Guidelines for 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 accounts unbundling.

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 Guidelines are directed principally to regulators but finally also to the European Commission as some provisions might need legal implementation. They can also serve as a benchmark for analysing national unbundling of accounts.

Unbundling is not a "yes or no" issue, where companies are either unbundled or not. Companies will be and are to date unbundled at varying degrees. Legal separation may contribute to a more satisfactory state of separation and therefore equal treatment of all market participants. Whether this will really happen remains an open question.

This paper seeks to establish Guidelines for Good Practice (GGP) on accounting unbundling. The European Commission's 2005 benchmarking report clearly showed that insufficient unbundling is one of the key factors reducing retail competition in many markets. Even the development of wholesale markets is impeded by too close a relationship between TSOs and affiliated producers or in the gas sector with storage providers, producers or importers.

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 focused on 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 therefore exempt companies from these guidelines. The Guidelines also are restricted to potentially challenging circumstances (like asset leasing, shared services, etc). They do not cover the usual practices of how to calculate CAPEX or OPEX[1].

The presented guidelines are the first set of unbundling guidelines. Those on informational and management unbundling will be elaborated after more experience is gathered on the actual implementation of the relevant requirements.

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[1] CAPEX = Capital Expenditure; OPEX = Operating Expenditure.

2. GGP on Accounts Unbundling

Article 19 and Article 17 of Directive 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 these two situations[2].

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 unbundled 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 will 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.

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 unbundling 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.

[2] 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.

G1 (LUC): The 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.

Thresholds should be defined by regulators. The thresholds should not be higher than those included in the national (or EU) legislation for public procurement. The publication should contain the following items:

- 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. However concerning the affiliation of network companies these 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 interests 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 to see 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.

In most countries utilities have to keep separate accounts for TSO activities, DSO activities, LNG, storage and other gas/electricity activities. Even if there exists a separate network company, national transposition of the Directive might (in accordance with the interpretation notes of the EU Commission) allow for common provision of distribution services in gas and electricity – or even for other network services. But as there is some potential for competitive forces even in networks a combination of network businesses in one company is potentially conducive to cross subsidization.

G3 (LUC): The unbundling rules for “multi-network” companies should be comparable to those which apply to the separation of accounts between electricity supply and electricity distribution for small companies, i.e. below the threshold for legal unbundling.

2.3. Overhead Cost

In the 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 standalone cost may give advice on a separation of cost and synergies although there may exist other possible and efficient means. Calculation of standalone 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.

G4 (LUC, LIC): Every change of allocation method initiated by utilities has to be 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 may be allocated according to the relation of stand alone cost.

However some regulators may want to use traditional keys to allocate overhead cost.

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 the means he normally has to evaluate the competitiveness of the incurred cost.

G5 (LUC): The network operators will define all shared services in a SLA (service level agreement): they will be able to choose between two possibilities of proving market conformity of agreed prices:

- If a tendering procedure is possible adequacy of the price may be proven by a successful (i.e. receiving several competitive offers) tendering
- If the relevant service is very special and competitive tendering not possible, the network operator has to include in the service level agreements with affiliated companies in the broad sense of G2:
    - A clear definition of the services procured;
    - A rule how cost is calculated;
    - That the regulator has the right to access all information necessary to evaluate the correctness of cost calculation;
    - That the contract is subject to final approval by the regulator;
- otherwise cost will not directly be accepted in OPEX but assessed according to its efficiency.

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.

G6 (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 disclose information on these assets. 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.

3. Invitation to Interested Parties to Comment

ERGEG invites all interested parties to comment on issues raised in this paper, and in particular to respond to the questions in section 4.

Following the end of the public consultation period, ERGEG will publish all comments received from stakeholders. If a respondent would like ERGEG to treat their contribution with confidentiality then this must be explicitly mentioned in their reply.

Any comments should be received by **23rd June 2006** and should be sent by e-mail to ergeg-unbundling@ergeg.org.

Any questions relating to this document should in the first instance be directed to:

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4. Summary of questions

The ERGEG invites stakeholders to comment on issues raised in the text. The main issues are whether to include specific cost into the regulatory accounts (i.e. to answer the question “Are the cost elements really related to the network business”) and whether to accept the proposed cost (i.e. to answer the question “Are reported costs really market based”). Specifically ERGEG would like responses to the following questions:

1. *General: Are there any other general guidelines you would like to propose in order to improve cost separation between integrated network companies and other services provided within the group or even within the network company (e.g. for “multi-network” companies)?*
2. *G1: Are the above mentioned transactions sufficient to cover economic relations between network and affiliated companies?*
3. *G2: Do you agree that these pieces of information should not be published but only made available to the regulators? Do you agree that the additional information included under G2 may constitute an economic incentive for unequal treatment of affiliated and non-affiliated companies?*
4. *G4: A clear definition of necessary network services is supposed to be the basis for cost allocation. Do you agree that in order do treat economies it is proposed to use the method of “standalone cost”. Could you imagine different practical solutions to allocate economies? If yes, what are the specific advantages of those methods?*
5. *G5: Working competition via public tendering should guarantee market based prices. Do you agree that these prices should be accepted as market based and do you have proposals on how to calculate cost in case of non-market based procurement (for instance in case of specific services which are only provided by the affiliated company)?*
6. *Do you agree that ownership (financing) of assets should not have any impact on capital cost?*