

Market Liberalisation: Conditions for Effective Unbundling

The separation of ownership and control of gas and power transmission networks is at the heart of the EU Commission's third attempt to liberalise energy markets. Here Lars Kjølbye,¹ Head of Energy Unit in the Competition Directorate of the EU Commission, sets out the conditions for successful unbundling and indicates that the third package could be in place by 2010.

Setting the scene

The European Union has, over the past decade, worked intensively to create integrated and competitive gas and electricity markets in Europe. This process has involved two main rounds of liberalisation measures aiming at opening up supply market to competition while ensuring that networks, which are normally considered natural monopolies, are operated in a non-discriminatory and efficient manner. While the liberalisation process has been partly successful, obstacles to creating

integrated and competitive gas and electricity markets persist. In the final report on its Energy Sector Inquiry published on 10 January 2007 the Commission identified a number of shortcomings.² It is with a view to addressing a number of these obstacles that on 19 September 2007 the Commission adopted its proposals for a third liberalisation package. The package has two main parts, namely (i) measures to ensure effective unbundling of production/supply activities on the one hand and network activities on the other hand, and (ii) measures to enhance the powers and independence of national regulators and enhance cross-border co-operation between respectively regulators and TSOs. In the following I will focus on unbundling.

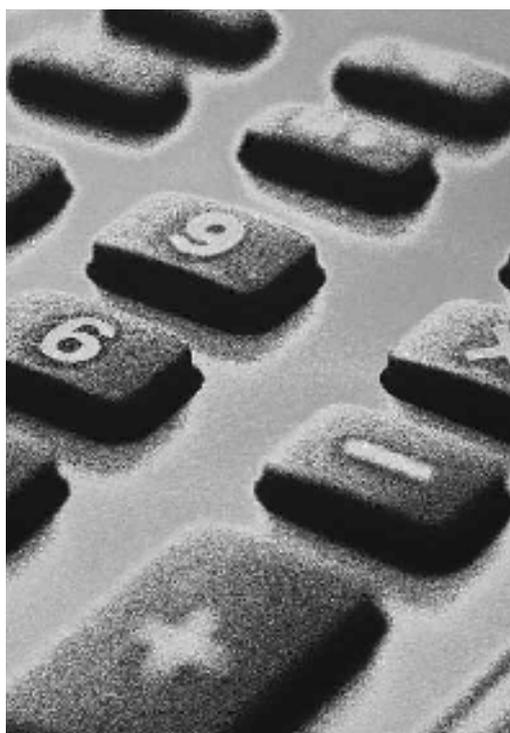
Effective ownership unbundling

Unbundling is at the heart of the current debate on how to achieve integrated and competitive energy markets. It is clear from the Commission's Sector Inquiry that the current requirement of legal and functional unbundling has not been effective. The Commission found that vertical integration creates substantial

(1) All views expressed are personal

(2) The final report on the sector inquiry is available on the DG Competition website:

<http://ec.europa.eu/comm/competition/sectors/energy/inquiry/index.html>



problems of discriminatory treatment of competitors and withholding of investments in new capacity except where such capacity is needed by the vertically integrated firm's own supply affiliate. This is a particular problem at a time when the EU needs large scale investments in networks in order to ensure security of supply. To address these problems the Commission has proposed ownership unbundling of transmission networks as the main and preferred option and the creation of independent system operators (ISO) as an exception that may be offered in Member States which have not already implemented ownership unbundling.

The benefits of ownership unbundling

Experience in Member States where ownership unbundling has been implemented is positive. In particular, data available suggests that ownership unbundling is positively correlated to investment in networks. Ownership unbundled TSOs for

which data is available show a significant and constant increase in investment levels after ownership unbundling took place.³ In contrast, the investment figures relating to networks of the vertically integrated German and French electricity TSOs are comparatively lower. Moreover, as mentioned in the Sector Inquiry, the share of reinvested congestion revenue was about twice as high for ownership unbundled TSOs as for integrated TSOs. Ownership unbundled TSOs in the EU-15 reinvested 33.3% of the received congestion revenue, whereas vertically integrated TSOs in the EU-15 reinvested merely 16.8%. Ownership unbundling also avoids both actual and perceived discrimination regarding third party access to networks, facilitating entry by third parties.

Conditions for the ISO model to be effective

The ISO model implies that the TSO is split into two separate functions: a transmission owner (TO) which owns the assets and which can remain part of a vertically integrated company and an independent system operator (ISO) which is independent from the vertically integrated company.⁵ The ISO model is more complex than the ownership unbundling model. It is necessary to regulate in great detail the interface between the TO and the ISO and compliance must be monitored continuously. However, the ISO model can achieve effective separation of network and supply activities provided that it is very deep in terms of transferring powers and functions from the TO to the ISO. The ISO must have full independence from the network owner and must manage the network in ►

(3) Examples include TSOs like Spanish REE, the Czech CEPS and the Portuguese REN, where the increase in the investment amount was significant.

(4) The ISO may operate several systems in a region in which case it is referred to as a regional system operator (RSO).



all its aspects. This means that it must be in charge of the day-to-day operation and maintenance of the network and must have the power to decide on and implement investments. If the TO does not wish to finance a given investment, the ISO must be able to seek alternative financing. When these far reaching conditions are satisfied, the asset owner cannot influence network decisions and can therefore not use the assets to distort competition in its favour. However, if the ISO is weakened vis-à-vis the asset owner, the latter will once again be able to do so. In that case unbundling will no longer be effective and the objective of creating integrated and competitive energy markets in the EU will not be achieved.

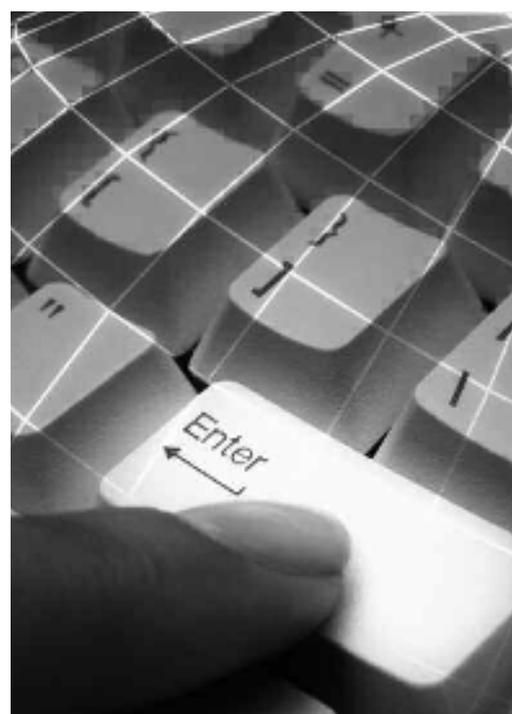
Regional cooperation between TSOs

In principle, the creation of regional system operators could result in important improvements compared to the current state of network unbundling. Indeed, the third package contains proposals that aim at enhancing cross-border cooperation between TSOs on important matters such as investment planning. However, such regional cooperation is not a substitute for effective unbundling of each participating TSO. If the TSOs are not properly unbundled at the base, regional cooperation may give rise to serious competition concerns. It would not be appropriate for TSOs to coordinate on investment plans and other important market parameters as long as they belong to undertakings that are at least potential competitors on supply markets since the decisions concerned have a direct impact on competition in these markets. In this regard, it would be immaterial whether the TSOs would commit to certain investment levels or to improving third party access. Our experience from cases shows that even when vertically

integrated firms commit to invest, there are a host of ways in which to delay implementation. Infrastructure projects have to navigate through a mine field of obstacles inter alia in the shape of permit requirements. It takes a wholehearted effort by the TSO to overcome such obstacles. A vertically integrated TSO has no incentive to wholeheartedly push a project that benefits competitors. This is the reason why, under the ISO model, it is crucial that the ISO takes decisions on and implements investments.

Who are the likely buyers?

Important synergies could be achieved through mergers between independent network companies. Ownership unbundled TSOs may therefore have an incentive to merge. However, one can also imagine other buyers, such as equity funds. Networks which generate stable and long-term revenues are attractive to certain types of investors. Indeed, the Commission is aware of very substantial interest in such an investment profile. However, for such ►



investments to be really attractive, the investor also needs to be confident that there is a strong and predictable regulatory framework in place which is administered by independent regulators. The third package proposals are of considerable importance in this respect since they seek to achieve this objective. At the same time the Commission is sending a strong signal to Member States in on-going merger cases that it will not tolerate attempts by Member States to frustrate mergers that are compatible with European merger control rules.

The third package contains certain proposals concerning investments by third country entities. Third country entities are treated in a broadly similar way to EU companies. The unbundling requirements will apply to both EU companies and companies from third countries. However, as regards the latter it was considered necessary to go a bit further in order to ensure that the unbundling requirements cannot be easily circumvented. Otherwise the creation of open and competitive energy markets would be at risk. What the Commission is looking for is not reciprocity but rather assurance that the unbundling proposals remain effective.

The way ahead

The Commission's proposals are now being discussed in the Council and the European Parliament which have to agree on a text before it can enter into force. The aim is to achieve adoption before the end of 2008. Under the proposals the new rules would become applicable 18 months after adoption. This means that the third package could be in place by 2010. ■

