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STRONG APPETITE FOR INVESTING IN EU ENERGY NETWORKS

Leading investment banks and energy market analysts testify that there is strong investor interest in acquiring transmission network assets. There is strong support for the EU Commission's proposed Directive on TSO ownership unbundling, which many investors and analysts believe would not harm either share or credit ratings of existing integrated businesses such as E.on or RWE in Germany.

On the contrary, the process of selling network assets could benefit consumers and enhance shareholder value by releasing resources to invest in non-regulated generation and supply sectors which offer higher rates of return on capital employed.

These are just some of the conclusions from recent market research sponsored by the energy regulators from Great Britain, Austria and The Netherlands. The research took the form of two focus group discussions (January 2008) between Ofgem, E-Control and the Netherlands Competition Authority and some fourteen leading investment banks and energy market analysts.

The research was organised by Moffatt Associates – an independent energy market research and business strategy consultancy based in London. The meetings were chaired by Walter Boltz – Managing Director of E-Control and Vice President of CEER.

These discussions also indicated **(For details see Appendix A and B attached)** that a majority of those consulted believe:

- The 3rd Package will improve energy market competition and that full-ownership unbundling is the most effective way of achieving this

- Greater wholesale market transparency regarding network capacity, energy flow data and transactions will increase market competition in the EU's energy market

- Full or partial privatisation of state-owned TSO assets (eg EDF) is a workable option

- Under the Commission's ISO second option the ISO should be allowed to raise outside capital to fund new network investment

- Clear and consistent guidelines on how to set regulated rates of return on TSO networks are needed to facilitate ownership unbundling

- The proposed new Agency of National Regulators should define a route map for ownership unbundling across the EU

Commenting on the future role of regulation Walter Boltz said ***" Ownership unbundling (OU) of private or state-owned assets is clearly the most effective and low-cost method of increasing market competition and ensuring the most efficient network investment at the lowest marginal cost. But while OU is a necessary condition for market competition it is not sufficient, and removing regulatory uncertainty is also essential. What would help owners to sell and buyers to buy would be greater certainty and consistency in energy network regulation in particular the creation of clear guidelines on how regulated rates of returns are set so that investors can determine future revenues. One of the roles of the new Regulatory Agency should be to encourage national regulators to set TSO revenues at a level which offers networks the prospect of securing their efficient operating costs including a reasonable return on capital employed. The implementation of the 3rd package could also be enhanced by regulators taking the lead to established common rules relating to the operation of wholesale markets, balancing mechanisms and investment incentives to reduce cross-border congestion"***

Commenting on the Commission's second option – the Independent System Operator (ISO) where by the state or private companies retain ownership of the assets but cede management control of the network to the ISO, Steve Smith, Managing Director of Networks at Ofgem said ***"In principle the ISO option could work and deliver access to the network for independent generators and suppliers on equal terms to the incumbents. Member States could keep network assets under state ownership or create national grids that may or may not be partially privatised. Although these types of compromise solutions take the networks out of the direct control of integrated businesses there is still a real danger that, when it comes to setting charges and delivering new investment, national economic and political interests will prevail over the needs of customers and the EU energy market as a whole. All of the ISO solutions would require a heavy burden and cost through complex and detailed regulatory oversight. Investors also raised concerns about the ability of an ISO to raise outside capital to fund new investment if it did not own the existing network assets."***

Commenting on the business case for OU, Machiel Mulder of the Netherlands Competition Authority (NMa) said ***"Discussions with the financial community have confirmed our view***

while OU cannot be enforced; it is by far the most cost-effective solution which in the long run will help ensure the delivery to customers of competitive, sustainable and secure energy."

The research has highlighted five key benefits of OU **(See Appendix C for details)** namely:

A. INCREASING COMPETITION

An unbundled energy market will, by providing non-discriminatory network access, encourage more competition in generation and trade, which will result in the despatch of the most efficient production. This reduces cost and is also beneficial in environmental terms because it makes it easier for renewable energy generators to access the network.

B. AVOIDING CONFLICTSOF INTEREST

Only by completely separating ownership and control of networks is it possible to guarantee that network investment to reduce congestion and enhance security of supply will be determined by the needs of the market rather than its impact on the profits of integrated energy businesses.

C. MAXIMISING NETWORK EFFICIENCY

Only with full ownership unbundling is it possible to give the TSO incentives to operate the network at maximum efficiency and therefore at the lowest possible marginal cost. With bundled networks there is always the risk of integrated companies using network control to maximise short term profits.

D. MORE EFFICIENT REGULATION

Bundled networks or commercially or politically controlled ISOs will always require maximum oversight by the regulators to ensure (a) third party access is being provided to independent generators and (b) network investment is targeted to where it is most needed to reduce congestion. With independent TSOs the incidence and cost or regulation are minimal.

E. BENEFITS FOR INCUMBENTS

There is evidence to support the view that state (taxpayers) and/or private shareholders in independent businesses would benefit from the sale of TSO network assets which would allow managers to focus investment on non-regulated sectors (e.g. production and retail distribution) where rates of return on capital are much higher.

ENDS

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