ERGEG Guidelines of Good Practice on Regulatory Accounts Unbundling

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1 Background

Unbundling, or separation of business activities, is a pre-requisite for effective competition and is therefore a key component of the liberalisation process. The ERGEG recognises the importance of Transmission System Operator (TSO) independence; separation of distribution and supply businesses; and other separation requirements. This paper establishes ERGEG's Guidelines for Good Practice on regulatory account unbundling.

At transmission level, legal separation is already supposed to be in place as required by the 2003 Directives. At the distribution level, this process is ongoing but by 1 July 2007 distribution network operators with more than 100,000 customers will have to be unbundled in legal terms. This means that by then many problems of vertical integration at least concerning governance, information and accounting should have been solved. The Strategic Energy Review The European Commission[1] and regulators[2] have examined the issue of unbundling closely. The European Commission's Sector Inquiry, and the ERGEG Assessment of Development of the European Energy Markets (2006) separately have identified unbundling as a major problem.

In its Strategic Energy Review, the European Commission states that "legal unbundling does not suppress the conflict of interest that stems from vertical integration, with risks that the network are seen as strategic assets serving the commercial interest of the integrated entity, not the overall interest of network customers and concluded that only strong unbundling provisions would provide the right incentive for system operators to operate an develop the network in the interest of all users. The Commission proposal two way for further unbundling provisions via new legislation, with a clear preference for ownership unbundling. This is strongly endorsed by the European regulators.

New legislation for effective unbundling takes time to come into force. Meanwhile, the regulators had already begun preparing guidance to properly implement the unbundling provisions required under the current legislation. From April – June 2006, there was an ERGEG public consultation on draft guidelines on regulatory accounts unbundling. 17 responses were received during this public consultation process. These and ERGEG's evaluation of the comments received (ERGEG Public Consultation on GGP on Regulatory Accounts Unbundling - Evaluation of the Comments Received (ref: E06-CUB-16-03) are posted on the ERGEG website (www.ergeg.org).

This paper establishes ERGEG's Guidelines of Good Practice on Regulatory Accounts Unbundling, following the ERGEG public consultation. The Guidelines are directed at regulators and the European Commission as some provisions might need legal implementation. They can also serve as a benchmark for analysing national unbundling of accounts.

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[1] See the findings of the Sector Inquiry (10 January 2007), the country reviews carried out by the European Commission and the proposal on unbundling in their Strategic Energy Review (10 January 2007).

[2] See the individual 2006 national reports by the regulators in each Member State and ERGEG's Assessment of the Development of the European Energy Market, 2006 (Ref: E06-MOR-02-03), 6 December 2006. http://www.ergeg.org/portal/page/portal/ERGEG_HOME/ERGEG_DOCS/NATIONAL_REPORTS/2006

Concerning some issues regulators are rather free to agree on a common procedure of unbundling. This is especially true for accounting unbundling. These Guidelines are aimed at integrated companies, i.e. where there is an incentive (and also possibility) for cross-subsidisation between the different activities. Full ownership unbundling or fully independent network operators are therefore exempt companies from these guidelines. The Guidelines are restricted to a selection of potentially challenging circumstances (like asset leasing, shared services, etc). They do not cover usual practices of how to calculate CAPEX or OPEX[3].

The presented guidelines are the first set of unbundling guidelines. Draft Guidelines on informational and functional unbundling are also under preparation by ERGEG.

2 GGP on Accounts Unbundling

Articles 19 and 17 of directives 2003/54/EC and 2003/55/EC respectively set out the legal minimum requirements of accounting unbundling. In view of the possibility to exempt small distribution companies from the obligation of legal unbundling it is necessary to distinguish between these two situations.[4]

In principle there are possibly three different outputs from various information systems on network operator's cost – the statutory accounts, the regulatory accounts and the regulator's cost basis for setting network tariffs.

There are different philosophies on how to use published unbundling accounts. They can either strictly correspond to the basis for setting tariffs or they can just serve to inform the public on how the company assesses their cost. Some regulators even establish a correspondence between statutory accounts and the cost basis for setting tariffs. The Guidelines do not treat specific issues of cost calculation and accounting (like depreciation periods, normalization of costs, etc.) as the regulators have to follow national rules in this respect.

Many problems in accounting unbundling would not be relevant in situations of ownership unbundling. The second best solution which is provided by the directives stipulates legally unbundled network operators. This would ideally entail network companies which own their assets, which do not share services with mother or sister companies and who are tendering all external services and products. In reality this is not the dominant realization of unbundling. The proposed Guidelines therefore try to tackle problems of accounting unbundling, where these criteria are not met.

[3] CAPEX - Capital Expenses; OPEX - Operating Expenses.

[4] These Guidelines therefore distinguish between legally unbundled companies (LUCs) and legally integrated companies (LICs) indicating applicability at the beginning of the relevant guideline. For instance: G1 (LUC, LIC) is applicable to legally unbundled as well as to integrated network companies.

2.1 External Accounting

As a legally separated company the network operator has to follow the national accounting rules. According to the directive criteria for a limited liability company are the minimum requirements for such an unbundled organisation. However additional information should be made available to the public as well in the unbundled accounts.

Major transactions

Special attention should be paid to a very detailed report on the subject of transactions and the legal partner of major transactions. In cases of cross share holdings or extensive financial engagement in different sectors it is not easy to see who might benefit from those transactions and if they are cross subsidising the competitive part of the value chain. As a minimum transactions should be published in an accumulated format according to different groups (for instance, IT-services, balancing energy, energy losses, legal advice, accounting services, etc.). Publication is necessary as it enlarges the audience (for example potential service providers who are able to service the network company at lower cost) and thereby valuable information might be brought to the attention of the regulator.

G1 (LUC): The legally unbundled network operator is required to publish all major transactions with affiliated companies in their regulatory accounting statements. In some jurisdictions however rules of confidentiality might restrict publication.

The publication should be in line with IAS 24 and contain transactions such as:

- Purchases and their value (description of purchases, including whether tendering procedure was used)
- Kind of sales and their value (description of sales, including information on participation in tendering procedures)
- Financing costs (including dividends paid to affiliated companies, derivatives etc)

2.2 Internal Accounting

National laws set standards for publication of financial relationships such as share holdings etc. In parallel to the goal to protect investors regulators should have the same or even more information in order to be able to protect customers in a monopolistic business. Therefore concerning the affiliation of network companies these financial standards are not far reaching enough, as there may exist major economic interest of the network company in competitive companies even without direct affiliation. The regulator should have full access to minor forms of affiliation and to economic interest between the network company and competitive business in order to see whether any form of influence on daily or major investment decisions is possible. Influence therefore does not only include direct influence from one company on the other one but also influence on decisions because of economic interest in the other company. The second category of “other relations” is a set of “soft” indicators, where an evaluation of the regulators seems necessary whether influence is established or not.

G2 (LUC): The network operator is required to forward all structural elements of affiliation to the regulator

- Exact kind of affiliation with competitive parts of the gas and electricity value chain
  - Active (network company is share holder in other company, extent of direct and indirect shareholding)
  - Passive (other company is shareholder in network company, extent of direct and indirect shareholding)
- Other relations such as credits, loans, guarantees, long term contracts, usage rights (description of kind of service)
- Small affiliations may be published in summary reports.

2.3 Overhead Cost

In case of legally unbundled network companies in some countries this company might be allowed to perform different network businesses. This is very critical, if the services face different degrees of competition (for instance combinations of telecom, district heating and electricity). There are almost always some economies of scale and scope involved so that the allocation of these economies is critical. Calculation of stand alone cost may give advice on a separation of cost and synergies although there may exist other possible and efficient means. Calculation of stand alone cost can serve as a benchmark for other possibilities regulators might use (or have to use). A ”fair” allocation of economies is a key to successful unbundling.

G3 (LUC, LIC): Every allocation method or change of the method initiated by utilities has to be explained and justified. In general the method has to follow two major principles:

- a clear definition of all necessary network services is the basis for deciding whether a service in principle is a network service;
- and costs have to be allocated according to transparent principles which allocate economies in an appropriate way...

2.4 Shared Services

It is foreseeable that some network operators, even after becoming a separate legal entity, will be closely linked to their affiliated companies via contracts. These contracts will be the basis for shared services either produced by the mother company, the network operator or a third company which is owned by both or only one of the above mentioned companies.

Shared services may consist of parts of the former integrated company which had been calculated and allocated as overhead cost. As assessment of overhead costs has been the most difficult part of tariff regulation, this problem is only translated but not solved in the new legally unbundled world. Therefore problems relevant for shared services are almost identical to those concerning overhead cost. Priority is given to market based procurement, where an affiliated company happens to be successful in the tendering procedure. If no tendering has been undertaken, the situation is comparable to an integrated business, where the regulator should have all means he normally has to evaluate the competitiveness of the incurred cost.

G4 (LUC): Network operators will define all shared services in a SLA (service level agreement). Companies have to prove that cost of shared services is market based. Regulators view a working tendering procedure as the preferred method. If tendering is not used or not possible the network operator will make sure that the regulator has the right to access all information necessary to evaluate the correctness of cost calculation of the service supplier;

The burden of prove that prices are market based and does not entail cross subsidization is with the network companies.

2.5 Assets

In some countries legally unbundled network companies will be free to own or to lease essential assets necessary to operate a network system. The principle is that this contract must not be to the disadvantage of final customers, i.e. must not be more expensive than a benchmark cost calculated as if the assets were part of the RAB (Regulatory Asset Base) of the network operator. Any additional cost is at the expense of ROR (Rate of Return) of shareholders of the network company.

G5 (LUC): The cost for a leased asset base shall not exceed the cost incurred if the assets would have originally been part of the RAB of the network company. The cost is normally calculated as:

(*approved*) **RAB** *
(approved) **WACC** (Weighted Average Cost of Capital of the network operator)

The network company has to provide information on these assets to the regulator. To be able to assess the adequacy of the (often leasing) contract, the contract shall include:

- the right of the regulator to get information on the assets, their book value, yearly depreciation, all detailed information which is necessary to calculate the theoretical cost of capital.