transmission system operator or a transmission system, and directly or indirectly to exercise control or exercise any right over an undertaking performing any of the functions of generation or supply";

within the Ministry are not entitled to make decisions, as they are not two different and independent public bodies with legal personalities. Therefore, the separation between two departments of the same Ministry does not comply with the independence requirements.

In its Opinion, the Secretariat outlined that the owner of the shares in the Transmission company, on the one hand, and in supply and generation companies, on the other hand, are owned by the same public entity, the National Agency of State Property. Although the Agency has retained certain rights as an owner related to the alienation of shares, the liquidation of the company, the disposal, pledging, or transfer of assets, and withdrawal and contributions to the share capital, it still has the authority to influence the decision regarding strategic transactions of the energy enterprise, such as withdrawal of shares/capital, encumbrance or selling the assets and shares. In its final decision on the certification of Georgian TSO, the Regulatory Commission concluded that, as the shareholder has the power to exercise control over the assets of the transmission system, this amounts to control within the meaning of the EC Merger Regulation and the Electricity Directive, it is contrary to the requirements of the independence and unbundling of the transmission system operator (Opinion 1/21 according to Article 3(1) of Regulation (EC) No 714/2009; Article 10(6) of Directive 2009/72/EC – Georgia – Certification of GSE, p. 10).

The Regulatory Commission assumes that the separation of control within one public body, the Ministry, through internal divisions of the Ministry is a temporary measure (The Regulatory Commission Decision №9/10 dated March 4, 2020, On Preliminary Certification of JSC Georgian State Electrosystem as the Electricity Transmission System Operator; p. 10). The Unbundling Plan approved by the Government of Georgia⁶ foresees the obligation of the Ministry to ensure the reallocation of the management rights of energy enterprises within the state institutions in a manner achieving the goals of independence and unbundling requirements provided by the Law by 31 December 2021.

Conclusion

Based on the information displayed in the Preliminary Decision made by the Regulatory Commission, the Energy Community Secretariat concluded that GSE is currently not unbundled in line with the unbundling ownership model as required by the Electricity Directive (Opinion 1/21 according to Article 3(1) of Regulation

⁶ The Government of Georgia adopted the Unbundling Plan through the Resolution N682 on 13.11.202, and it entered into force on 17.11.2020.

(EC) No 714/2009; Article 10(6) of Directive 2009/72/EC – Georgia – Certification of GSE, p. 8). Furthermore, the Secretariat noted that GSE is still directly and indirectly controlled by the same public body, also holding the public companies active in the generation and/or supply of natural gas or electricity.

Under the conclusions made by the Secretariat, a decision on the certification of GSE as an electricity transmission system operator adopted by the Regulatory Commission is subject to the conditions established by the said decision.

The European Union's strategic documents stress that the effective ownership unbundling of electricity supply and generation from monopolistic electricity transmission and distribution activities is critical to competitive electricity market development. Therefore, under the final decision delivered by the Regulatory Commission, all the measures necessary to comply with the requirements of the Transmission System Operator Unbundling Plan (The Resolution N682 of the Government of Georgia made on 13.11.2020, Article 4, paragraph 1) shall be completed by the end of the year 2021, in particular, managing rights for the enterprises active in transmission activities on one hand and generation and supply activities, on the other hand, shall be reallocated to be controlled by truly separate public bodies, independent not only from each other but also from third bodies such as the Government, the Prime Minister or the President.

Based on the analysis of Unbundling Plan on the one hand and the decisions made by the Regulatory Commission on the other hand, the requirement set under the Unbundling Plan is too broad, unclear, and vague as to what transmission system operator is concretely and precisely obliged to do. As a result, the transmission system operator is not obliged to act under the Unbundling Plan. It needs to be responsible for reaching the specific outcome, which is necessary to ensure an effective unbundling regime consistent with the requirements of the Electricity Directive.

Under Unbundling Plan, the Ministry of Economy and Sustainable Development of Georgia shall ensure the separation of management of the relevant companies through negotiations with state bodies and initiating the appropriate amendments to ensure effective unbundling and solve the fundamental inconsistency with the general unbundling requirements. However, GSE as a transmission system operator, is not entitled to make decisions regarding the reallocation of the companies, nor can it influence the relevant amendments to legislation, if needed.

In Secretariats' opinion, GSE was certified without meeting the requirements necessary for compliance with the provisions of the unbundling ownership model and,

thus, in breach of Energy Community law. In addition, it was noted in its Opinion that, in similar situations, the Secretariat has already considered that maintaining a transmission license under the conditions mentioned above would *de facto* perpetuate a breach of one of the most fundamental requirements for TSO under European law, unbundling (Secretariat Opinion 3/17 of 15 June 2017 *EMS*, Secretariat Opinion 2/17 of 22 April 2017 *Yugorosgaz-Transport*). In particular, the Secretariat noted that such requirements are not suitable or appropriate to remedy the lack of compliance with the unbundling ownership model, as imposing conditions on transmission system operators that are not in the company's sphere of competence fails to demonstrate suitability criteria (Opinion 3/17 according to Article 3(1) of Regulation (EC) No 714/2009 and Article 10(6) of Directive 2009/72/EC – Serbia – Certification of EMS, p. 10).

In a perfect scenario, after the deadline determined by the Unbundling Plan, energy enterprises involved in transmission/distribution energy activities, on the one hand, and the energy enterprises involved in generation/supply/trade, on the other hand, shall be managed by separate state bodies/institutions, and at the same time control by the same third party over these enterprises shall be excluded. Therefore, control by the National Agency of State Property as the shareholder of these companies shall be excluded.

Ownership unbundling is only sufficient if it results in the independence of the control of the network operator. The “control” constitutes “*rights, contracts or any other means which, either separately or in combination and having regard to the considerations of fact or law involved, confer the possibility of exercising decisive influence on an undertaking*” (EC Merger Regulation, Article 3(2)). The critical consideration in this regard is the concept of “decisive influence.” The EC Merger Regulation clarifies that decisive influence can arise in particular from:

- a) Ownership or the right to use all or part of the assets of an undertaking; or
- b) Rights or contracts which confer decisive influence on the composition, voting, or decisions of the organs of an undertaking.

The National Agency of State Property as the owner of shares in Transmission Company, on the one hand, and generation and Supply Company, on the other hand, is entitled to make decisions regarding the disposal, pledging, or transfer of assets. In its final decision on the certification of Georgian TSO, the Regulatory Commission concluded that this amounts to control within the meaning of the EC Merger Regulation and the Electricity Directive. It is contrary to the requirements

of the independence and unbundling of the transmission system operator.

The Regulatory Commission is entitled to monitor the continued compliance of the transmission system operator with the requirements of independence and unbundling, regardless of the required level of independence and/or unbundling model (Law of Georgia on Energy and Water Supply, Paragraph 1 of Article 49). Furthermore, the Regulatory Commission is entitled to re-open the certification procedure in case of reasonable doubt of noncompliance with the independence and unbundling requirements of the transmission system operator (Law of Georgia on Energy and Water Supply, Article 49, paragraph 2 (b)).

Considering the above-listed non-compliances with the requirements of the Law, the Regulatory Commission concluded that Georgian State Electrosystem could be certified as a transmission system operator upon conditions to meet relevant needs by the end of the year 2021. However, after the expiry of this period, it is necessary to reevaluate the compliance of the transmission system operator with the requirements of independence and unbundling, which is the ground for the re-certification procedure based on Law and the Transmission System Operator Certification Rules.

The Regulatory Commission must ensure the independence of the transmission system operator for re-certification purposes according to the following criteria:

- a) The executive bodies of the transmission system operator shall be appointed by the authorized person/body who, at the same time, does not exercise similar authority over the energy enterprises that are not involved in generation/supply/trade activities;
- b) The transmission system owner must not assert any influence over the operational and commercial decisions of the transmission system operator;
- c) The Energy enterprises involved in transmission and distribution, on the one hand, and the energy enterprises engaged in the generation/supply or trading activities, on the other hand, should be managed by state bodies/institutions that, at least in the process of exercising these powers, do not have a standard controlling body.

It can be concluded that the Georgian Transmission System Operator has been certified and nominated as the sole transmission licensee in Georgia upon the specific conditions. Therefore, with the fulfillment of all criteria, the main objective of ownership unbundling (prevention of discrimination, optimization of the use of

infrastructure, incentivizing economic investment) can be reached. However, in case of non-compliance with the unbundling ownership requirements and, thus, re-certification of Georgian TSO, the Government of Georgia shall consider the costs of such procedure for the country and, precisely, the state-owned company.

Therefore, the responsible public entities shall work with the Regulatory Commission and the Transmission System Operator to ensure timely and proper planning and implementation of necessary activities to meet unbundling ownership requirements.

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