Unbundling in EU Gas market

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Essence of unbundling

- Development of competitive gas markets working at their most efficient
  - *From* vertically integrated monopoly providing ‘bundled’ services at single tariffs
  - *To* competitive markets with separated monopoly and competitive activities, different tariffs for each service
- Transition from monopoly market to a competitive market brings about rapid change of market environment and of market structure specifically

- **Unbundling**
  - Avoids potential conflict of interest for integrated utilities
  - Prevents utility to *shift* costs between regulated and unregulated businesses
  - Enables utilities to identify the cost structure of their business activities
  - Allows for separate costing of services and introduction of competition
Forms of unbundling

♦ **Accounting unbundling**
  - requirement for Gas undertakings to keep separate accounts for different activities (transmission, distribution, LNG and storage activities). Supply activities to eligible and to non-eligible customers shall be separated in the accounts of these undertakings until full market opening.

♦ **Management unbundling**
  - separate management structures in TSO/DSO; management mustn’t participate in other activities of integrated undertaking, no conflict of interest, functional independence regarding organization and decision-making rights of the unbundled TSO/DSO should not prevent some form of co-ordination between parent company and its subsidiary

♦ **Legal unbundling**
  - separate legal entities; transmission and distribution have to be done by a separate company

♦ **Ownership unbundling**
  - separate ownership of assets; companies mustn’t be owned by the same parent company
Developing legal regulatory framework for unbundling (1)

Existing EU liberalization directives and enforcement:

- **Natural Gas Directive 98/30/EC** – entered into force 10 August, 2000
  - **accounts unbundling** between different activities (generation, transmission, distribution and retail)
  - phased market opening till 2010
  - regulated or negotiated access
  - derogations

- **Electricity Directive 96/92/EC** – entered into force February, 1999
  - **accounts unbundling** – separate accounts for generation, transmission and distribution
  - phased market opening till 2005
  - negotiated access or single-buyer procedure

- **Annual benchmarking (progress) reports** – First in October 2001, Second Report October 2002

- In 1999 the European Commission took the initiative to set up the **European Gas Regulatory Forum of Madrid** consisting from both regulators and market players

- legal unbundling of transmission by July 2004, distribution by July 2007
- management unbundling effective from July 2004
- no ownership unbundling – strictly rejected by the EU

- market opening for all non-household customers by July 2004, for all customers by July 2007
- regulated access
- establishment of regulator with well defined functions in all member states
EU speeds up liberalization and unbundling

Legal unbundling

Ownership unbundling

Unbundling of accounts

June 22, 1998
98/30EC

July 26, 2003
55/2003EC

July 2004

Legal unbundling for DSO

Legal unbundling TSO
Management unb. DSO
Additional measures to ensure independent acting*

* mng may not participate in other activities of the integrated undertaking
no conflict of interests
compliance programme

Unbundling of accounts implementation

August 2000

July 2007
Gas Directive 2003/55/EC

♦ Unbundling of transmission system operator TSO – Article 9

♦ 1. Where the transmission system operator is part of a vertically integrated undertaking, it shall be independent at least in terms of its legal form, organization and decision making from other activities not relating to transmission...

♦ 2. In order to ensure the independence of the transmission system operator...the following minimum criteria shall apply:
  (a) persons responsible for the management of the transmission system operator may not participate in company structures of the integrated natural gas undertaking responsible for the operation of the production, distribution and supply of natural gas;
  (b) appropriate measures must be taken to ensure that the professional interests of persons responsible for the management of the transmission system operator are taken into account in a manner that ensures that they are capable of acting independently;
  (c) the transmission system operator shall have effective decision-making rights, independent from the integrated gas undertaking, with respect to assets necessary to operate, maintain or develop the network.
  (d) the transmission system operator shall establish a compliance programme, which sets out measures taken to ensure that discriminatory conduct is excluded, and ensure that observance of it is adequately monitored.
Gas Directive 2003/55/EC

Unbundling of distribution system operator DSO – Article 13

1. Where the distribution system operator is part of a vertically integrated undertaking, it shall be independent at least in terms of its legal form, organization and decision making from other activities not relating to distribution...

2. In order to ensure the independence of the distribution system operator...the following minimum criteria shall apply:
   (a) persons responsible for the management of the distribution system operator may not participate in company structures of the integrated natural gas undertaking responsible for the operation of the production, transmission and supply of natural gas;
   (b) appropriate measures must be taken to ensure that the professional interests of persons responsible for the management of the distribution system operator are taken into account in a manner that ensures that they are capable of acting independently;
   (c) the distribution system operator shall have effective decision-making rights, independent from the integrated gas undertaking, with respect to assets necessary to operate, maintain or develop the network...

Member States may decide not to apply paragraphs 1 and 2 to integrated natural gas undertakings serving less than 100,000 connected customers.

Article 33, section 2 - Member States may postpone the implementation of Article 13(1) until 1 July 2007. This shall be without prejudice to the requirements contained in Article 13(2).
Interpretation

♦ Basic elements of unbundling regime
  ♦ Legal unbundling of TSO and DSO from other activities not related to transmission and distribution respectively (Art. 9, 13, section 1)
  ♦ Functional unbundling – necessary to ensure the independence of TSO and DSO (Art. 9, 13, section 2)
  ♦ Accounting unbundling – requires keep separate accounts for different activities (Art. 17)

Possible exemptions from legal and functional unbundling (Art. 13/2d, Art. 33/2)

<table>
<thead>
<tr>
<th>Obligation</th>
<th>Operator</th>
<th>TSO</th>
<th>DSO – more than 100 000 customers</th>
<th>DSO – less than 100 000 customers</th>
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DSOs do typically unbundle slower than TSOs
### Overview of market opening – gas
Third Benchmarking Report on the Implementation of the Internal Electricity and Gas Market
3/2004

<table>
<thead>
<tr>
<th>Country</th>
<th>Declared market opening (%)</th>
<th>Unbundling: TSO</th>
<th>Unbundling: DSO</th>
<th>Unbundling: Regulator</th>
<th>Transmission tariff structure</th>
<th>Capacity booking procedure</th>
<th>Balancing conditions favourable to entry</th>
<th>Concentration in wholesale market</th>
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<tr>
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## Overview of market opening – electricity

**Third Benchmarking Report on the Implementation of the Internal Electricity and Gas Market**

3/2004

Electricity sector generally ahead of the gas industry

<table>
<thead>
<tr>
<th></th>
<th>Declared market opening (%)</th>
<th>Unbundling: TSO</th>
<th>Unbundling: DSO</th>
<th>Unbundling: Regulator</th>
<th>Overall network tariffs</th>
<th>Balancing conditions favourable to entry</th>
<th>Biggest 3 generators' share of capacity (%)</th>
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Cross-border Hungarian Experience

♦ **Legal base for unbundling** - Act XLII/2003 on gas supply (GET) from January 1, 2004

„The integrated natural gas undertakings shall, **in their internal accounting**, be obliged to unbundle the assets and resources, the incomes and expenses of their natural gas transmission, distribution and storage activities, and to separate them from non-gas activities, and to present them in the Supplement of the balance sheet and in the income statement prepared for the various activities in a way, as if each activity would be carried out by individual companies.“

♦ **Market structure**

♦ MOL Hungarian Oil and Gas Public Limited Company - unbundling of gas business into fully owned subsidiaries on December 31, 2003
  > MOL Földgáztároló Rt - storage
  > MOL Földgázellátó Rt. - wholesale
  > MOL Földgázszállító Rt. – transmission system operation activities

- **MOL - 100% tax holiday in 2003** ➞ **no effect of unbundling on the corporate tax liability in 2003**
- **subsidiaries will be fully consolidated in MOL Group IFRS accounts, therefore the effect of the revaluation will not be reflected in these accounts**
- **revaluation has a significant effect on the corporate tax base of subsidiaries from 2004, as depreciation will be accounted on the basis of revalued assets** ➞ **according to IAS 12, a significant deferred tax asset will be booked in the balance sheet and income statement of MOL Group for 2003**
Cross-border Austrian experience (1)

♦ Legal base for unbundling

♦ Accounting


♦ Legal

  > **Gas** - 01/10/2003 or 01/01/2004 (depending on the beginning of the business year of the concerned company involved) – enforcement of the amendment to GWG, Federal Law Gazette I no. 148/2002 - implemented most of the provisions of the EU-Directive EC 55/2003 regarding legal and functional unbundling

  > **Electricity** – 01/07/2004 (expected date of implementation of the directive EC 54/2003 regarding legal and functional unbundling) - current – but not published - draft of an amendment to the Electricity Act

Gas - practical implementation by the companies has just started

Electricity - current draft of the Federal Ministry of Economic Affairs and Labour (not published yet) provides a transition period for DSO until the beginning of 2006
Cross-Border Austrian experience (2)

- Austrian gas market – legal unbundling
  - Market structure
  - 3 super regional TSO, 4 regional TSO, 19 DSO
    - OMV Erdgas: January 1, 2003 - transfer of trading activities into EconGas (50% ownership)
  - tax neutral unbundling – by splitting
    - request for exemption from the land transfer tax (3.5%)
Cross-Border German experience (1)

♦ Legal base for unbundling


♦ Legal unbundling – amendment to the EnWG implementing the new Directives expected till mid 2004 (as of February 24, 2004 almost ready, but still not available)

♦ Accounts and information - all

♦ Functional and legal – all with more than 100,000 customers

♦ Implementation

♦ So far only by integrated super regional companies and a few larger regional companies

♦ Market structure

♦ 5 super regional TSO (RWE, Ruhrgas, Wingas, VNG, EnBW), 10 regional TSO, 705 local distributor companies
  > E-ON: Ruhrgas transferred January 1, 2004 transmission business to a new subsidiary Ruhrgas Transport
  > RWE – met requirements of TSO unbundling by restructuring launched Oct. 1, 2003
    » RWE AG – holding company (3 TSOs, e.g. RWE Transportnetz Gas, six German and six foreign regional multi-energy distributors,...)
Cross-border German experience (2)

- Short time for implementation (not yet regulated by the German law)
- Negative approach towards legal unbundling, accounting was sufficient – too expensive, no competitive effect
  - Pushed through the exemption for DSO with less than 100,000 customers
  - Efforts to negotiate an alternative to legal unbundling for DSO till 2007
- High costs: investments of Euro 500 to 600 Mil. Expected + annual costs of 170 to 200 Mil. Euro*
- Tax issues
  - Exemption from tax on profit from sales of shareholdings in one company to another company in force since 2002

* Based on a study by A.T. Kearney
Experience in other EU countries - France

♦ Unbundling delayed

♦ Legal base for unbundling
  ♦ French government slow to liberalize its natural gas market according to the European Directive (98/30/EC) - in December 2002, the French parliament, almost 3 years past the EU deadline, made the Directive into national law
  ♦ „Gas de France had, nonetheless, already opened its grid to third-party access in August 2000, allowing French largest industrial consumers to choose their suppliers“

  ♦ regarding the 2003/55/CE European directive the French Department of Energy has been preparing the Act, which establishes obligation of legal unbundling
    >it should come into force no later than July 1, 2004
    >it has not been transmitted to the French Parliament yet

♦ Market structure
  ♦ 3 TSO and 25 DSO
  ♦ French natural gas industry run by Gaz de France (GdF) - the state-held company with a monopoly on imports and distribution of natural gas in France – several storage, transportation, distribution and supply and trading subsidiaries
Experience in other EU countries - UK

- Ownership unbundling
  - Vertical re-integration of generators and suppliers
  - Legal base for unbundling
- Market structure
  - 1 transmission (British Gas) and 1 distribution system operator
  - British Gas asked by Ofgas in 1993 to build “Chinese walls” (separating accounting) between the transportation and supply arms. This led to the unbundling of British Gas into British Gas Energy (BGE) and British Gas TransCo (BGT)
Experience in other EU countries - Spain

- **Legal base for unbundling**
    > The exclusive corporate purpose of firms carrying out one or more of *regulated activities* (regasification, storage, transportation and distribution) must be *solely to carry out those activities and they cannot, therefore, carry out trading activities*.
    > The sole corporate purpose in the gas sector of companies trading natural gas must be that activity and they cannot conduct any regasification, storage, transportation or distribution activities.
    > The sole corporate purpose in the gas industry of firms owing any facility forming part of the natural gas basic network must be transportation activity although secondary transportation network gas pipelines may be included as part of their assets and they must keep separate accounts in their internal accounting for regasification, storage and transportation activities.
    > Natural gas companies *carrying on more than one of regulated activities shall keep separate accounts* for each one in their accounting...

- **Market structure** — 1 super regional and 4 regional TSO, 26 DSO
  - **Gas Natural Group (GN)** - leading natural gas conglomerate = Gas Natural SDG (main NG distributor); Gas Natural Aprovisionamientos (supplies); Gas Natural Comercializadora (trade); Gas Natural Servicios (services company); Gas Natural Overseas Trading Company; 14 natural gas distribution companies in Spain..
    > in order to comply with privatization legislation spun off of 65% of *Enagás* (gas transmission company), (previously, GN controlled 100% until the Spanish government requested that it reduce its share to 35%)
Experience in other EU countries - Ireland

Legal base for unbundling

unbundling of accounts
- integrated natural gas undertakings required to maintain separate accounts for their distribution, transmission, storage and supply activities
- required to keep separate accounts of their eligible customer supply business, as well as consolidated accounts for all their other non-natural gas activities
- Bord Gáis Éireann (BGÉ) - subject to additional accounting requirements because its particular position in the Irish gas market - obliged to keep separate accounts for all its business activities, not just the activities mentioned above
- arrangements are in place within BGÉ to ensure that each of its Business Units (BU) are ring-fenced from the operations of its other Business Units

⇒ management unbundling
- discussion between Commission for Energy Regulation and BGÉ on further (legal) separation of BU

Market structure – 1 TSO and 1 DSO
- BGÉ (Bord Gáis Éireann) - vertically integrated company
  - established under the 1976 Gas Act, wholly owned by the Irish Government
  - responsible for the transmission, distribution and supply of natural gas in Ireland
- BU - Bord Gáis Transmission, Bord Gáis Distribution, Bord Gáis Energy Supply, other businesses (utility grid installations, telecommunications, combined heat and power solutions)
Experience in other EU countries - Italy

- Legal unbundling
  - Medium liberalized market, fully opened since January 2003
  - Legal base for unbundling
    - Legislative Decree 164/2000 implementing EU Directive 98/30/EC
- Market structure
  - 2 TSO and 583 DSO
  - Dominant operator of production and imports - ENI
  - Transmission system operators – Edison and Snam Rete Gas – separated from ENI according to Legislative Decree 164/2000
  - Distribution system operators – Snam – owns 35% of distributors
Experience in other EU countries-Greece

- No unbundling of gas supply and transmission yet \(\Rightarrow\) derogation resulting from old directive 98/30EC (valid for emergent markets: Finland, Portugal and Greece)

- TSO: one monopoly subject – DEPA (plans to separate DEPA’s activities between transmission and supply)

- DSO (to households and small customers): three independent private companies
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Prerequisites of unbundling

♦ In general regulation for businesses should be efficient – legally driven changes should be preceded and conditioned by the Regulatory Impact Assessment producing the evidence of their benefit for businesses and consumers and relevant interdependencies.

♦ RIA should assess the following: - Time and financial feasibility for all market players and transaction costs neutrality, - tax neutrality, - cross-border symmetry with respect to the cross-border competitors etc.

♦ Legal Unbundling (Transgas and 8 GDCs!) – additional regulatory costs, should be accepted by ERO, but at the detriment of customers’ prices

♦ Unbundling and TPA access to systems (Transmission/ Distribution and storage) additional costs of incumbents for technical devices (remote measurement,..) necessary to TPA, otherwise not functional

♦ Etc…
Possible consequences

 Depend on the new structure of company
  holding
  new subsidiary

 Relevant costs
  tax burden (Czech legislation – separation into holding is tax neutral)
  administration costs – need of new licenses, registrations in the Companies Register
  operational costs
  accounting costs – process should be accounts neutral – generation of no goodwill/badwill

 Expected risks and problems
  time discrepancy between prepared legislation and required date of unbundling – when time
demand shows that the steps necessary for unbundling should start before relevant legislation
becomes in force
  valuation problems
  In case of partial sales of the company possible problems with minority shareholders, tax
administrator – might attack price for the sale of assets
  transfer of assets and liabilities
  transfer of property rights
  financing by acquirers